

# Ethiopia Economic Update

## THE INESCAPABLE MANUFACTURING- SERVICES NEXUS:

Exploring the potential  
of distribution services



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# Acknowledgements

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# Executive Summary

## 1. Ethiopia's gross domestic product (GDP) growth is estimated to have rebounded to 10.9 percent in FY2017<sup>1</sup>.

According to official statistics, Ethiopia's annual rate of economic growth, which averaged 10.3 percent over 2005/06–2015/16 (compared with the regional average of 5.4 percent), slowed to 8 percent in FY2016 due to drought-related lower agricultural production. With agricultural recovery, gross domestic product (GDP) growth rebounded in FY2017. The pursuit of prudent fiscal policy – with a fiscal deficit at 3.4 percent of GDP – should help keep inflation under control, providing monetary conditions remain tight in the aftermath of the devaluation of the Birr in October 2017. Key challenges relate to poor export performance (Ethiopia's growth has been driven by investment followed by private consumption) and weak trade balance, which reflect the lack of external competitiveness and the vulnerability to terms-of-trade shocks. The rising risk of external debt distress may affect Ethiopia's access to external finance. These developments require continued policy adjustment to crowd-in the private sector and strengthen Ethiopia's competitiveness.

**2. How sustainable is Ethiopia's growth model?** To answer this question, part 1 of this Economic Update, on recent economic developments and outlook, discusses Ethiopia's growth strategy, emphasizing the sustainability of the country's investment-focused and export-led growth model. Part 2 looks at the interlinkages between manufacturing and services, with a special focus on the role of distribution services<sup>2</sup> in promoting Ethiopia's export competitiveness and eventually its structural transformation.<sup>3</sup>

- <sup>1</sup> World Bank estimated growth at 8.4 percent, while the IMF estimated growth at 9 percent in 2016/17.
- <sup>2</sup> In the WTO Services Sectoral Classification List (MTN.GNS/W/120), largely based on the United Nations Provisional Central Product Classification, the distribution sector is defined to include four major services: commission agents' services, wholesale trade services, retailing services, and franchising. Commission agents are distinguished from the other categories in that they trade on behalf of others, that is, they sell products that are supplied and usually owned by others to retailers, wholesalers, or other individuals. Wholesale trade services consist in selling merchandise to retailers; industrial, commercial, institutional, or other professional business users; or other wholesalers. Retailers sell goods for personal or household consumption. Franchisers sell specific rights and privileges, for instance, the right to use a particular retail format or trademark, defined as retail sales of motor vehicles and fuel (ISIC rev 3.1 G50), retail trade in all other goods, and repair of personal and household goods (ISIC rev 3.1 G52) through specialized and nonspecialized outlets of all dimensions (traditional stores, department stores, supermarkets, and hypermarkets). Hotels and restaurants are excluded.
- <sup>3</sup> Traditional definitions of structural transformation emphasize the reallocation of production factors or resources between sectors. The traditional view considers structural change to be fundamentally dependent on modifications in the relative importance of different sectors over time, as measured by their share of output or employment. More recent literature on structural transformation stresses the positive role of productivity growth within sectors through the reallocation of factors of production between firms within sectors. Structural transformation defined as movements of factors of production between firms and reallocation of resources from lower to higher productivity activities within the same sector, means that improvements and shifts in production within each sector are an important element of development, and that transitioning from an agricultural to manufacturing is not the only avenue as traditional development views suggest. It means instead increasingly embracing higher value-added production or more productive activities in the same sector or type of commodity or transitioning from the informal production to formal activities with the assistance of more technology, services, and know-how as well as better linkages to input and output markets.



# **Part 1: Recent Economic Developments & Outcome**

## Economic Developments in FY2017

**3. Real GDP growth is estimated to have picked up to 10.9 percent in FY2017 (July 2016 to June 2017), mainly due to a recovery in agricultural production after last year's drought.** The crop harvest is estimated to have increased by 7.9 percent during the FY2017 agricultural season (compared with a 2.4 percent increase during FY2016) and to have generated positive spillover effects on the industrial and services sectors, which continue to account for most of the growth from the supply side. On the demand side, growth has remained driven by government consumption and investment. The 15 percent devaluation of the Birr in October 2017 is expected to sustain exports in the medium term and improve the external balance, providing the exchange rate correction pass-through on inflation is contained and structural bottlenecks to trade are addressed.

**4. Inflation in FY2017 remained in single digits, although end of year inflation increased by 1.3 percentage points as compared to FY2016.** The relaxation of monetary policy, measured by the growth of reserve money prior to the devaluation of the Birr in October 2017, has triggered inflationary pressures that have been repressed under

allegedly consumer protection measures. Annual inflation as measured by the Consumer Price index (CPI) increased by 13.4 percent in January 2018 (as compared to January 2017). The monthly CPI decreased by 0.4 percent between December 2017 and January 2018.

**5. The federal government's fiscal policy embarked on a moderately expansionary stance in FY2017.** The increase in fiscal revenue, mainly from nontax sources, is unlikely to compensate for the increase in total expenditure. The federal government's fiscal deficit is estimated to have increased to 2.9 percent of GDP in FY2017.

**6. Ethiopia's export sector remains particularly small.** Total goods and services exports do not exceed 10 percent of GDP, significantly below the 24 percent expected from a country the size of Ethiopia at its level of development. The improvement in the trade balance was driven by a slowdown in imports rather than an acceleration in exports. This export underperformance is mainly due to structural and competitiveness issues, including an overvalued exchange rate.

*Providing macroeconomic policies remain appropriately tight and efforts are made to strengthen external competitiveness, the economy is expected to move toward a more sustainable path.*

**7. Given increased vulnerabilities due to export weaknesses and faster-than-anticipated disbursements of non-concessional loans, Ethiopia's external debt situation will become difficult in the medium term.** Ethiopia's risk of debt distress was downgraded from "moderate" to "high" in the 2017 DSA following the significant and protracted breach of two external debt burden thresholds.

The deterioration in debt indicators was mainly due to poor export performance, but there was a significant improvement in debt policy over the year. In July 2017, Bank Sr. Management approved the decision of the NCBP committee to discontinue the remedies applied to Ethiopia's IDA17 allocations, while retaining a \$400 million ceiling on such borrowing in FY18. Performance under the NCBP ceiling will be reviewed in April 2018.

## Economic Prospects for FY2018 and beyond

**8. The economic prospects for FY2018 and the medium term should remain stable, although less spectacular than during 2005/06–2015/16.** Annual real GDP growth is projected to hover around 8 percent in FY2018 and the medium term. The government's macroeconomic policies are expected to remain sound, with moderate fiscal deficits and prudent monetary policy. Although the rate of inflation should remain in the single digits, the inflation differential with competitors may widen and need to be corrected appropriately to preserve Ethiopia's external competitiveness. On the upside, foreign direct investment inflows supported by incentives and ongoing development of industrial parks are expected to boost the manufacturing sector and

the country's export capacity. On the downside, the economy will remain vulnerable to the risk of an overvalued exchange rate and limited progress with structural adjustments. The main challenges to the economy are related to the weak performance of the tradable sector, which reflect the lack of external competitiveness and the country's vulnerability to terms-of-trade shocks. A larger and stronger private sector would seem to be the main response to strengthen Ethiopia's trade competitiveness and resilience to shocks. The authorities are counting on the expansion of the private sector, especially through foreign investments in the industrial parks, to make Ethiopia's strong growth momentum more sustainable.



**Part 2:  
Manufacturing  
-Services Nexus:  
Exploring the Potential  
of Distribution Services**

**9. The focus section of this edition of the Economic Update deals with the interconnection between services and manufacturing performance.**

The report aims to invigorate and deepen the discussion about the role of services in Ethiopia's exports, as directly tradable activities and intermediate inputs to manufacturing exports. At the government's request, the focus is placed on the analysis of one category of services—distribution services—and in particular the role of these services in the dairy, teff, sesame, and textiles value chains. The broader context for this analysis is the debate on growth and structural transformation and ways to advance the government's export development agenda.

**10. As in other countries, services matter for Ethiopia's economic growth and development.**

The performance of the services sector is an important indicator of the performance of the economy as a whole and the export sector in particular. Yet, many modern services remain underdeveloped in Ethiopia. Services that are considered strategic by nature are allowed to operate only as strict public monopolies (for example, the telecom, utility, and air and sea transport sectors) or through limited domestic private ownership (for example, the financial sector). Other services sectors, such as professional services or health services, are not valued to the extent of their potential contributions to competitiveness and value addition. They have not been considered a strategic priority and have seen limited reform. Traditional services, such as distribution services, tend to operate in a heavily regulated environment that prevents competition and innovation, including by prohibiting the presence of foreign services suppliers and investment. According to the World Bank Services Trade Restrictiveness Database, Ethiopia is completely (100 percent) closed in retail.

This is in contrast with most examined countries including most restrictive countries such as India and Indonesia, which despite harsh foreign equity restrictions<sup>4</sup> permit some foreign participation in the sector.

**11. With a contribution of around 14 percent to GDP<sup>5</sup> in 2015/16, distribution services are an important driver of growth in Ethiopia.**

Distribution services also represent a crucial link between suppliers and producers. With improved efficiency and higher productivity due to the emergence of larger supermarket chains and a possible internationalization of distribution in Ethiopia, the sector has great potential to benefit producers and consumers and contribute to increased food security and alleviation of rural poverty. Modern distribution channels and procurement systems that reduce transaction costs and facilitate market exchanges can increase the access of small farmers to high-value markets and accelerate their transition from subsistence farming to market participation. For consumers, organized markets can provide substantial benefits, including better quality products at affordable prices. So far, however, modern distribution channels have failed to capture a large portion of the retail market in Ethiopia. Across the country, informality still prevails; small-scale farmers have found themselves marginalized by the distribution sector and its new practices; and very poor households often pay more per unit for basic products than wealthier households.

**12. Despite the growth of distribution services over the past decade, several factors jeopardize its potential to contribute more directly or indirectly to Ethiopia's export performance.**

Yet, many factors tend to impede the positive contribution of distribution

<sup>4</sup> India imposes a FDI cap of 51 percent on multi brand retail trading while 100 percent FDI is allowed for single brand product retail trading. Indonesia requires 100 percent local capital for small scale retailers.

<sup>5</sup> This share compares favorably with neighbors in East Africa, where distribution services accounted for between 8 and 18 percent of GDP over the past decade.

services, including, among others, a high degree of informality across the sector, poor access to finance, explicit trade barriers that fragment markets and supply chains, nontariff barriers related to standards and rules of origin, domestic regulatory measures governing market access and producer conduct, talent shortages, poor infrastructure, and limited market data.

**13. The case studies on the role of distribution services in the dairy, teff, sesame, and textiles value chains show that although distribution services are**

**critical in the performance of each value chain, they are only one part of the story.**

Eliminating the obstacles to distribution services could help link rural producers to markets for inputs, facilitate the sale of raw milk, or reduce post-harvest and storage losses. But other binding constraints, such as limited access to finance or lack of skills, would need to be addressed in parallel for distribution services reforms to benefit consumers and facilitate value chains climbing into higher value-added activities (such as cheese or sesame oil) and increase exports.

**14. The case studies draw conclusions on the critical role of services in manufacturing value-addition of broader relevance and implications.**

First, the services sectors suffer from being treated in isolation and not as part of an interconnected chain of value addition, from production to final consumption. Yet, the case studies presented in this report show that since supply chains are a series of linked international markets for goods and services, with policies in one market having spillover effects in other markets along the whole value chain, services should be considered at par with manufacturing, to achieve the desired export performance. Policy formulation needs to deal with the goods and services markets together, as there are significant links between the two sectors. Moreover, such links call for modal neutrality—trade and regulatory policies that enable services firms to provide services through all modes of supply without impeding a switch from one mode of supply to another.

Second, that many services are now tradable and can be a source of export-led growth and export diversification has not sufficiently captured the attention of Ethiopian policy makers. This may reflect that the development of modern services is a relatively recent phenomenon, and also the assumption that the comparative advantage of a low-income country like Ethiopia lies in agriculture and labor-intensive manufacturing. Although Ethiopia's services exports are currently dominated by traditional services such as transport or tourism, exports of modern services, such as communication or business services, are beginning to emerge and their role in export diversification and export earnings should not be neglected.

Third, there is a genuine concern among policy makers that the state of regulation and the regulatory capacity of the administration are too weak to allow for the further liberalization of services. And finally, there is a worry that opening services sectors that operate under a monopoly would lead to declines in government revenue and potentially more outflow of foreign exchange in the form profit repatriation.

**15. Although a wholesale services policy reform in Ethiopia's current environment would be neither feasible nor desirable, there are several steps that could usefully be taken to increase economic efficiency and support the country's development objectives.** Countries throughout the region are

moving toward integrating their services markets. There may be long-term costs to Ethiopia if it is left behind in services, but also manufacturing and processed agricultural products. Starting by reforming nonstrategic sectors, such as distribution services, could be a good entry point into the world of services reforms.

**16. The case of distribution services is illustrative of the opportunities for exports, benefits from greater services openness, and policy reforms and approaches that will be required for these to be realized.** This sector can provide the basis for a broader discussion of services trade policy reforms. Although the following list is not exhaustive, it provides some initial guidance for reform in this important sector.

*Raising awareness about the importance of distribution services for the formal and informal sectors in Ethiopia is an important first step in designing a comprehensive reform strategy that is linked with national development plans.*

*Taking steps to relax explicit trade barriers, eliminate regulatory obstacles, and address informality issues. With distribution services closed to foreign participation, Ethiopia remains behind all East African countries and other comparators in removing explicit trade barriers. Opening up the sector to foreign competition, would benefit consumers and provide incentives for the development of more competitive local suppliers, and would clearly raise welfare in the country if liberalization was accompanied by strategies for easing adjustment of local stores that might be undermined by the entry of modern retailers. Reforms should also focus on developing the necessary regulatory frameworks, including rules and regulations affecting the business environment, eliminating disproportionate entry requirements such as lengthy registration procedures, multiple licenses, or inadequate zoning regulations. Price controls represent a serious impediment to competition and quality and should be removed.*

*Addressing the concerns of the poorest households and facilitating the inclusion of smallholders in modern distribution chains should be a priority in Ethiopia. Measures could include the creation of organized market outlets for small-scale operators to encourage their graduation from the informal sector, better access to financial services in the informal sector, and support to traditional and informal operators to acquire market-relevant skills.*

Addressing skills issues in the distribution sector. A strong distribution sector will require local know-how and talent. Developing local training programs and putting in place apprenticeship opportunities will be critical to achieving long-term success.

Addressing infrastructure constraints (such as roads, ports, and so forth). Steps must be taken to address the infrastructure and insecurity concerns raised by the business community.

**17. Guidance on the implementation of reforms could be provided by an in-depth political economy analysis that looks at the local stakeholders and global operators, to help identify the feasible measures with the greatest benefits.**

## *Services matter greatly for Ethiopia's industrial ambition*



# 1

## Recent Economic Developments & Outlook



## 1.1 Economic Developments in FY2017

With agricultural recovery, gross domestic product (GDP) growth is expected to have reached 10.9 percent in FY2017. Inflation should remain in single digits, providing that monetary policy remains tight in the aftermath of the recent devaluation. The fiscal deficit is projected to increase, but remain below 3 percent of GDP. Although the general government accounts are in balance, the federal government's fiscal policy has embarked on a moderately expansionary stance. Following an improved trade balance, driven by imports rather than exports, the current account deficit declined to 8.2 percent of GDP in FY2017. Ethiopia's export sector is particularly small, mainly due to structural and competitiveness issues, including an overvalued exchange rate. The unchanged financial landscape of Ethiopia is characterized by lending dominated by state-owned enterprises (SOEs); undercapitalization of the Commercial Bank of Ethiopia, the largest SOE bank; low insurance penetration; limited development in the capital market; and an increased number of bank branches in urban areas. Given increased vulnerabilities due to export weaknesses and faster-than-anticipated disbursements of nonconcessional loans, Ethiopia's external debt risk situation will become difficult in the medium term.

### Real Sector

**1. Real GDP growth was estimated at 10.9 percent in FY2017<sup>6</sup> (July/June), mainly due to a recovery in agricultural production after last year's drought** (figure 1.1, panel a). Increases in crop production and agricultural recovery are expected to generate positive spillover effects on the industrial and services sectors, which continue to account for most of the growth from the supply side. Growth has been driven by the industrial sector with a 4.4 percent contribution to growth, followed by the services sector contributing 4 percent, and agriculture contributing 2.5 percent. Construction contributed 3.5 percent to the overall GDP growth. On the demand side, growth remains driven by government consumption and private investment (figure 1.1, panel b).

**2. The crop harvest was estimated to increase by 7.9 percent during FY2017. The harvest during the main agricultural season in FY2017 increased by 8.8 percent (compared with a 1.3 percent drop during the same season last year)** (figure 1.1, panel c), mainly due to productivity increases ranging from

5.5 percent to 8.3 percent in the production of teff, wheat, maize, and sorghum (figure 1.1, panel d). The belg season harvest dropped by 4.5 percent; however, belg season crop harvests constitute only 6 percent of total harvest. Crop harvests from commercial agriculture increased by 7.5 percent. The negative impact of the current drought, which has been affecting about 8.5 million people in the southeastern part of the country, appears to be minimal on overall GDP growth.

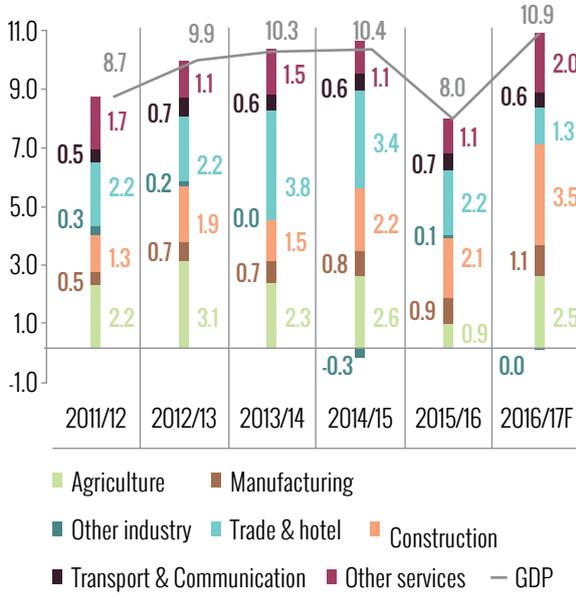
**3. Several leading economic activity indicators point to strong growth in the industry and services sectors in FY2017.**

During FY2017, electricity generation increased by 19 percent (year over year), and electricity sales to industries grew by 21 percent, suggesting solid manufacturing industry activity (figure 1.1, panel e). On the services sector side, during the same period, Ethiopian Airlines' passenger traffic and cargo services continued to grow, by 15.4 and 27.2 percent, respectively, following an expansion of the network and improved capacity (figure 1.1, panel f).

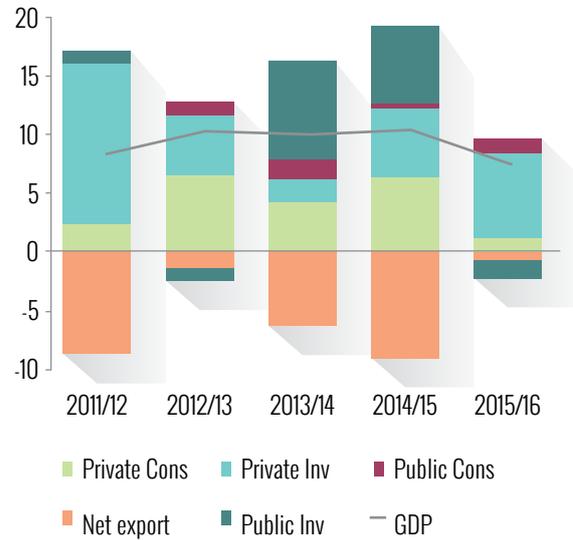
<sup>6</sup> World Bank estimated growth at 8.4 percent, while the IMF estimated growth at 9 percent in 2016/17.

Figure 1.1 Economic Activity

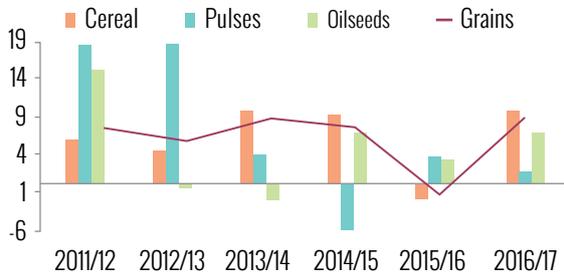
**A Real GDP growth: Supply side (%)**



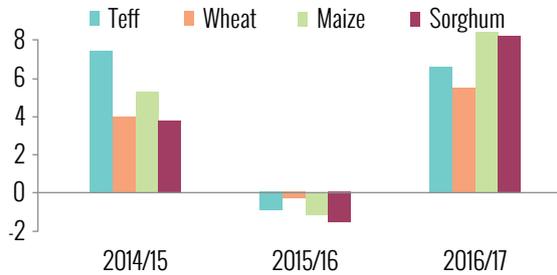
**B Real GDP growth: Demand side (%)**



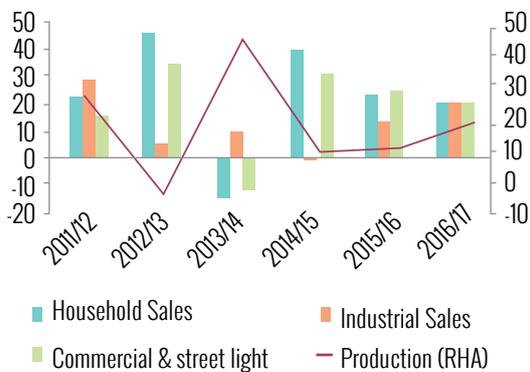
**C Crop production growth (%)**



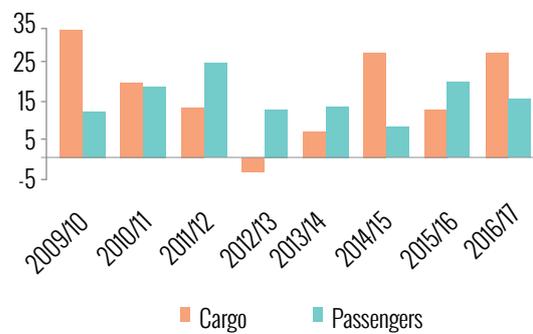
**D Main season crop productivity growth (%)**



**E Electricity production and sales growth (%)**



**F Ethiopian Airlines activity growth (%)**



Sources Panel a and b: National Planning Commission (NPC); panels c and d: Central Statistical Agency (CSA); panel e: Ethiopian Electric Power (EEP)/Ethiopian Electric Utility (EEU); panel f: Ethiopian Airlines.

## Monetary Sector

### 4. Inflation in FY2017 remained in single digits, with annual average inflation at 7.1 percent, but with an uptick over recent months.

Inflation rose to 13.6 percent in November 2017, the highest since January 2016, mainly because of food inflation. Food prices, which constitute about 53 percent of the average household consumption basket, are a major driver of inflation. Food inflation has increased by 18.1 percent, the highest since September 2012 (figure 1.2, panel a). Following the post-drought grain harvest of the main growing season, food prices were initially stabilized, but picked up since April 2017, driven by high demand for cereals, fats and oils, and meat during the Easter holiday celebration. In addition, the government purchased large quantities of food items from the domestic market to supply the drought-affected areas. The recent devaluation of the Birr could trigger further inflationary pressures in the coming months. However, so far, the month on month food inflation has shown a modest decline (0.4 percent in November) after the devaluation.

### 5. Food prices are a major driver of inflation, but nonfood prices, which have declined moderately in FY2017 have started to increase starting August 2017.

Commodities with inflationary tendencies, such as meat, bread and cereals, fruits, dairy products, nonalcoholic beverages, and other food items, have recorded an inflation rate of 10 percent or higher since July 2017 (figure 1.2, panel b). By contrast, nonfood inflation recorded the lowest increases in more than a decade, reaching 4.6 percent in April. The relative slowdown in nonfood inflation in FY2017 is likely due to the lagged effects of declining

international prices since mid-2014 and tighter monetary conditions over the past year. However, nonfood inflation gradually increased since May 2017 and reached 8.6 percent in November 2017.

### 6. The relaxation of monetary policy, measured by the fast growth of reserve money, may have triggered inflationary pressures in the first quarter of FY18.

The National Bank of Ethiopia (NBE) targets reserve money<sup>7</sup> as the nominal anchor for monetary policy; broad money<sup>8</sup> is used as an intermediate instrument. Reserve money growth decreased slightly to 22.7 percent in June 2017 after an increase of 30.2 percent in May 2017 (compared with 16.3 and 19.9 percent growth, respectively, during the same months of last year). The growth in reserve money was mainly driven by increases in NBE's net foreign assets (128 percent) and net credit to the government (27.2 percent) (figure 1.2, panel c). The lagged effect of expansive monetary policy has certainly contributed to the inflationary situation of nonfood items over the first quarter of FY18. The real deposit rate remained in negative territory and the real lending rate tends toward zero, following the rising overall inflation trend. With strong demand for bank credit, the maximum lending rate started to move upward, increasing the spread from the minimum deposit rate since last year's third quarter (figure 1.2, panel d). In October 2017, NBE increased interest rates on deposits from 5 to 7 percent; however, real deposit rates will remain negative.

### 7. Driven by increases in domestic credit, broad money growth remains in line with reserve money growth.

Broad money grew by

<sup>7</sup> Reserve money is defined as the sum of currency issued by the NBE (including the vault cash of commercial banks and currency outside banking system) and balances of commercial banks on accounts with the NBE.

<sup>8</sup> Central banks track the growth of "broad money" to help forecast inflation. The exact definition varies between countries, but broad money usually includes short-duration deposits and short-term securities other than shares. These are less liquid than currency or demand deposits (which make up "narrow money") but can be encashed fairly quickly.

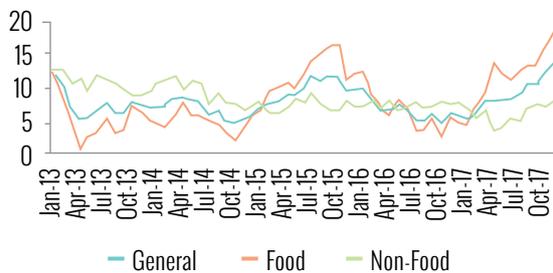
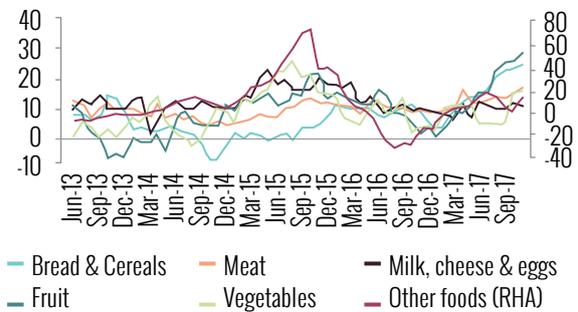
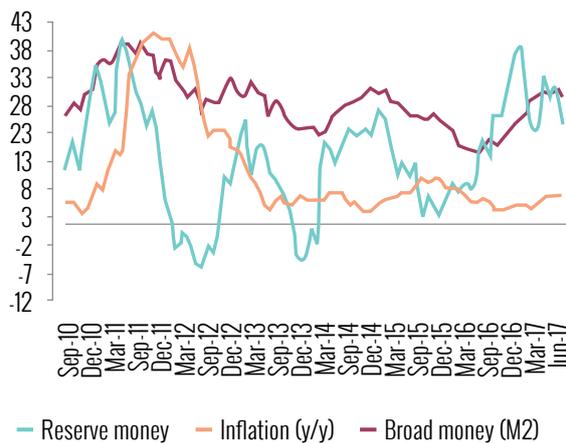
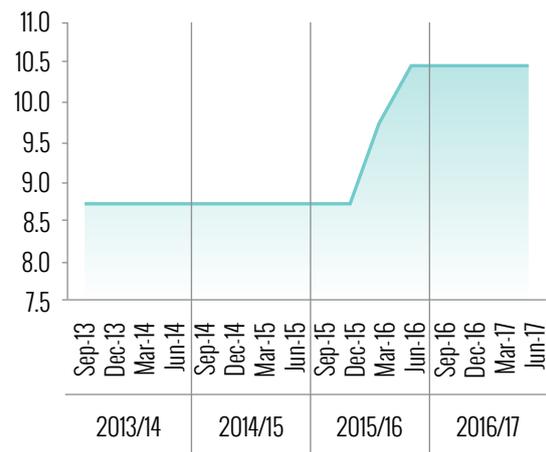
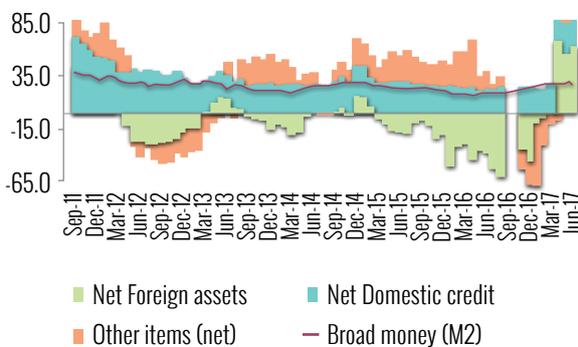
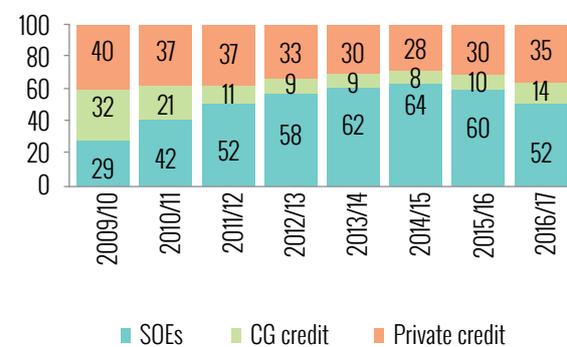
29 percent in June 2017 (year-on-year), up from 20 percent in June 2016, about 10 percentage points faster than the growth of nominal GDP. Net domestic credit growth played a leading role in broad money growth, while net claims on government growth remained the main source of credit increase (increasing by 79 percent in June 2017). Credit to the private sector increased by 48 percent in June 2017. Domestic credit to SOEs moderated, increasing by 10 percent (year-over-year) following a constraining environment for external non-concessional loans for public infrastructure investment (figure 1.2, panel e). The share of public enterprises in total outstanding domestic credit declined to 52 percent from 60 percent in FY2016, while the share of private sector credit increased by 5 percentage points to 35 percent at the end of June 2017 (compared with June 2016). The share of the net central government credit stock in total domestic credit picked up to 14 percent (figure 1.2, panel f) despite printing money to

finance the budget deficit (see figure 1.3, panel b, in the next subsection).

### **8. The NBE appropriately tightened its monetary policy in the immediate aftermath of the devaluation.**

The NBE raised the floor on time and savings deposits from 5 to 7 percent and reduced the 2017/18 target growth of base money. The NBE's operational target for monetary policy (growth of base money) was reduced from 22 percent to 16 percent to contain the pass-through from the exchange rate into domestic prices. Furthermore, the NBE introduced a limit of 16.5 percent on the FY18 outstanding credit growth of commercial banks. The credit cap is applied to firms in the non-export, non-manufacturing sectors. Given the lagged effect of monetary policy, the NBE would need to be particularly vigilant as the relaxation of monetary policy in the first part of the year – that is before the October devaluation – may have created inflationary pressures that would need to be reduced in the coming months.

Figure 1.2 Monetary Sector

**A Inflation (y/y, %)****B Major food items inflation (y/y, %)****C Broad money, reserve money, and inflation (% , y/y)****D Interest rate premium (max - min interest rate) (%)****E Broad money growth (M2, y/y, %)****F Composition of domestic credit stock (%)**

**Sources** Panels a and b: CSA; panels c and d: CSA and National Bank of Ethiopia; panels e and f: National Bank of Ethiopia.

**Note** In panel f, monetary survey data are used, which exclude Development Bank of Ethiopia (DBE) in private credits. CG = Central Government; SOEs = state-owned enterprises; y/y = year over year.

## Fiscal Sector

### 9. The general government<sup>9</sup> fiscal policy stance remained cautious in FY2017.

The general government fiscal deficit (excluding SOEs) reached 3.4 percent in 2016/17, showing one percentage point increase compared to 2015/16. This may be due to an increase in additional spending to finance drought affected areas. Although domestic revenue (tax and non-tax) increased by 11 percent, the increase was not sufficient to compensate for higher total expenditure, which increased by 17 percent mainly driven by recurrent expenditure up by 29 percent compared to the 2015/16 level. The growth in capital expenditure moderated to 6 percent from 23 percent in FY2016, mainly due to a decline in external assistance and slowdown in additional external loan in capital expenditure. External loans for capital expenditure increased by 14 percent in FY2017, which is far below the 47 percent growth registered in FY2016. On the financing side, the deficit was covered by domestic and external borrowing (2.5 and 1.6 percent of GDP, respectively), and through the repayment of cash balances and residuals (totaling 1.0 percent of GDP). A large portion of domestic financing relied on borrowing from non-bank sources through the sale of T-bills. Direct advances issued by the NBE to the central treasury reached 1.5 percent of GDP in 2016/17 up from 1.1 percent of GDP in 2015/16 (Figure 1.3.2).

**10. Revenue growth slowed in FY2017.** Except for domestic indirect taxes, growth in all revenue components slowed down. Revenues and grants increased by 10 percent in FY2017, mainly due to an increase in tax and nontax revenues from SOE state dividends and domestic indirect taxes. However, collection from foreign trade taxes declined by 0.4 percentage point of GDP, potentially due to the decline in imports of transport and industrial capital goods. Similarly, direct taxes and domestic indirect

taxes in percent of GDP dropped by 0.15 and 0.16 percentage point, respectively, compared with the same period last year.

### 11. Despite the salary increase initiated in the previous year and the support to drought-affected areas in FY2017 general government spending remained stable.

Total expenditures in percent of GDP in FY2017 stood at 18.4, unchanged as compared to FY2016. However, recurrent expenditure in percent of GDP rose to 9.9 (showing a 1 percentage point increase from FY2016) following the salary increases for public servants and drought-related spending. On the other hand, capital expenditure slowed down to 8.6 in percent of GDP, from 9.4 in FY2016. Keeping the balance between recurrent and capital budget is important to meet the running cost of additional capital expenditure of public sector projects, to fund the operations of existing productive assets and to ensure effective service delivery in general. Evidence seems to point to underfunding of recurrent costs, raising concerns of the sustainability of public sector services (Public Expenditure Review 2015).

### 12. The federal government's fiscal policy has embarked on a moderately expansionary stance.

During FY2017, the fiscal deficit increased by 0.7 percentage point of GDP, mainly due to lower revenues in percent of GDP and increased recurrent spending (figure 1.3, panel e). Total federal government expenditures decreased by 0.2 percentage point of GDP. Capital expenditure in percent of GDP decreased by 0.4, while recurrent spending and regional transfers also increased by 0.2 and 0.3 percentage points respectively. The federal government fiscal deficit that accumulated during FY2017 (about 1.5 percent of GDP) was financed through external—mainly concessional—financing (1.6 percent of GDP) and domestic financing (2.3

<sup>9</sup> The general government includes the fiscal operation of federal and regional governments excluding SOEs.

percent of GDP) with large repayments of cash balances and residuals (1.2 percent of GDP).

**13. The government approved a supplementary budget equivalent to 1.1 percent of GDP in mid-FY2017.** Half of the supplementary budget was intended to finance the salary increment for civil servants that would be effective during the second half of the fiscal year. The remaining part of the additional budget was intended to finance the youth revolving fund and drought relief, and provide additional financing to the urban safety net program. About 56 percent of this additional budget was planned to be financed by surpluses from the Oil Stabilization Fund (determined by the domestic and international fuel price differential). Revenue mobilization from privatization receipts and additional proceeds from SOEs were also assumed to contribute to the supplementary budget.

**14. The federal government approved the FY2018 budget with a deficit set at 3.5 percent of GDP.** This compares with a 3.3 percent deficit in FY2017. Spending and revenues are expected to decline as a share of nominal GDP, with a steeper decline in revenues compared with spending, leading to a widening of the deficit. Federal revenues are expected to decline from 11.6 to 10.6 percent of GDP, due to lower tax revenues driven mainly by drops in direct tax revenues and domestic indirect

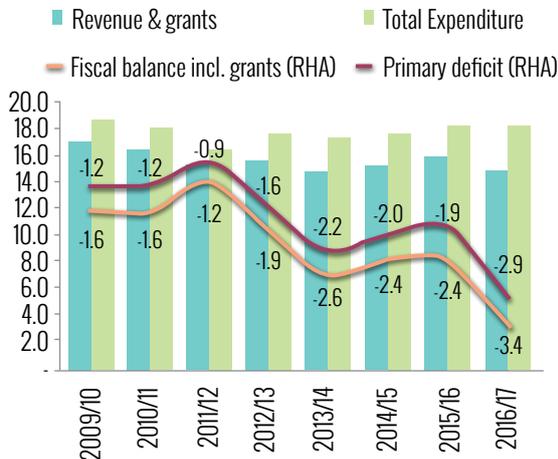
taxes. Similarly, the spending budget falls from 14.9 to 14.1 percent of GDP, as a result of lower allocation to the capital budget and decreased allocation to Sustainable Development Goals support programs at the local level. It is important to note that the federal government's budget excludes regional budgets from own sources and may therefore not give a full picture of the general government's fiscal activity.

**15. SOEs play an important role in the government's public investment program and need to be considered in the fiscal analysis.** Although SOEs play a key role in infrastructure development, the financing of public projects by SOEs through domestic and external loans has meant a buildup of external debt and associated vulnerabilities. Among other indicators, the public debt-to-GDP ratio increased from 36.3 percent in 2011/12 to 54.9 percent in 2016/17. This is somewhat in line with the trend observed for many commodity-exporting countries in Africa in recent years following the global commodity price depression. Most recently, the debt service-to-export ratio, which indicates liquidity issues in the debt profile, has increased rapidly, from 10.3 percent in 2013/14 to 19.6 percent at the end of June 2017; it essentially doubled in two and a half years (figure 1.3, panel f).

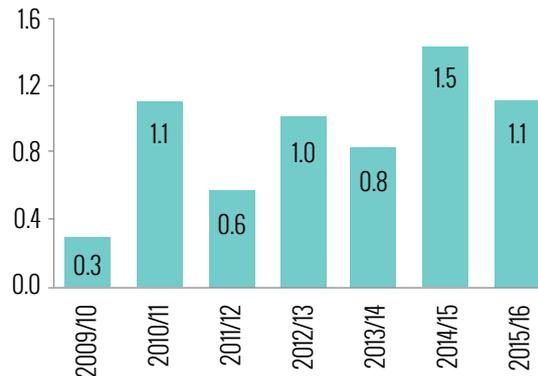
*Ethiopia's macroeconomic policy stance has generated persistent Birr overvaluation, large external imbalances, foreign exchange shortages, and a higher risk of debt distress*

Figure 1.3 Fiscal Sector

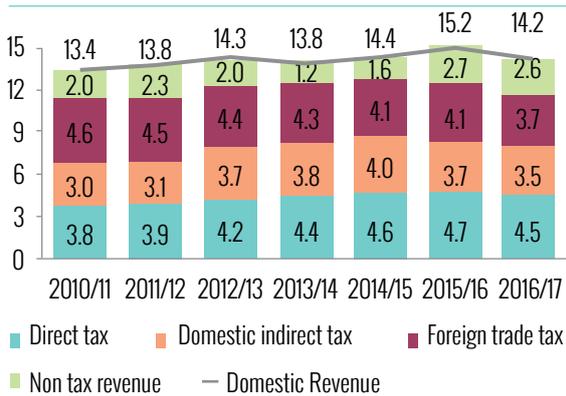
### A General government fiscal deficit (% of GDP)



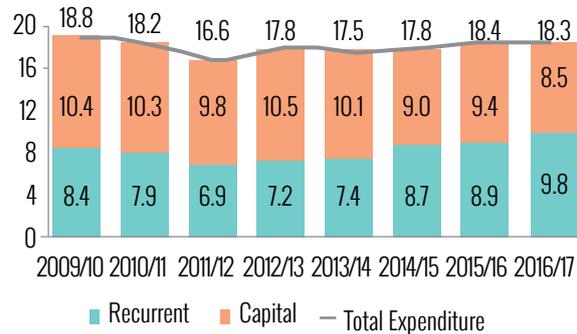
### B Direct advance from NBE (% of GDP)



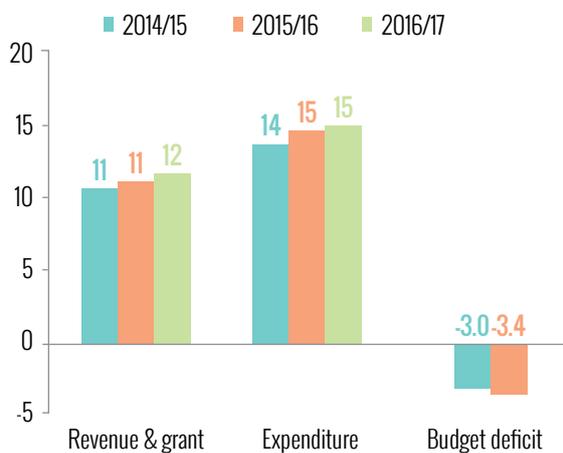
### C General Government revenue (% of GDP)



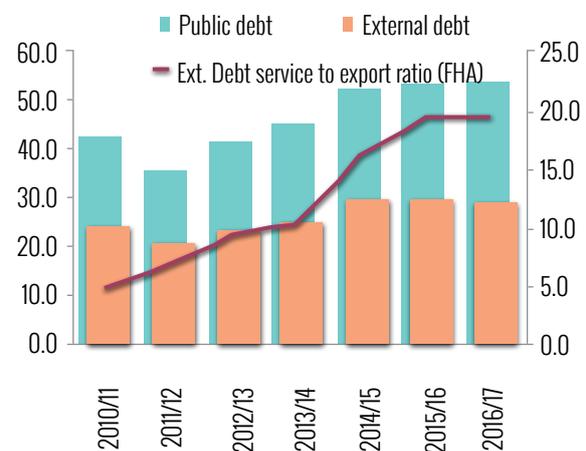
### D General government spending (% of GDP)



### E Federal government fiscal operations (% of GDP)



### F Debt stock-to-GDP and debt service ratio



Source: Ministry of Finance and Economic Cooperation (MOFEC).

Note: GDP = gross domestic product; NBE = National Bank of Ethiopia.

## External Sector

**16. Following an improved trade balance, driven by reduced imports rather than increasing exports, the current account deficit declined to 8.2 percent of GDP in FY2017.** The current account deficit gap (including official transfers) narrowed by 2.2 percentage points of GDP during FY2017, due to a large drop in private transfers by about 41 percent compared with the same period in the previous year. Following the improvement in the goods and services trade balance, the trade deficit narrowed by 3.6 percent of GDP compared with FY2016, due to lower imports (rather than higher export earnings) (figure 1.4, panel a). The current account deficit was financed largely by foreign direct investment (FDI) inflows, which increased by 38 percent; external borrowing; as well as drawdown of the foreign exchange reserve accumulations. Foreign exchange reserves declined by about 6 percent against the same period last year and reached

US\$3.2 billion at the end of June 2017 (which is 2.0 months of the following year's imports) (figure 1.4, panel b). The external sector continues to be vulnerable to terms-of-trade shocks and weakened external competitiveness, which need to be carefully managed.

**17. Private transfers, one of major sources of forex earnings, underperformed in FY2017.** Private transfers<sup>10</sup> declined by 8.6 percent, resulting in a loss of 1.4 percentage points of GDP. The decline is related to the reduction in nongovernmental organization (NGO) relief transfers after the 2016 drought and lower transfers due to the public unrest during the first quarter of the fiscal year. Private individual transfers dropped by 14.7 percent compared with FY2016. Private transfers were a good financing source for the current account deficit in the past, but their contribution during the first nine months of the fiscal year was lower than expected.



*The trade deficit narrowed  
by 3.6% of GDP*

<sup>10</sup> Private transfers include private individual transfers, NGO transfers, and estimated unofficial remittances.

**18. Goods exports underperformed in FY2017. Exports of goods modestly increased by 1.4 percent during FY2017, driven by a 7.2 percent increase in the export volume index that was espoused by a price index increase of 2.2 percent** (figure 1.4, panel c).

Among the major export products, the value of coffee exports increased by 22 percent, due to the price increase in arabica coffee, as well as a rise in the volume of exports. At the same time, pulse exports increased by 20.5 percent, due to better prices and volumes compared with last year. Flowers, oilseeds, live animals, and leather declined by 3, 26.4, 54.2, and 1.1 percent, respectively, due to declines in prices and volumes. Overall, since 2010/11, Ethiopian exports as a percentage of GDP have been on a declining path (figure 1.4, panel d). During FY2017, services exports increased by 4 percent, primarily due to the better performance of government services.<sup>11</sup> Exports of transportation services declined by 2.0 percent.

**19. Ethiopia's export sector is particularly small. Total goods and services exports do not exceed 10 percent of GDP, significantly below the 24 percent expected from countries at this level of development.**<sup>12</sup>

This export underperformance is mainly due to structural and competitiveness issues, such as rigid labor and product markets including an overvalued exchange rate. Challenges range from supply issues and quality of products, to marketing channels, branding, and so forth. The whole supply chain of the major export products, from production to final destination, needs to be examined.

**20. Moreover, the contribution of services must be investigated thoroughly.** Ethiopia is working on developing the manufacturing sector as a major source of export earnings. To realize this vision, it is important to look at the link between the manufacturing and services sectors, to enhance and increase the leverage in both sectors. (Part 2 of the report provides more details on this topic.)

**21. Ethiopia's overvalued currency has manifested in persistent, large external imbalances, foreign exchange shortages, and overall slow pace of structural transformation.** To support exports and encourage the private sector, on October 10, 2017, NBE devalued the Birr by 15 percent and has relaxed foreign exchange controls (see box 1.1).

*At less than 10% of GDP,  
Ethiopia's export sector is  
particularly small for a country  
at this level of development*

<sup>11</sup> Government services is a residual category covering all transactions by embassies, consulates, military units, and defense agencies with residents of economies in which the embassies, etc. are located and all transactions with other economies. Transactions in this category comprise those for goods and services (such as office supplies, furnishings, utilities, official vehicles and the operation and maintenance thereof, and official entertainment) and personal expenditures incurred by diplomats and consular staff and their dependents in the economies in which they are located. Also recorded in this category are transactions by other official entities (such as aid missions and government tourist, information, and promotion offices) located in economies abroad.

<sup>12</sup> World Bank (2014b).

**Box 1.1****The Promise of Devaluation and Relaxation of Foreign Exchange Controls**

To support exports and encourage the private sector, on October 10, 2017, the National Bank of Ethiopia (NBE) devalued the Birr by 15 percent. Furthermore, foreign exchange controls have been relaxed with the issuance in October of two NBE directives on (i) external loans and suppliers' credit, and (ii) retention and utilization of export earnings and inward remittances. Under the first directive, any domestic investor can now access an external loan, if the investor generates foreign currency. The debt-equity ratio to access a loan from foreign sources has been revised to 60-40, replacing the hitherto 50-50 ratio. Under the second directive, exporters of goods and services are authorized to retain 30 percent of the proceeds of their exports indefinitely in their forex account (replacing the previous 10 percent threshold).

Recent empirical analysis conducted by the World Bank provides strong evidence that a more competitive real exchange rate would provide an environment that is more conducive to manufacturing-led structural transformation, sustained growth acceleration, and improved external balance. For instance, a 10 percent depreciation of the real effective exchange rate would reduce the current account deficit by about 2 percentage points of gross domestic product (GDP) (through a 5 percent increase in exports and a 6 percent decrease in imports) and increase real GDP

growth by more than 2 percentage points. However, the devaluation would also raise the cost of debt servicing and public foreign currency debt stock denominated in local currency. Moreover, the devaluation could lead to inflation, as imports would become more expensive, with possible adverse impacts on the poor.

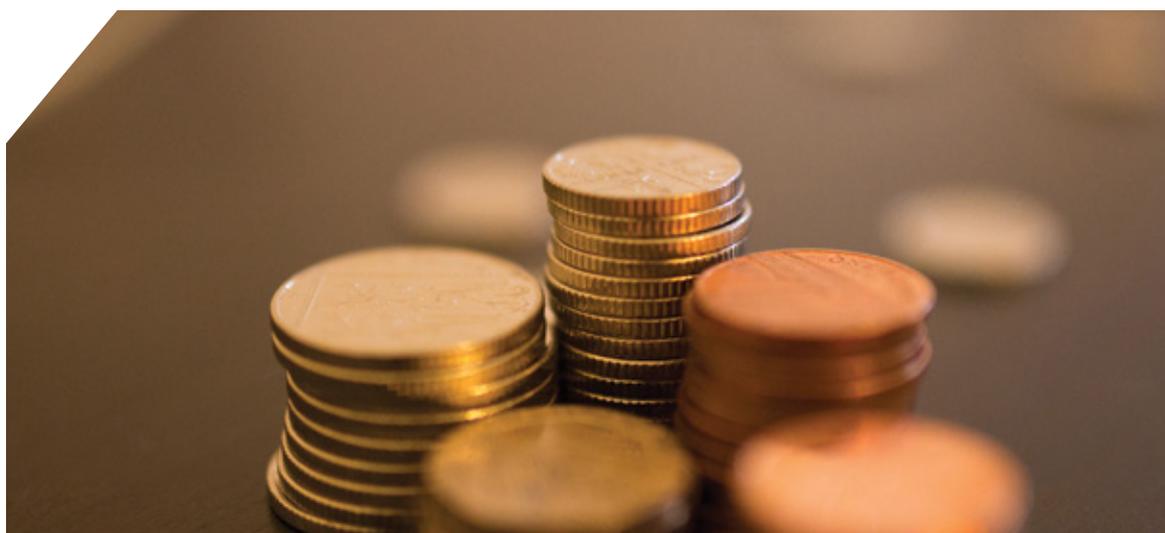
To limit the pass-through to inflation, any devaluation needs to be accompanied by appropriately tight monetary and fiscal policies. In that context, the decision to increase interest rates is appropriate and timely. Looking forward, it is important to continue to adjust the macroeconomic stance, including foreign exchange, monetary, and fiscal policy, for Ethiopia's economic conditions and ambitions. A one-off exchange rate correction is unlikely to be sufficient to redress the structural bottlenecks that hinder exports. A comprehensive policy package would help find the right balance between the implementation of productivity-enhancing structural reforms, including measures to strengthen the business environment (for example, trade logistics, access to finance and land, burdensome customs regulations, skills gaps, and so forth) and the flexibility of the exchange regime. A measure of this balance would be the capacity to build the stock of foreign exchange reserves over the medium term.

**22. The exchange rate played an important role in explaining the low export earnings.**

A competitive exchange rate encourages the supply of goods for export and at the same time provides better prices for international buyers of Ethiopian products. NBE discontinued reporting on the parallel market rate, but anecdotal evidence suggests that the parallel market premium ranged from 10 to 17 percent in FY2017. This provides an indication of the appreciation of the real effective exchange rate and shows that domestic inflation is still higher than foreign inflation and the rate of nominal depreciation.

**23. Declines in goods imports—mainly driven by a slowdown in capital and intermediate goods imports—contributed to the improvement in the trade deficit**

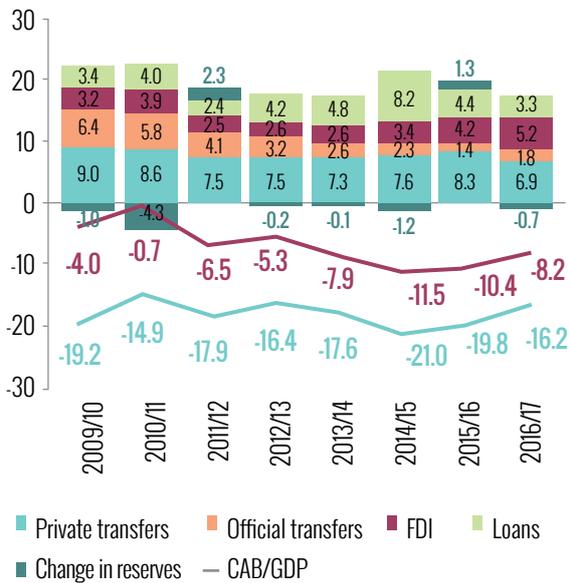
**during FY2017.** Imports of goods declined by 5.5 percent during FY2017, mainly driven by a 15.5 percent decline in raw material imports and a 12 percent reduction in imports of capital goods. Consumer goods imports also declined, by 7 percent. This could be the result of low foreign exchange reserves and a constraining environment for accessing non-concessional borrowing. Capital goods imports, which are associated with large public sector investment activities and largely financed through external loans, declined with low external disbursement during the fiscal year. Fuel imports increased by 36 percent during this period (figure 1.4, panel e). It is obvious that the total exports of goods and services cannot cover the cost of consumer goods and fuel imports. Services imports also declined, by 1.4 percent, in FY2017.



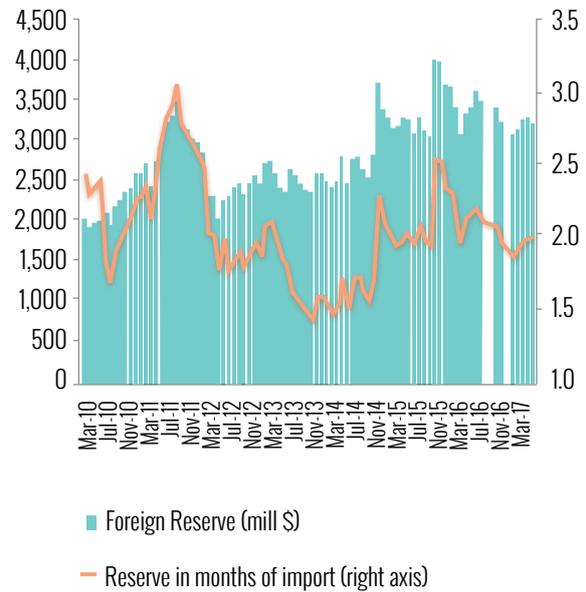
*Declines in goods imports contributed to the improvement in the trade deficit during FY2017*

Figure 1.4 External Sector

### A External current account balance (% of GDP)



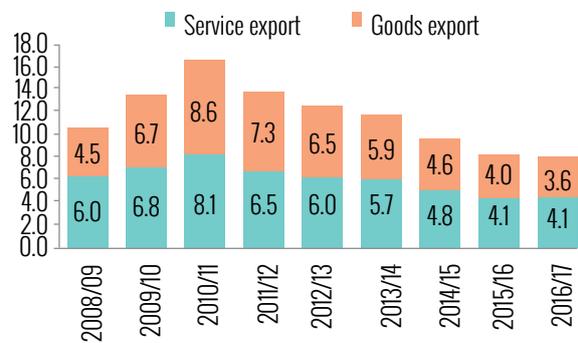
### B Gross official foreign exchange reserves (US\$ millions)



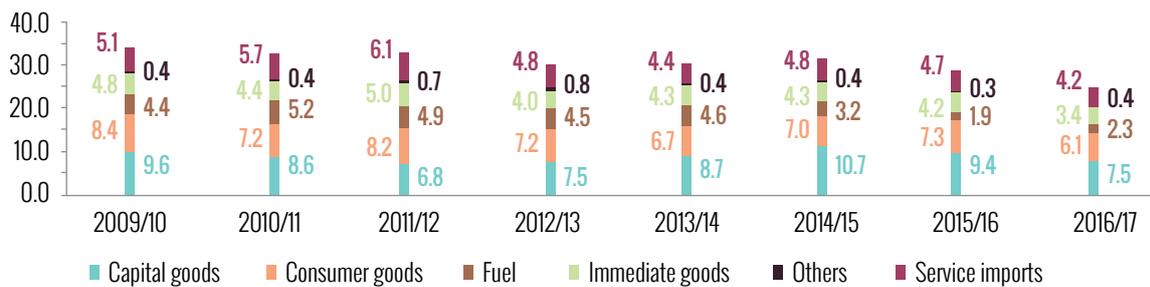
### C Growth in exports of goods (%)



### D Exports of goods and services (% of GDP)



### E Imports of goods and services (% of GDP)



Sources: National Bank of Ethiopia and Ministry of Finance and Economic Cooperation (MOFEC)

## Financial Sector

**24. The structure of the financial sector has barely changed over more than a decade and is dominated by state-owned financial institutions.** The financial sector in Ethiopia currently consists of 18 banks, 17 insurance companies, 35 microfinance institutions, and five capital goods finance companies. Banking is the dominant subsector, accounting for 78 percent of total financial sector assets, followed by insurance companies, representing 15 percent (figure 1.5, panel a). The two state-owned banks (Commercial Bank of Ethiopia and Development Bank of Ethiopia) account for 65.7 percent of total deposits, 62.4 percent of outstanding credit, 35.9 percent of total branch networks, 64 percent of total banking sector assets, and 48.9 percent of total banking sector capital as of December 2016; the remaining 16 private banks cover the balance. The state-owned insurance company accounts for 23 percent of the total capital of the industry. Micro finance institutions, which mainly serve the rural population, represent only about 6 percent of the financial sector capital. New additions to the financial sector are five capital finance companies that started operation in the past few years. There is no foreign bank or foreign financial institution in Ethiopia. Currently, there are 35 micro finance institutions, with total capital of US\$419 million, a total network of 1,647 branches, and total outstanding credit of US\$1.2 billion as of December 2016.

**25. The domestic credit market is dominated by lending to SOEs—mainly to finance infrastructure investment—contributing to weak financial intermediation.** Domestic credit as a percentage of GDP increased from 28.3 percent in 2014 to 32.1 in 2016, while private credit increased from 8.7 to 11.7 percent. A large part of domestic credit was credit for SOEs—17 percent between 2014 and 2016. However, with a policy preference for financing SOEs at low cost, the credit market tended to crowd out the private sector. The 2017 Doing Business report ranks Ethiopia at the 170th place of 190 economies in ease of getting credit—

one of the lowest ranks in the world and two ranks down from Ethiopia's position in 2016. Enterprise Survey 2015 also reveals that the proportion of enterprise investment in Ethiopia financed by banks is only 7.8 percent, while a large proportion (83.3 percent) of investment is self-financed—an indication of financial disintermediation.

**26. Although the aggregate capital adequacy ratio of the banking sector is good, the Commercial Bank of Ethiopia (state-owned and the largest bank in Ethiopia) seems highly undercapitalized.** The Commercial Bank of Ethiopia's capital-to-assets ratio is about 3.5 percent, which is less than one-third of the private banking sector average capital-to-assets ratio of 12 percent. In recognition of this, the government has decided to raise the Commercial Bank of Ethiopia's capital by threefold to US\$1.7 billion. The fund will be financed by interest-free and tax-free government bonds. The Ministry of Finance and Economic Cooperation will issue the bonds on behalf of the government. The bonds will mature in 10 years after a five-year grace period. However, the banking system's ratio of capital-to-risk-weighted assets stood at 17 percent (double the minimum requirement). The ratio of nonperforming loans to total gross loans stands at 3 percent, which is well below the 5 percent limit. The banking sector's return on equity (ROE) and return on assets (ROA) were 39.7 and 3.0 percent, respectively, in 2015, which is much higher than Sub-Saharan Africa's average ROE of 14.9 percent and ROA of 1.7 percent. The high profitability of Ethiopian banks vis-à-vis their regional peers can be mainly attributed to low overhead costs of 2.2 percent in 2014, less than half compared with the Sub-Saharan Africa average of 4.7 percent (figure 1.5, panel b).

**27. Insurance penetration in Ethiopia is very low and products are concentrated in general insurance lines of business.** In 2015, the ratio of total insurance premiums to GDP was 1

percent, which is much lower than the Sub-Saharan Africa average of 3.5 percent (figure 1.5.4). Most of the insurance business in Ethiopia is targeted at the corporate market and focused on general insurance. The corporate focus implies that, to date, insurers have had little experience in intermediating products to individuals, and cost margins have not yet been tested against the more cost-sensitive retail business. Premiums from the retail sector are almost entirely derived from motor insurance. As of December 2016, there were 17 insurance companies in Ethiopia with 465 branches. About 54.4 percent of the insurance branches were in Addis Ababa and 85 percent of the total branches were private.

**28. Capital markets in Ethiopia mainly comprise Treasury bills (T-bills) and government bonds.** T-bills are transacted on a weekly basis and government bonds are occasionally issued. The maturities of T-bills are 28, 91, 182, and 364 days; 91 and 364 days are the most demanded terms (figure 1.5, panel d). The total outstanding T-bills as of December 2016, was US\$2.9 billion. The Public Servants Social Security Agency, Development Bank of Ethiopia, and Private Organization Employees Social Security Agency are the three major buyers of T-bills in Ethiopia. Outstanding corporate bond holdings reached US\$9 billion as of December 2016, of which about 94 percent was held by two state-owned institutions: Ethiopia Electric Power (85.4 percent) and Railways

Corporation (8.7 percent). The Commercial Bank of Ethiopia is the sole purchaser of these bonds, making the bank susceptible to the financial performance of SOEs and single-borrower risk. Ethiopia has yet to develop a secondary capital market.

**29. Despite significant improvements in outreach led by the expansion of bank branches, penetration of formal financial institutions remains very limited in rural areas.** The number of bank branches in Ethiopia has more than tripled in the past five years, from 970 branches in 2011 to 3,187 branches in 2016 (figure 1.5, panel e). Access to banks remain concentrated in the capital city and other urban centers. Of the total nationwide, 34.4 percent of branches and more than 50 percent of ATMs are in Addis Ababa. However, there is a large untapped market of borrowers and savers who are not using formal financial services. According to Findex 2014, 48 percent of Ethiopian adults reported saving or setting money aside, yet only 14 percent saved formally at financial institutions. During the same period, 44 percent of Ethiopian adults reported that they borrowed money, but only 7 percent borrowed from financial institutions. The Government of Ethiopia has recognized financial inclusion as a priority area in its Growth and Transformation Plan (GTP II), and has approved the National Financial Inclusion Strategy.

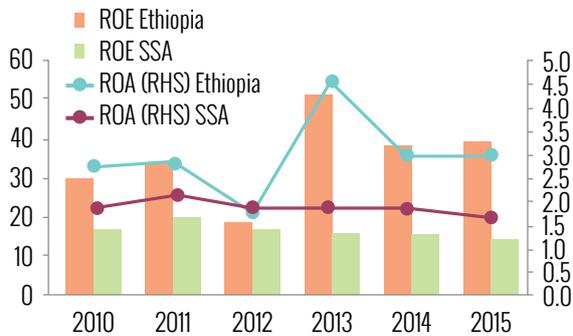
*Financial repression may help contain inflation, but at a potential growing economic cost in terms of market distortion and resource misallocation*

Figure 1.5 Financial Sector Indicators

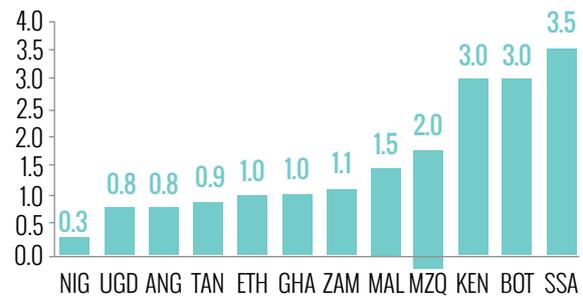
## A Capital share of the financial sector, 2015/16 (Birr, millions)



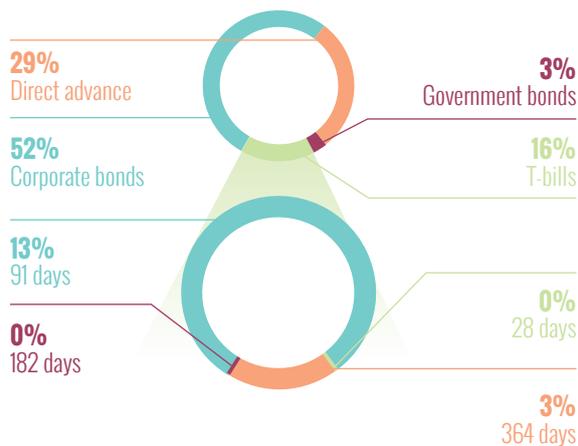
## B ROE and ROA (%)



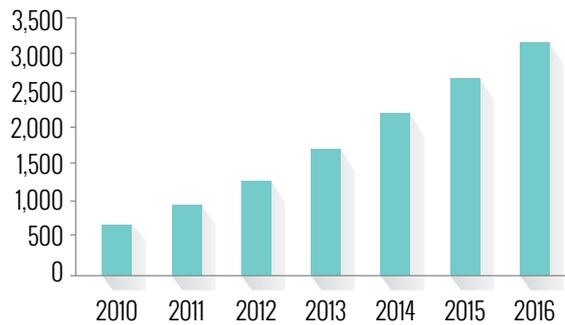
## C Insurance premiums to GDP, 2015 (%)



## D Composition of the capital market, by instrument



## E Development of bank branches



Sources Panels a, e, and f: National Bank of Ethiopia; panels b, c, and d: National Bank of Ethiopia and African Insurance Barometer.

Note ANG = Angola; BOT = Botswana; ETH = Ethiopia; GDP = gross domestic product; GHA = Ghana; KEN = Kenya; MAL = Malawi; MZO = Mozambique; NIG = Niger; ROA = return on assets; ROE = return on equity; SSA = Sub-Saharan Africa; TAN = Tanzania; UGD = Uganda; ZAM = Zambia.

## 1.2 Economic Prospects in FY2018 and Beyond

*Post-drought real GDP growth is expected to recover moderately in FY2018 and an average growth of 8 percent is expected in the medium term. The general government's fiscal policy is expected to continue with a moderate fiscal deficit that is consistent with macroeconomic stability. The government would pursue robust monetary policy to maintain inflation in single digits in the aftermath of the recent devaluation. On the upside, FDI inflows, supported by incentives and ongoing industrial parks development, are expected to boost the manufacturing sector. On the downside, the economy will remain vulnerable to the weak economic performance of key trading partners and rationing of foreign exchange. On balance, with potential improvements in manufacturing and exports, GDP growth is projected to remain robust in the medium term and stay around 8 percent annually. Poverty should decrease accordingly, although persistent drought could result in poverty rates declining less than projected. The challenges to the economy are related to exports performance, rising oil prices, overvalued exchange rate, and vulnerability to debt risks. Positive economic growth is expected to continue to lower the poverty rate.*

### **30. In FY2018, real GDP is expected to recover as agricultural performance improves.**

Following normal rainfall during the main growing season, agricultural production continued to grow in FY2017, recovering from a lower growth in FY2016. The negative impact of the current drought in pastoralist areas, although adversely affecting livelihoods and livestock production, is expected to be minimal, but could have significant poverty impacts. On the upside, FDI inflows supported by incentives and ongoing development of industrial parks, are expected to boost the manufacturing sector. On the downside, the economy will remain vulnerable to the weak economic performance of key trading partners and rationing of foreign exchange. On balance, with potential improvements in manufacturing and exports, GDP growth is projected to remain robust in the medium term and continue to hover around 8 percent annually (figure 1.6).

### **31. To contain debt sustainability risks, external non-concessional borrowings and their related public investments are expected to slow in the coming years.**

Exports are not projected to pick up in FY2018; however, an improvement as compared to the last five year's trend could be expected. Notwithstanding the recent 15 percent nominal devaluation, the level of the real exchange rate and pressure on foreign exchange may continue to contain exports.

### **32. Exports could recover in the medium term, as large investment projects, such as the railway to the Port of Djibouti, large power dams (with potential for electricity exports), or industrial parks, are completed.**

The Addis Ababa–Djibouti Railway will improve trade logistics and reduce the transportation cost of moving goods in and out of the country. It will take only 10 hours for the new railway to take goods between Ethiopia and Djibouti, a significant improvement over the three to four days by truck currently. Further, the Hawassa Industrial Park and the second phase of the Bole-Lemi Industrial Park have started operations and are set to increase manufacturing exports and contribute to the diversification of exports. Investments in hydropower, industrial parks, export processing zones, and public policies to encourage FDI and private investment in light manufacturing industries are expected to support export growth and diversification. The completion of power transmission lines to neighboring countries (Kenya and Sudan) and expansion in power generation capacity are expected to increase electricity exports, further boosting the diversification efforts (box 1.2). A recent United Nations Conference on Trade and Development (UNCTAD) report shows that Ethiopia has recently enjoyed large FDI inflows, ranking first in Sub-Saharan Africa, with US\$3.2 billion inflows in 2016.

## Box 1.2

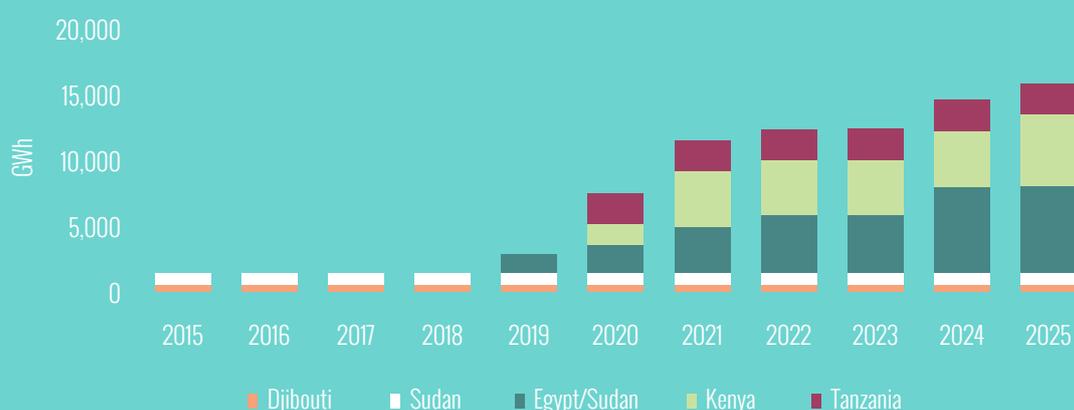
## Take-Off in Electricity Exports

Ethiopia's cost of supplying electricity is among the lowest in Sub-Saharan Africa, presenting unique export opportunities. According to World Bank estimates, Ethiopia will have more than 9,000 megawatts (MW) of installed capacity by 2020 (estimated to be the second highest installed capacity available in the region). This would provide more than 25,000 gigawatt hours (GWh) of renewable electricity that would be able to meet domestic and export demand. Therefore, over the next few years, Ethiopia is expected to become a regional energy superpower and develop into the cornerstone of the regional power market and East African Power Pool (EAPP).

Electricity exports are set to double in 2019, to US\$250 million, and reach US\$1 billion by

2023. Currently, Ethiopia's power exports are limited to Sudan and Djibouti (figure B1.2.1). However, power transmission interconnection to Kenya (financed by the World Bank and other partners) is scheduled to be commissioned in the first half of calendar year 2019 (tower and stringing work is substantially advanced, and the converter station is under construction). With this interconnection to Kenya, capable of more than 2,000 MW of transfer capacity, exports will be expanded to Tanzania and possibly other countries in the EAPP. Over the medium term, additional connections to Sudan and the Arab Republic of Egypt are also planned. In addition, envisaged EAPP interconnection to the Southern African Power Pool could further open the market for Ethiopian exports to Southern African countries.

**Figure B1.2.1 Ethiopia: Destination of Electricity Exports**



The acceleration in export revenues is due to a combination of the significant growth in export volumes and a relatively high export price. Based on signed Power Purchase Agreements (PPAs) between Ethiopia and Kenya, and Ethiopia and Tanzania (others are being planned and negotiated), the growth in exports

is expected to rise 10-fold, from 1,443 GWh in 2016 to 14,657 GWh in 2023. Thus far, the negotiated average price under the PPAs has been US\$0.07/kilowatt hour. Based on this, the value of exports is expected to increase from US\$250 million in 2019 to US\$1 billion in 2023 and US\$1.2 billion in 2025 (table B1.2.1).

**Table B1.2.1 Ethiopia: Projections of Electricity Exports, 2016–25**

Electricity Exports	2016	2017	2018	2019	2020	2021	2022	2023	2024	2025
Value of exports (US\$ millions)	101	101	101	250	523	811	872	1,026	1,118	1,210
Price (U.S. dollar, kWh) <sup>1</sup>	0.07	0.07	0.07	0.07	0.07	0.07	0.07	0.07	0.07	0.07
Volume (GWh)	1,443	1,443	1,443	3,571	7,471	11,586	12,457	14,657	15,971	17,286

**Sources**

Ethiopian authorities and World Bank staff estimates.

<sup>1</sup> As per the Framework Agreement.

Projections are on a calendar year basis

**33. Pressures on the financing of public investment projects may lead the government to relax its fiscal stance.** Given the slow pace of tax reforms, domestic revenue may be insufficient to finance the infrastructure investments contemplated in the national development plan, potentially resulting in larger fiscal deficits. Crowding-in the private sector to finance infrastructure (“the cascade” or “maximizing finance for development”) could usefully be explored to address the growing public financial constraint. With limited improvements in external competitiveness and the recent recovery in oil prices, the current account balance is projected to remain weak in the medium term. Furthermore, monetary discipline will be required to preserve the low-inflation environment experienced over the past two years.

**34. Ethiopia has received a large allocation of International Development Association (IDA) resources to enhance productivity in various social and economic sectors.** With the record high IDA 18 replenishment (for FY2018–FY2020), Ethiopia’s IDA allocation increased by about 50 percent to reach US\$4.8 billion. In addition, Ethiopia has the potential to access more resources from different IDA resource windows. These resources are intended for investment in agriculture, urban development, roads, energy, service delivery, and human resource development such as education,

health care, and safety nets, and infrastructure development. With the recently approved new country partnership framework, the World Bank is planning to frontload about two-thirds of the IDA resources in FY2018, to maintain the continuity of past investment programs, contribute to closing the financing gap, and help address the foreign exchange shortage. IDA resources are expected to generate improvements in total factor productivity and generate economic growth in the medium term.

**35. The relatively low inflation environment experienced in the past two years may not last in the aftermath of the recent devaluation if monetary conditions are not tightened.** Inflation can remain in single digits, providing monetary policy remains tight. However, the fast growth of reserve money and recent devaluation of the Birr could trigger inflationary pressures in the coming months. The recent increase in deposit interest rates was a welcome step in attempting to contain inflation. The expected recovery in global commodity prices is a further potential source of inflation of tradable goods prices under loose monetary conditions.

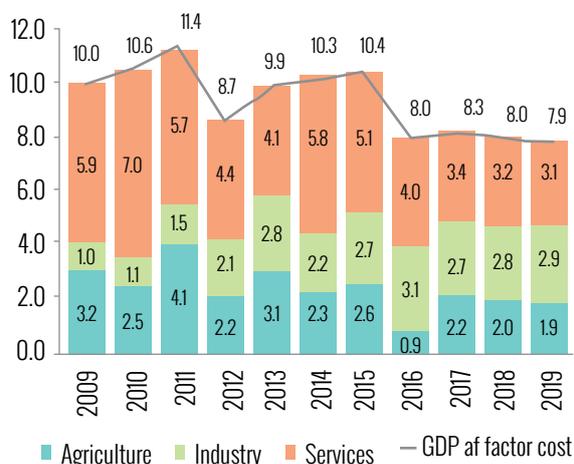
**36. Rising external imbalances and the worsening of the debt situation constitute major challenges to the economy.** The lack of external openness, rising international oil prices,

and an overvalued exchange rate (after the recent devaluation) will continue to have adverse effects on the competitiveness of the economy. The rising risk of external debt sustainability may potentially impact Ethiopia's access to external finance. The reserve position is low and declining. Weak growth

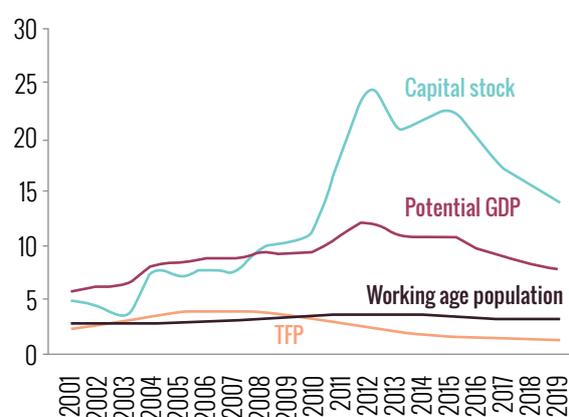
of major trading partners (such as China) could affect short- to medium-term growth. Finally, although the state of emergency was lifted in August 2017, political disruption associated with social unrest could negatively affect growth through lower FDI, tourism, and exports.

**Figure 1.6 Economic Outlook: Selected Projections to 2019**

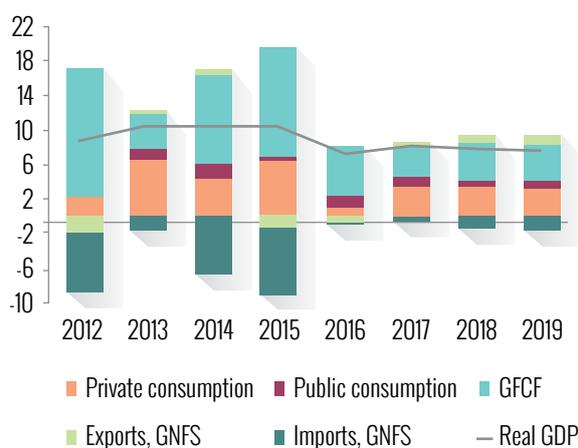
**A GDP growth: Supply side, 2009–19 (%)**



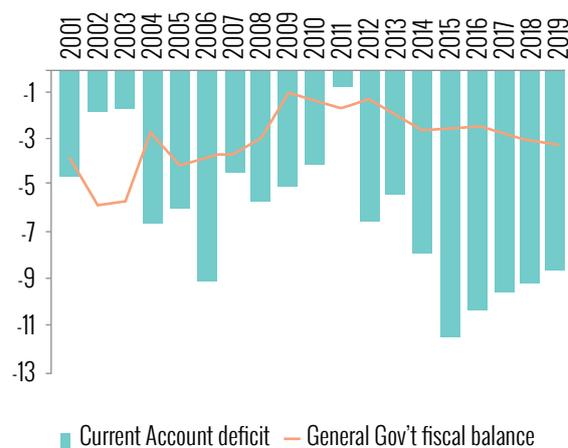
**B Determinants of potential output, 2001–19 (%)**



**C GDP growth: (Demand side, 2012–19 (%)**



**D Fiscal and external balances, 2001–19 (%)**



Source World Bank staff compilation, based on data from the Macro-Fiscal Forecasting Model.

Note GFCF = gross fixed capital formation; GDP = gross domestic product; GNFS = goods and non-factor services.

### Box 1.3

#### Ethiopia and the East Asian Model: Similarities and Differences

A key component of the East Asian model is the high level of investment coupled with high domestic savings rates. Further, sound macroeconomic management was instrumental in East Asia, contributing to stable savings rates. This was supported by liberalization and structural reform of the financial sector, which allowed private firms to access credit markets. Private investment far outpaced public investment in Korea. China's model involved very high public investment rates; yet, private investment also increased rapidly in China as the economy developed. But even where the public sector played a large role, such as in China or Vietnam, a much more pronounced role of competition and market forces paved the way for efficiency gains in the economy. High savings rates allowed investment rates to rise and remain at high levels. In addition, FDI played a key role in the success of the East Asian model, with the exception of Korea, which had its development episode in the pre-globalized world.

Another crucial element of the East Asian model is export-led growth, especially through active industrial policies for manufacturing development. The ability of governments to pursue strategies and plans based on an identification of their countries' comparative advantages was instrumental. To foster and support their export promotion activities, many East Asian economies implemented additional competitive exchange rate policies. Emphasis on human capital was another characteristic of the East Asian model, especially in the cases of China and Korea. Investment in research and development (R&D) also played an important role, especially after the initial phase of development.

Although Ethiopia shows a certain similarity with the East Asian model, important differences (summarized in table B1.3) raise questions about the replicability of the East Asian model in Ethiopia.

#### **Similarities**

High savings and investment rates are similar to the levels observed in East Asia, but, given very high investment rates, the savings-investment gap is particularly pronounced in Ethiopia.

Strong agricultural production growth preceded the economic take-off.

The role of SOEs in the economy in Ethiopia is somewhat similar to their role in China (and Vietnam), but lacks the notion of competition to enhance SOE performance. Likewise, SOE investment in the East Asian model saw declining importance over time.

#### **Differences**

In Ethiopia, manufacturing exports are very low compared with any of the comparator countries considered.

At the same time, Ethiopia's real exchange rate is overvalued, and this is markedly different from the East Asian model.

Ethiopia lags in providing credit to the private sector, especially compared with China or Singapore.

Although Ethiopia's public investment push has precedent in China's experience, Ethiopia has not seen private investment picking up to the extent seen in China.

**Table 1.1: Summary: Ethiopia Compared with Selected Indicators in East Asia**

Country	GDP per capita growth (annual %)	Savings (% of GDP)		Investment (% of GDP)		Exports		Credit to private sector (% of GDP)
		Gross domestic	Gross national	Gross capital formation	FDI	Manufacturing (% of exports)	Real exchange rate*	
Korea, Rep. (1960-70)	7.99	9.13	N/A	19.39	N/A	58.09	+	16.46
Hong Kong SAR, China (1960-70)	3.47	22.96	N/A	25.59	N/A	93.54	-	N/A
Thailand (1960-70)	6.87	18.06	N/A	20.18	N/A	2.83	+	13.82
Indonesia (1966-76)	4.19	16.09	N/A	16.60	N/A	1.45	-	N/A
Malaysia (1967-77)	8.65	26.80	25.83	22.64	3.20	10.12	-	25.23
Singapore (1967-77)	4.50	24.74	28.63	35.56	5.65	35.14	-	49.13
China (1982-92)	8.62	35.63	37.63	36.33	0.89	57.79	-	73.78
Vietnam (1991-2001)	3.36	18.93	25.18	25.36	6.62	44.29	-	22.73
Cambodia (1995-2005)	5.70	5.00	11.18	16.57	4.96	96.88	+	6.33
Ethiopia (2004-15)	7.96	19.27	32.11	36.11	2.18	8.06	+	20.38

**Note** A growth period is identified with a landmark political event and/or the liberalization and opening of the economy if this coincides with accelerated growth. The periods identified do not imply that countries were not able to grow during more than 10 years. GDP per capita: Korea only available from 1961; Hong Kong SAR, China, only available from 1966; Thailand only available from 1961. Gross domestic savings: data on Ethiopia only available from 2011. Gross capital formation: Ethiopian savings are based on the 2011 National Accounts revision, which increased savings rates due to methodological changes. Data are only available for 2011-14. FDI: for the Republic of Korea; Hong Kong SAR, China; and Thailand, data are not available in the growth periods. Data for Malaysia are only available from 1970. Data for Singapore are only available from 1970. Manufacturing exports data: for China, only available from 1984; for Vietnam, from 1997; for Cambodia, from 2000; for Ethiopia, until 2014. Real exchange rate data: data for Ethiopia are only available until 2011. Credit data: for Vietnam, not available in 1994; for Ethiopia, only available for 2014. GDP = gross domestic product; N/A = not available.

# Services & Manufacturing Linkages: Exploring the Potential of Distribution Services

# 2



## 2.1. Introduction

### **37. This Ethiopia Economic Update focuses on the connection between services and manufacturing, to help advance the government's export development agenda.**

Although the importance of services for development is widely recognized, the role of services, tradable and non-tradable, in growth and structural transformation is generally less understood. Services not only offer promising opportunities for export diversification, but also are key inputs in the production of most goods, for export and domestic consumption. Services imports are equally important, as they can improve the availability and quality of services through increased competition, better technologies, and access to foreign capital. This, in turn, can have a strong impact on the domestic business environment and lead to productivity increases through broader access to essential services inputs.

### **38. A dynamic services sector is a necessary condition for manufacturing and agroprocessing to thrive.**

Access to quality services as inputs to production is important for manufacturing performance. Lack of quality services as inputs can impede the emergence of a competitive manufacturing sector, which matters for the quality and value addition of goods. Manufacturing and agroprocessing cannot be competitive without accessing good quality and varied inputs from the

services sectors. At this stage, however, Ethiopia seems to lack adequate access to necessary services inputs, such as finance, electricity, and water, as evidenced by several studies.<sup>13</sup>

### **39. The objective of this Economic Update is to invigorate and deepen the discussion about the role of services as tradable activities, and as intermediate inputs in Ethiopia.**

The analysis is conducted in the context of the debate on growth and structural transformation in Ethiopia. World Bank (2015) shows that Ethiopia did not follow the conventional path of economic development through export-oriented industrialization, with workers moving from agriculture to high-productivity manufacturing. The analysis contrasted this "premature deindustrialization,"<sup>14</sup> characterized by a shift of labor from agriculture to services, with the potential of services becoming the new growth escalator<sup>15</sup> for Ethiopia. The report concluded that rather than following one approach or another, Ethiopia would need to move forward across all sectors, focusing on agricultural productivity improvements, manufacturing growth to support the strategy of industrialization, and development of services. At the government's request, emphasis will be placed on distribution services,<sup>16</sup> with individual case studies on the role of distribution services as inputs in the dairy, teff, sesame, and textiles value chains complementing the analysis.

<sup>13</sup> World Bank (2014a).

<sup>14</sup> Rodrik (2015).

<sup>15</sup> Ghani and O'Connell (2014).

<sup>16</sup> In the WTO Services Sectoral Classification List (MTN.GNS/W/120), largely based on the United Nations Provisional Central Product Classification, the distribution sector is defined to include four major services: commission agents' services, wholesale trade services, retailing services, and franchising. Commission agents are distinguished from the other categories in that they trade on behalf of others, that is, they sell products that are supplied and usually owned by others to retailers, wholesalers, or other individuals. Wholesale trade services consist in selling merchandise to retailers; industrial, commercial, institutional, or other professional business users; or other wholesalers. Retailers sell goods for personal or household consumption. Franchisers sell specific rights and privileges, for instance, the right to use a particular retail format or trademark, defined as retail sales of motor vehicles and fuel (ISIC rev 3.1 G50), retail trade in all other goods, and repair of personal and household goods (ISIC rev 3.1 G52) through specialized and nonspecialized outlets of all dimensions (traditional stores, department stores, supermarkets, and hypermarkets). Hotels and restaurants are excluded.

**40. What is the role of services in Ethiopia’s structural transformation? How do distribution services contribute to Ethiopia’s growth and structural transformation? What are feasible reforms to accelerate their positive impact on the economy?**

To answer these questions, the next section discusses the importance of services for the country’s growth and development, looking at the services content of economic activity, services employment, services trade and value added in exports, and the role of services as intermediate inputs. The role of

distribution services is highlighted in the analysis. The following section presents a diagnostic of distribution services markets in Ethiopia. In doing so, the section pays special attention to their poverty-reducing potential and the challenges that impede the growth of the sector. Next, the report highlights the role of distribution services in value chains, with an emphasis on their role as intermediate inputs and tasks in dairy, teff, sesame, and textiles. The last section discusses options for policy reforms.

## 2.2. Setting the Stage: Services in Ethiopia’s Economy

**41. Services are a large and dynamic sector, but manufacturing remains a relatively small and stagnant part of Ethiopia’s economy.**<sup>17</sup> As shown in World Bank (2015), “Ethiopia’s Great Run,” the services sector was one of the driving forces behind the country’s growth acceleration. Recent data confirm that services continue to contribute considerably to economic growth and structural change. Services remain not only the largest sector in economic output, accounting for 41 percent of GDP in 2016, they also accounted for about 50 percent of economic

growth over the past decade (figure 2.1). Over the past years, Ethiopia’s output more than tripled in real terms, taking over agriculture as the sector contributing the most to GDP.<sup>18</sup> Since 2005, the sectoral drivers of growth have shifted further toward services, and more recently, industry. However, as noted in World Bank (2015), the recent rise of industry is due to a construction boom rather than being driven by a rise in the manufacturing sector, which has been largely stagnant at about 4 percent of GDP.

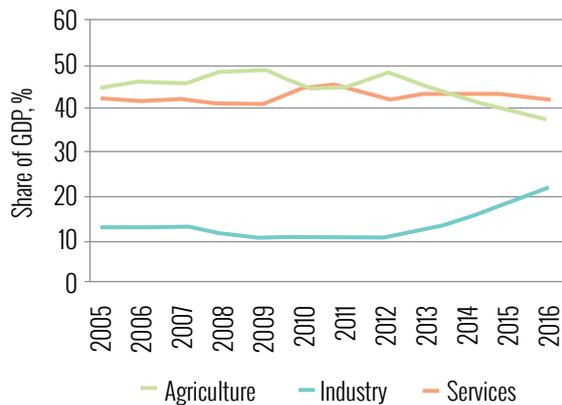
*Services offer promising direct and indirect opportunities for Ethiopia’s manufacturing development*

<sup>17</sup> The analysis is based on latest available data: World Development Indicators and Balance of Payments Statistics published in 2017, World Bank Value Added Database - latest version for 2011, Input-Output Table for Ethiopia - latest available data for 2011.

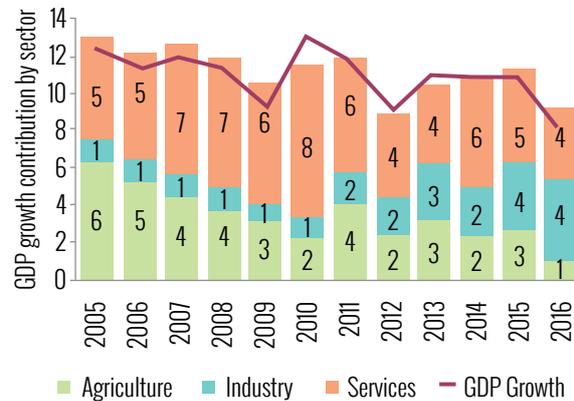
<sup>18</sup> Martins (2014).

Figure 2.1 Sectoral Contributions to Ethiopia's Economy

## A Sectoral share in GDP, 2005–16



## B Sectoral GDP growth contributions, 2005–16 (%)



Sources World Development Indicators 2017, Macro Poverty Outlook, 2017.

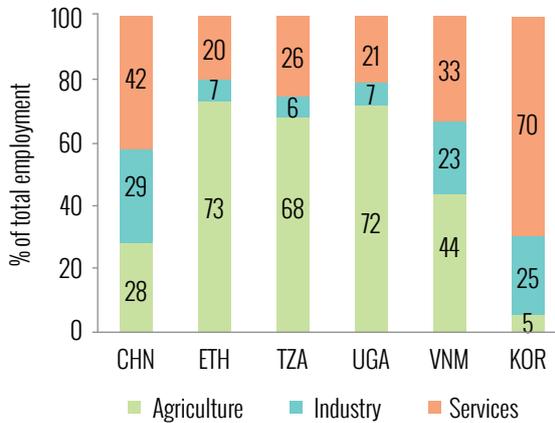
**42. Although the structure of output shifted from agriculture toward services, the corresponding employment shift was modest.** Despite the shift of output from agriculture to services, agriculture continued to dominate employment, although its employment share declined from 80.2 to 77.3 percent between 2005 and 2013. Although workers moved mainly into services (1.8 percentage points), Ethiopia's services sector still absorbs only a small share of the population (World Bank 2015). In high-income countries, where services tend to explain the largest share of GDP, compared with agriculture and manufacturing, services employ 74 percent of the workforce on average (40 percent in upper-middle-income countries and 33 percent in lower-middle-income countries) (Hollweg et al. 2005). By contrast, in Ethiopia, in 2005 the services sector employed only 14.7 percent of the workforce even if it accounted for about 40 percent of value added,

and in 2013 it was estimated to employ about 20 percent of the workforce (figure 2.2, panel a). This share lies significantly below the average for countries at similar levels of development with a similar share of services in GDP, and is lower than all comparators.

**43. Fast labor productivity growth in services may explain the gap between the composition of employment and output changes.** Labor productivity in most services grew much faster than in agriculture and manufacturing (figure 2.2, panel b), pointing once again to the dynamism of services. Labor productivity levels are the highest in sectors such as distribution (commerce), finance, utilities, mining, and transport, and lowest in agriculture and manufacturing. For instance, labor productivity in distribution was twice as high as in manufacturing and construction.

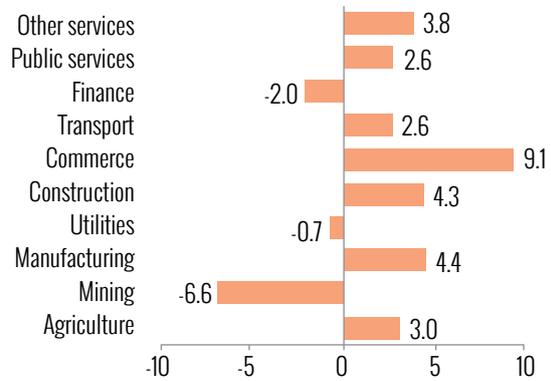
Figure 2.2 Employment by Sector and Labor Productivity

## A Employment, by sector (%)



Note CHN for 2015, ETH for 2013, TZA for 2014, UGA for 2013, KOR for 2016 and VNM for 2015

## B Labor productivity growth, 1999–2013 (%)



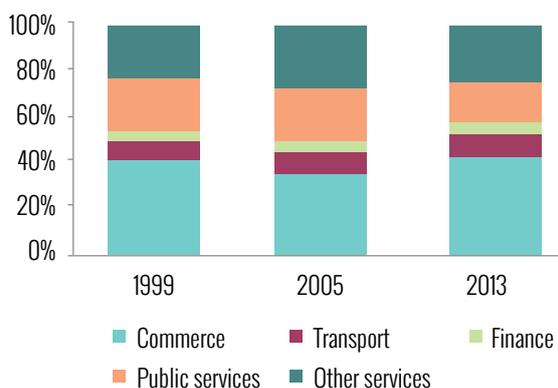
Source World Bank (2015).

**44. Distribution (or commerce), other services, and the public sector are the most important services subsectors for services output and employment in Ethiopia.** These three sectors account jointly for 85 percent of sector value added and 92 percent of services jobs. Specifically, each sector accounts for roughly a half, a quarter, and a fifth, respectively, of value added and jobs in the services sector.

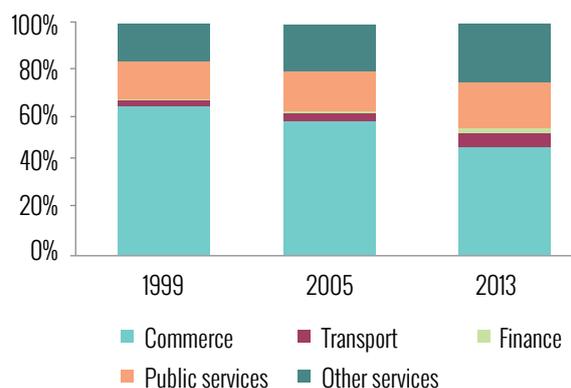
The remaining services sectors are transport (10 percent of services output and 6 percent of services jobs) and finance (5 percent of services output and 2 percent of services jobs) (World Bank 2015). Output shares have hardly changed over time, although the employment shares have increased in “other services” and public services and declined in commerce (figure 2.3).

Figure 2.3 Services Value Added and Employment Shares in Ethiopia

## A Value-added shares (%)



## B Employment shares (%)



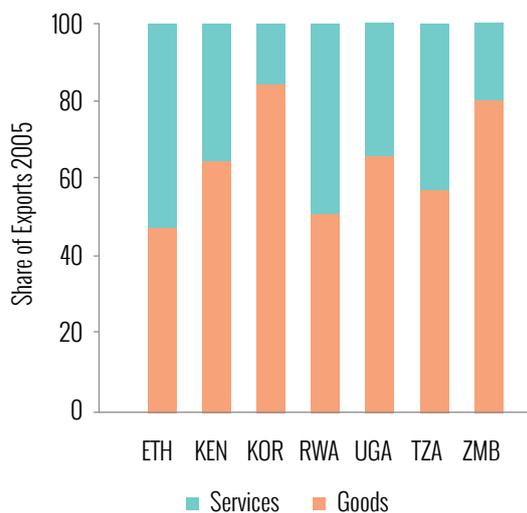
**45. A striking feature of the Ethiopian services sector is its significant role as an exporting branch of the economy.**

Not only did services exports account for more than 50 percent of Ethiopia's total exports between 2005 and 2015 (figure 2.4), but the share of services exports in the sector's output (fluctuating between 17 and 26 percent over the past decade) was comparable to the export-to-output ratio of Ethiopia's traditional export products. For example,

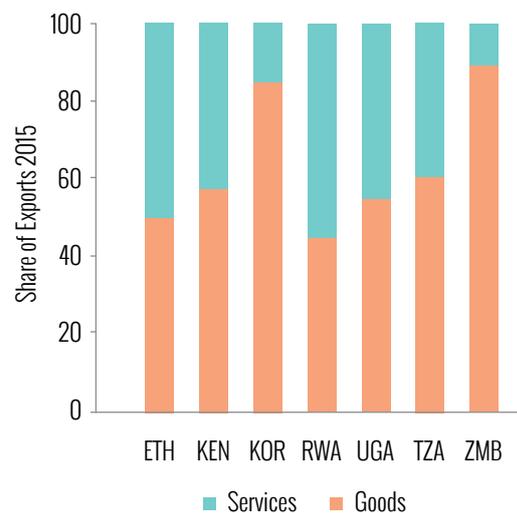
Taffesse and Ferede (2004) reveal that in 2000 the "other services" sector's exports-to-output ratio was marginally higher than that of the "traditional agricultural exportables" sector, which includes tea, flowers, fruits, and vegetables. Furthermore, despite relatively underdeveloped infrastructure, Ethiopia's services trade has registered dynamic growth rates over the past 10 years. Recent data reveal a compound annual growth rate for services exports of 16 percent over 2011–13.

**Figure 2.4 Shares of Services in Total Exports, 2005 and 2015**

**A 2005**



**B 2015**

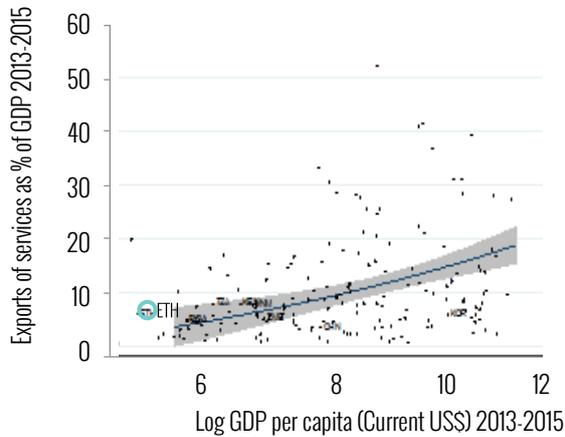
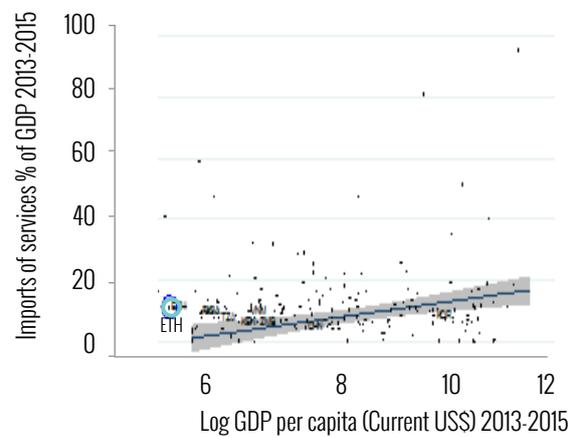


Source IMF BOP 2017.

**46. Services exports and imports are higher than expected from an average country at Ethiopia's level of development.**

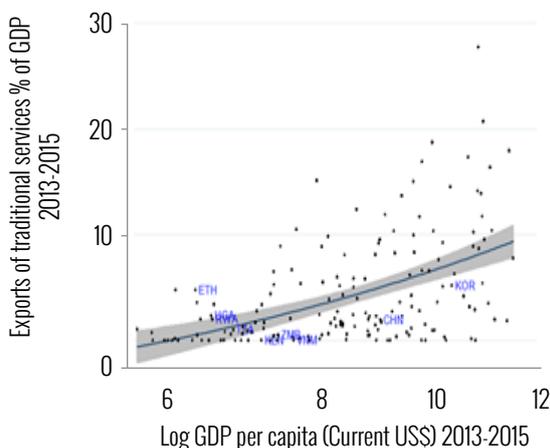
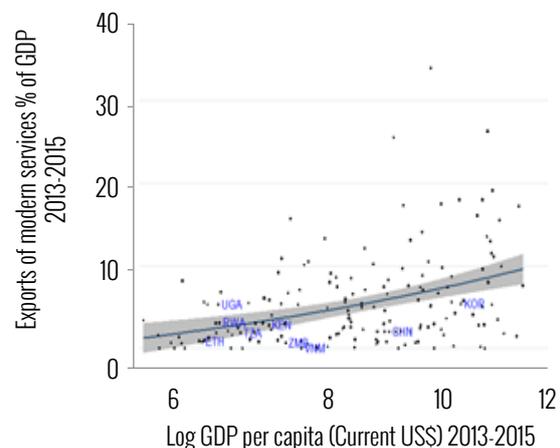
A cross-country regression based on the International Monetary Fund Balance of Payments Statistics shows a positive picture, indicating that Ethiopia's services exports were slightly higher than expected for an average country at its level of development (figure 2.5, panel a). It is important to point out that although exports of services are critical to

the efficient functioning of an economy, services imports are equally important. Imported services, especially from developed countries, often enhance the total factor productivity of domestic firms. Ethiopia seems to be taking advantage of cheaper and higher quality services from abroad. Ethiopia's services imports are again higher than what would be expected for a country at its level of development (figure 2.5, panel b).

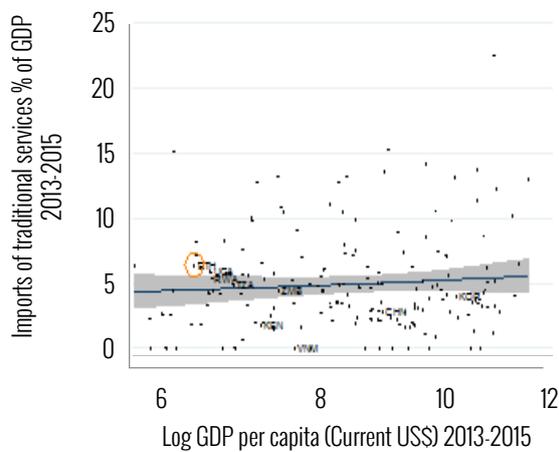
**Figure 2.5 Ethiopia's Services Exports and Imports, 2013–15**
**A Services exports**

**B Services imports**


**47. Ethiopia's exports and imports are concentrated heavily in traditional services activities; the country's modern services exports remain among the lowest of its comparators** (figure 2.6). "Modern services" include communication, banking, insurance, business, and remote access services; transcription of medical records; call centers; and education. These services differ from "traditional services," such as transport or travel, which demand face-to-face interaction. In addition to being important inputs into production, modern services exhibit

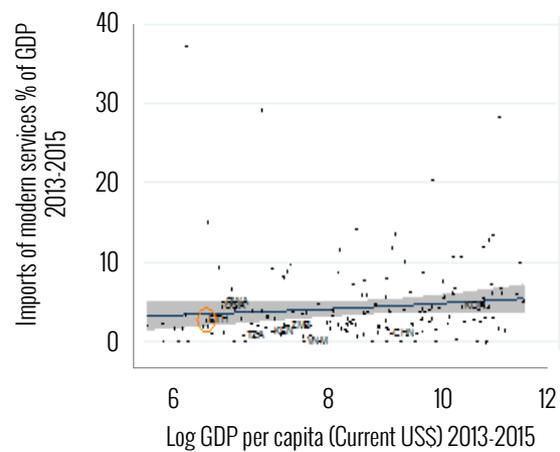
higher productivity and generate high-skilled and better-paid jobs. However, many modern services sectors have relatively low employment intensity and require higher educational levels. Ethiopia's exports and imports of traditional services as a share of GDP reached 7 percent in 2010–12, significantly overperforming comparator countries (except Tanzania and Kenya) and other countries at a similar level of development. Instead, Ethiopia significantly underperforms in modern services exports and imports, which measured close to 2 percent of GDP in 2010–12.

**Figure 2.6 Traditional and Modern Services Exports and Imports versus GDP per Capita, 2013–15**
**A Exports of traditional services**

**B Exports of modern services**


### C Imports of Traditional Services



### D Imports of Modern Services



Source WDI, 2017.

**48. The expansion of Ethiopia's services exports was mainly driven by transport and travel.** Jointly, they accounted for 90 percent of total services exports in 2012, up from 75 percent in 2002. This is attributed to Ethiopian Airlines, which is Ethiopia's largest export earner (three times as big as coffee) and accounts for 60 percent of Ethiopia's services sector (World Bank 2014). Ethiopia's services export structure is very similar to that of Zambia or Kenya, with high shares of transport and travel. It contrasts with that of Korea, a substantially more developed economy, where, even if transport is one of the largest subsectors, modern services such as insurance play an important role. Modern services exports have

been growing slower and inconsistently for some sectors, including financial and other business services.<sup>19</sup> China and Korea, as well as Tanzania and Uganda, have been successful in exporting other business services.

**49. Although important, the contributions of services to GDP and gross trade data ignore the links that services have with other sectors of the economy.** Indicators such as forward and backward linkages, gross exports, direct value-added exports, and total value-added exports can be used to assess the role of services in the domestic economy and in relation to international trade (box 2.1).

<sup>19</sup> The category "other business services" includes merchanting and other trade-related services; operational leasing services; and miscellaneous business, professional, and technical services (legal, advertising, consulting, accounting, R&D, and so forth).

## Box 2.1

## Measuring Services Linkages

In addition to value added as a percentage of GDP and employment per sector, more sophisticated indicators, such as forward and backward linkages, can be used to assess interlinkages in an economy. The value added of production for domestic and export markets can be used to estimate how much value added a country carries over from other sectors and how much value added it brings forward into other sectors.

*Forward linkages* indicate how much value is carried by other sectors, that is, how important each sector is as an intermediate input for other sectors. This indicator treats the sector as an upstream activity. Some studies consider forward linkages as a measure of the “upstreamness” of the industry (for example, Antras et al. 2012).

*Backward linkages* show how much value added a sector carries from other sectors, that is, how much the sector embodies inputs that it will further process. This indicator treats the sector as a downstream activity. Some researchers contend that backward linkages measure the “length of global value chains” (for example, Fally 2011).

Other measures that quantify the degree to which the value added of services goes into downstream exported sectors include the following:

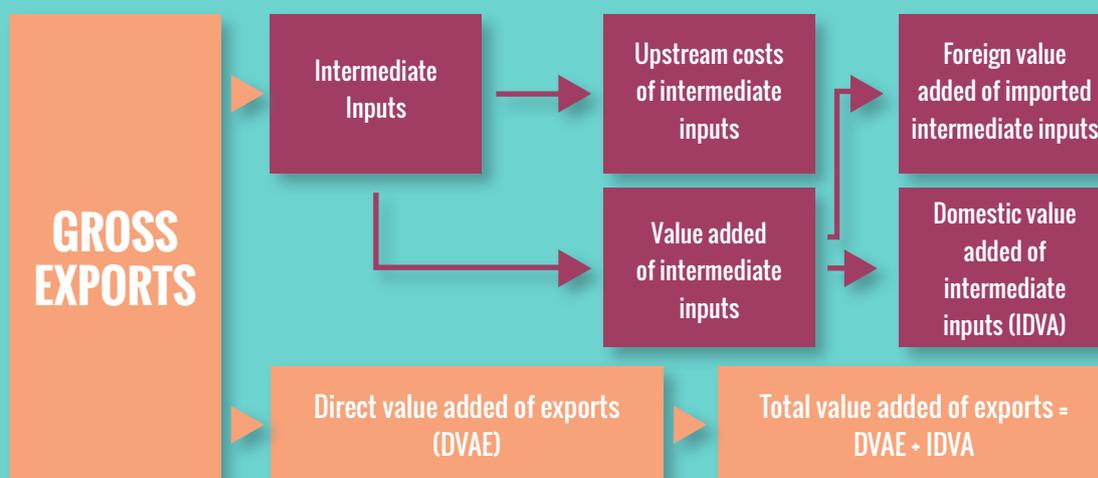
*Gross exports.* Gross or total exports capture the value added embodied in the production of the exports as well as all domestic and imported intermediate inputs. Gross measures of trade statistics are registered in customs or balance

of payments, usually at the transaction value, that is, the price paid or payable for the goods and services. Transaction values measure the gross value of goods and services.

*Direct value added of exports.* This is a sector’s domestic value added embodied in its own exports, measured as gross exports less domestic and foreign inputs. The measure captures the true sector-specific value added of exports. It is increasingly important in an environment where global production is fragmented across production-sharing networks. For example, a business process outsourcing (BPO) service from India contains telecommunication services, from local providers and from foreign owners of satellites. The delivery price of the BPO service accounts for the cost of such inputs. The direct value of exports nets out domestic and foreign inputs and captures the true value added generated in the BPO sector in India.

*Total value added of exports.* This measure adds to the direct value added of exports the portion of the value added of the inputs that are produced domestically. To continue with the BPO example, the measure captures the value added of the BPO service plus the value of the domestic satellites used as inputs in the underlying telecommunication service (but not the value of the foreign-owned satellite input). The measure captures the full domestic component of an exported service. This in turn can be expressed in terms of forward and backward linkages. Figure B2.1.1 explains these concepts.

**Figure B2.1.1 Total Value Added of Exports**



**50. Ethiopia continues to outperform comparators when measuring services exports on a value-added basis** (figure 2.7). Ethiopia's gross services exports as a share of total exports are the highest when benchmarked against peer countries (except Zambia). Ethiopia also outperforms other countries at a similar level

of development in all three measures of services export shares (the share of services in total exports measured as gross, direct, or total value added). The direct value added of Ethiopia's services exports continues to be one of the highest among comparators (with the exception of Kenya).

**Figure 2.7 Services' Export Share (Gross Value, Direct Value Added, and Total Value Added Considering Forward Linkages), 2011**



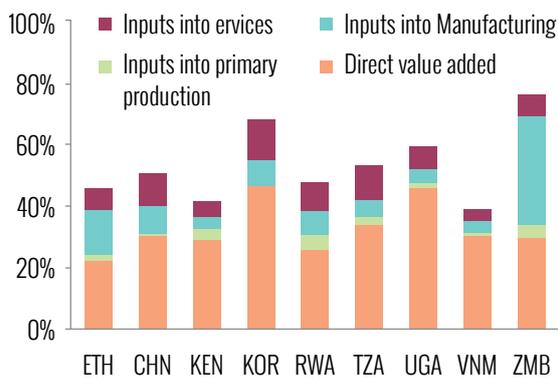
Source: World Bank Value Added Database.

**51. In contrast with other comparators that have successfully generated a strong manufacturing export base, the structure of the services contribution to domestic production and exports is strikingly similar in Ethiopia.** In general, the direct contribution of services is more important for other comparator countries' GDP than for Ethiopia's. In Ethiopia, the direct contribution of services represents 48 percent of services' total contribution to GDP, compared with 59 percent in China, 68 percent

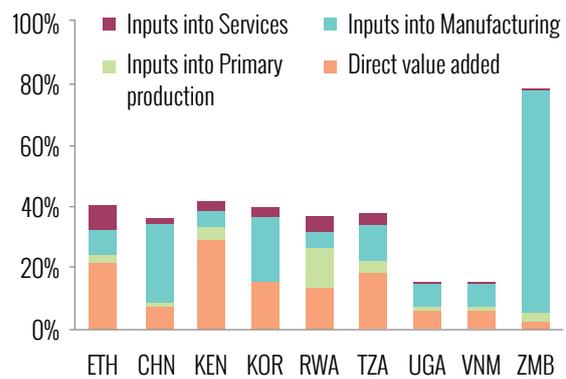
in Korea, and 78 percent in Vietnam. This suggests that services in Ethiopia tend to be used more as inputs than final consumption. The opposite is true for exports, where services are exported directly or by other services sectors. Services inputs into manufacturing exported value added are much more important in China, Korea, and Vietnam than in Ethiopia (figure 2.8), while manufacturing production and exports rely more heavily on services in Ethiopia than in the other countries (figure 2.9).

**Figure 2.8** Composition of Services Value Added (Forward Linkages), 2011

**A Percentage of GDP**



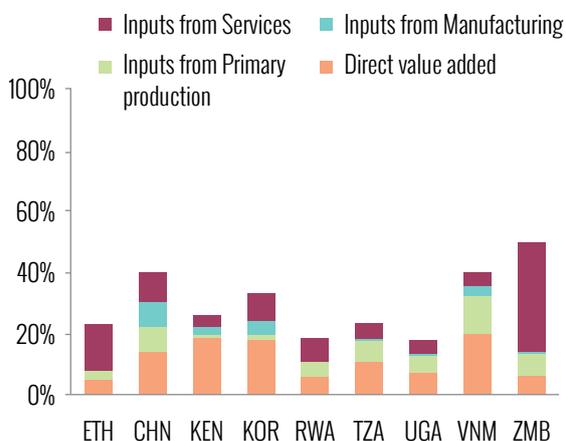
**B Percentage of exported value added**



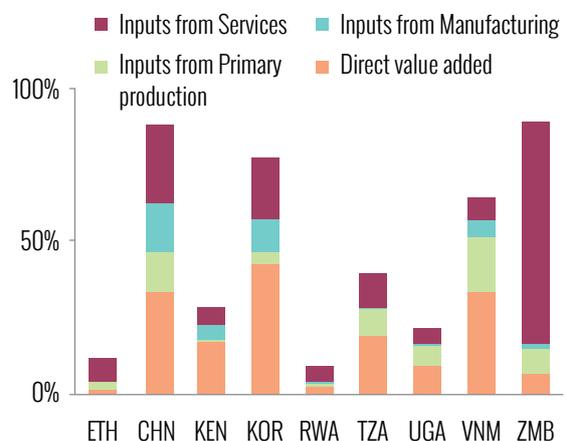
Source: World Bank Export of Value Added Database.

**Figure 2.9** Composition of Manufacturing Value Added (Backward Linkages), 2011

**A Percentage of GDP**



**B Percentage of exported value added**



Source: World Bank Export of Value Added Database.

## 52. Linkages exist primarily with traditional rather than modern services, with distribution services, such as wholesale and retail activities, seemingly the most important services inputs for manufacturing production in Ethiopia.

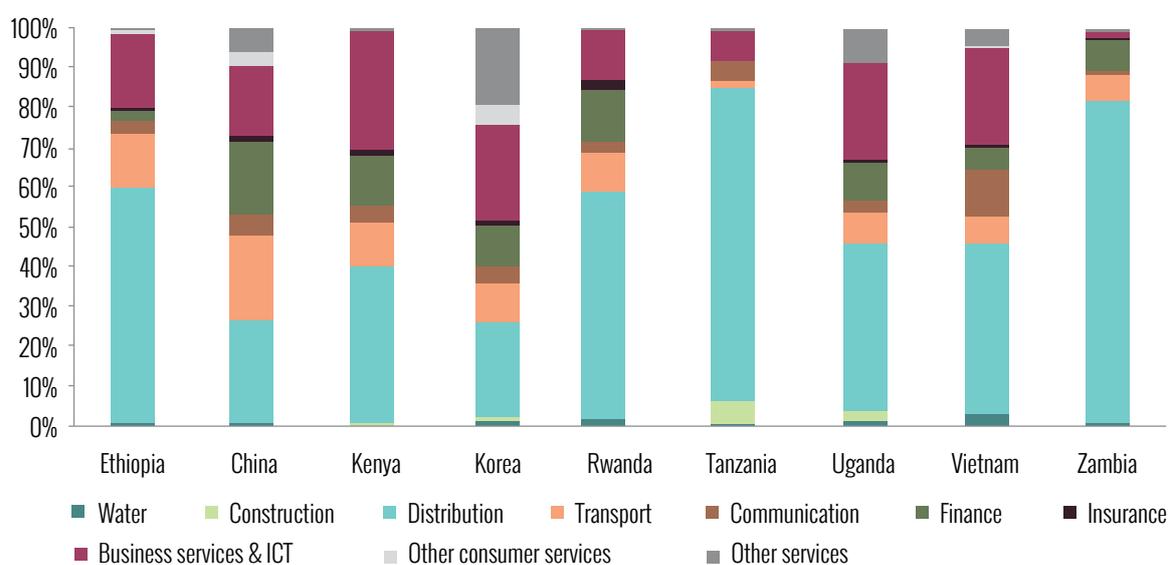
The structure of services-manufacturing linkages in Ethiopia's domestic economy is very similar to that observed in its exports (figures 2.10 and 2.11). The following key findings emerge from the linkages analysis:

The most important services inputs for manufacturing production in 2011 were distribution and trade, transport, and business and information and communications technology (ICT). These three sectors combined accounted for more than 90 percent of all intermediate services inputs for manufacturing production; 60 percent is from distribution and trade services alone.

Although, in general, manufacturing in Ethiopia uses few modern services as inputs, business and ICT services are an exception. Business and ICT services represent about 20 percent of total services inputs in manufacturing in Ethiopia. Exporting firms appear to be far ahead of non-exporting firms in adopting modern business processes (World Bank 2014).

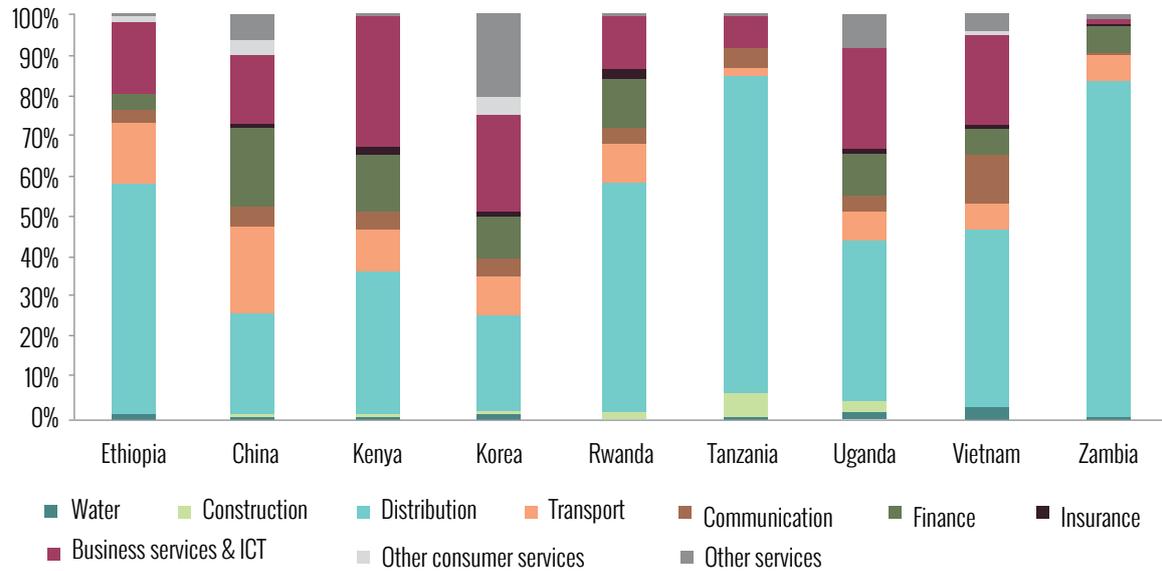
The linkages between financial services and manufacturing are particularly weak. Access to finance has been flagged as a serious constraint in Ethiopia (World Bank 2014). In 2011, financial services represented only about 3 percent of total services inputs in manufacturing. The percentage of investment that is financed through firms' own funds, or the ratio of collateral to the total loan, is very high in Ethiopia, suggesting difficulties in access to finance. This is not an issue of demand, but one of supply; the Government of Ethiopia operates a rationing scheme whereby credit is allocated to the highest need (public investment, export priority sector, critical imports, and others). The negative real interest rate leads to excess demand and quantity rationing, such that many firms are completely excluded from access to finance.

**Figure 2.10** Composition of Domestic Services Inputs in Manufacturing Production, by Country, 2011



Source: World Bank Export of Value Added Database.

**Figure 2.11** Composition of Domestic Services Inputs in Manufacturing Exports, by Country, 2011

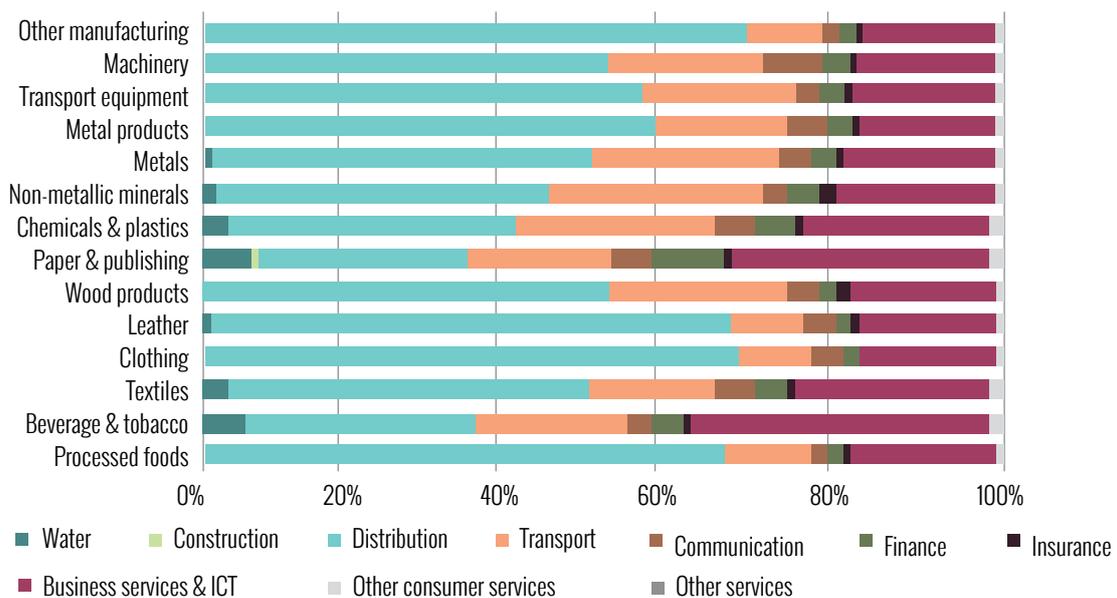


Source World Bank Export of Value Added Database.

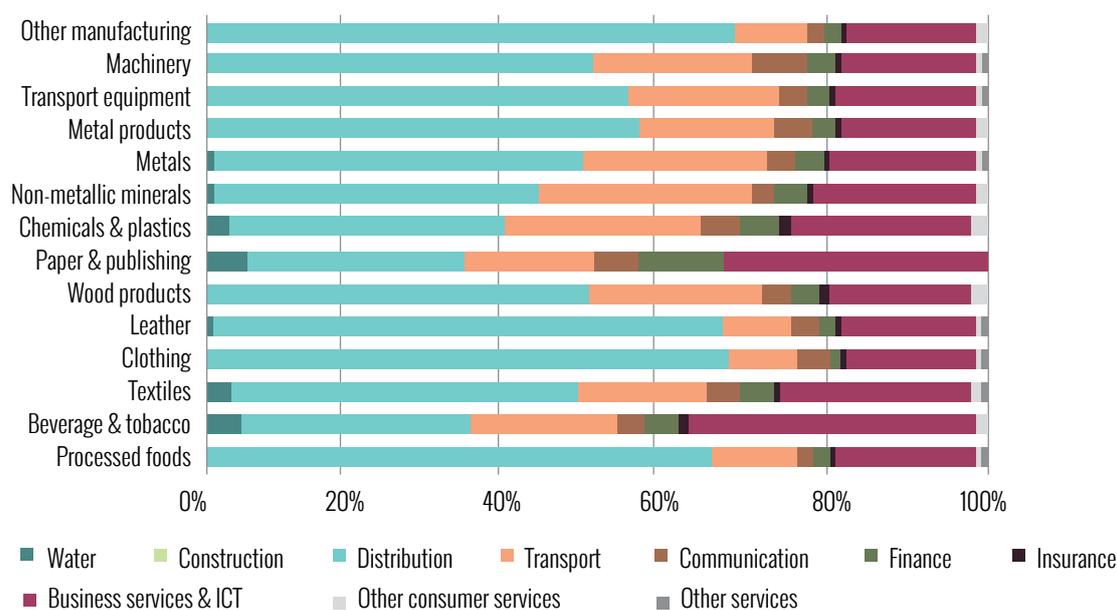
**53. Distribution services are the most important input for 11 of 14 manufacturing sectors** (figures 2.12 and 2.13). Key findings based on a disaggregated analysis by manufacturing sector reveal that distribution services continue to be the most important services input for nearly all of Ethiopia’s manufacturing activities

(except paper and publishing and beverages and tobacco). When considering all inputs (not just services), distribution services are the most important input for 11 of 14 manufacturing sectors, and in nine manufacturing sectors distribution services contribute more value added than the manufacturing sector directly contributes.

**Figure 2.12** Composition of Services Value Added in Manufacturing Production, by Sector in Ethiopia, 2011



Source World Bank Export of Value Added Database.

**Figure 2.13** Composition of Services Value Added in Manufacturing Exports, by Sector in Ethiopia, 2011

Source World Bank Export of Value Added Database.

**54. Although they are useful in providing the big picture on the role of services, results based on global databases need to be assessed with care.** In addition to giving an overall picture about services linkages with the economy, global databases, such as the World Bank Value Added Database or UNCTAD EORA Global Multi-Region Input-Output Database, are valuable for making comparative assessments among countries. However, often such databases are constructed with many assumptions to generate the missing information (for instance, extrapolating or interpolating values for missing observations through cross-entropy methods) and then employ balancing conditions for the entire data set.<sup>20</sup> This means that the data can be far removed from what is happening on the ground. This is a particularly important point for African countries, including Ethiopia. Indeed, we find substantive differences in the contributions of all economic sectors as input providers or demanders of inputs if we compare the latest national input-

output table for Ethiopia with the World Bank Value Added Database (figures 2.14 and 2.15). Moreover, the sectoral classification in the input-output table is different from the one in the World Bank Value Added Database, making comparisons difficult.<sup>21</sup>

**55. Statistical discrepancies call for a cautious interpretation of the results.** Nevertheless, evidence from a variety of sources seems to suggest that, for manufacturing to succeed, a different approach toward services is needed. In part, the structure of manufacturing may be one that does not demand substantial modern services. Little value added is taking place, suggesting that Ethiopia may be in assembly activities that demand primarily traditional services. But even in sectors where more domestic value added is generated, such as food processing, there seems to be insufficient use of essential services such as financial, utility, and water supply services. Insufficient services may be inhibiting manufacturing from moving into domestic value-added activities.

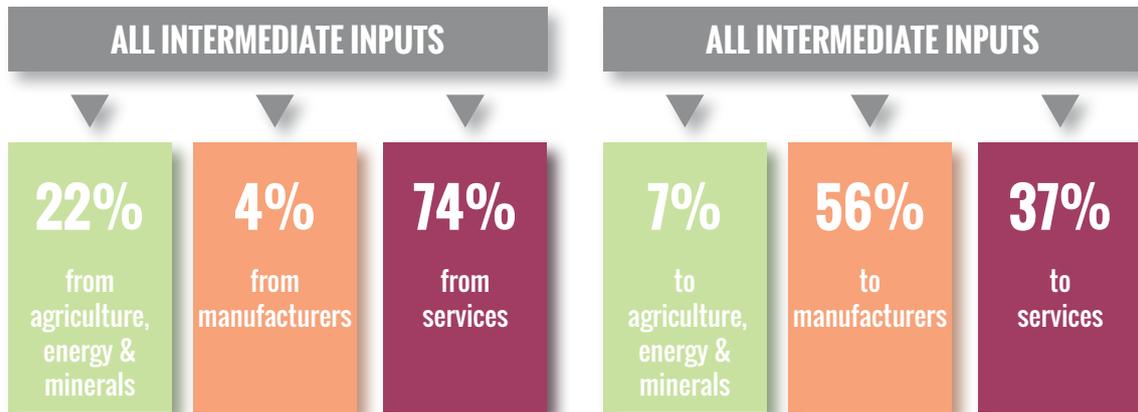
<sup>20</sup> Lenzen et al. (2013, 2012).

<sup>21</sup> For example, distribution services do not feature in Ethiopia's input-output table. It remains unclear how the shares in the World Bank database were computed. To enable comparative assessments, the team has opted to use the World Bank database for the analysis.

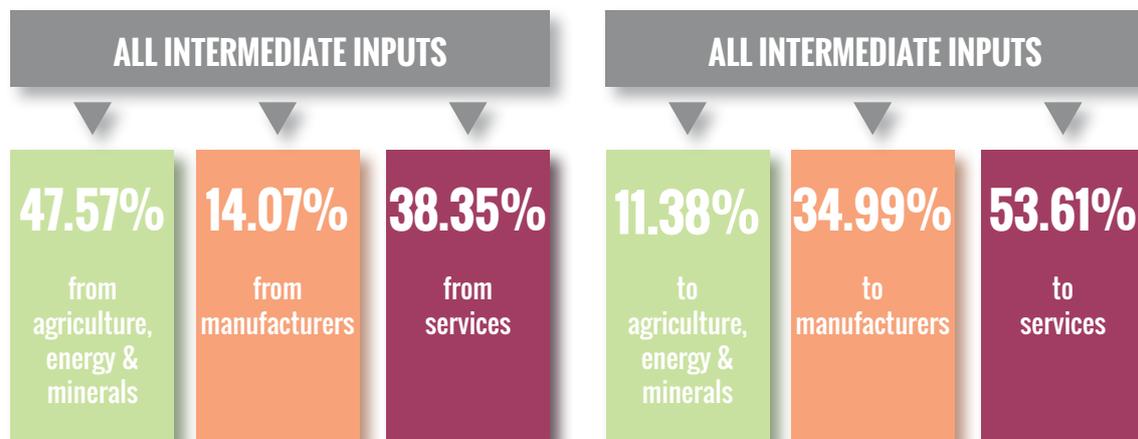
Firm-level diagnostics can shed further light on important questions behind this result. For a better understanding of the relationship between services

and the economy, analyses based on more recent input-output tables as well as firm-level data would be needed to complement the current examination.

**Figure 2.14** Inputs into and from Productive Sectors in Ethiopia,  
Based on the World Bank Export of Value Added Database for 2011



**Figure 2.15** Inputs into and from Productive Sectors in Ethiopia,  
Recalculated Based on the Input-Output Table for Ethiopia for 2011



### 2.3. Potential of Distribution Services

**56. Distribution services have become a significant driver of growth in Ethiopia over the past decade.** Distribution services contribute about 15 percent of GDP and employ an important part of the population (over 42 percent of the active population in 2013, including a high proportion of informal, unskilled, female, and part-time workers) (World Development Indicators, National Labor

Force Survey). The recent growth of distribution services has been propelled by strong economic growth over the past decade, increasing population, continued urbanization, higher incomes, and political stability, leading to the emergence of supermarkets and larger retail stores mainly in the capital, Addis Ababa (USDA 2016).

**57. Distribution services have experienced emerging recognition in Ethiopia.** For example, GTP II covering 2016–20 states that retail and wholesale are expected to be important drivers for services sector growth during the plan period. In addition, improvements in wholesale and retail trade-related activities are expected to boost the transport and storage sectors.

**58. Indeed, as a crucial link between suppliers and producers, distribution services have great economic potential.** With improved efficiency and higher productivity, due to the emergence of supermarket chains, the sector has great potential to benefit producers and consumers and contribute to increased food security and the alleviation of rural poverty. From the perspective of producers, modern distribution channels, procurement systems, and buying centers can reduce transaction costs and facilitate market exchanges, which increase the access of small farmers to high-value markets and accelerate the transition from subsistence farming to market participation.

## Retail

**59. At this stage, Ethiopia’s retail sector is characterized by little to no formal shopping culture, with existing formal markets relying almost exclusively on basic**

**consumer packaged products and dry goods.** Ethiopia’s retail market has limited market saturation, but also low maturity. Supermarkets sell few fresh products; rather, fresh products are grown at home or acquired in informal markets. Consumer spending is generally much lower than in more mature, neighboring markets. For buyers in these markets, price is the key factor (A. T. Kearney 2014, 2015). Formal distributors in Ethiopia tend to be supermarkets and small and medium-size retailers. Modern retail stores have direct procurement systems and buying centers. Retail outlets, including supermarkets, tend to grow by first focusing on urban areas and large cities, mainly the capital city (box 2.2).

**60. For consumers, the emergence of supermarket chains in Ethiopia is starting to transform the retail environment in the country.** Many middle-class consumers already benefit from a greater variety of goods at affordable prices in modern retail outlets. The rise of supermarkets and their operational efficiencies is expected to lower prices further throughout the food system, to the benefit of consumers. This is especially likely for processed and semi-processed goods, such as maize meals, wheat flour, bread, oils, meat, fish, and dairy, which typically make up more than 50 percent of these stores’ sales (Minten and Reardon 2008).

### Box 2.2

#### Players in Ethiopia’s Retail Grocery Business

Eight major supermarket chains, with a total of 21 stores, are open across Addis Ababa. The major food retail stores—Shoa, Fantu, Safeway, Friendship, Bambis, All-Mart, Novis, and Loyal—supply a wide array of products, most of which are imported foods and beverages. In addition to these major players, there are many mid-size and smaller stores that supply the market.

The United States, Europe, Turkey, the Arab Republic of Egypt, and the United Arab Emirates

are among the top suppliers of food and beverage products sold through Ethiopia’s retail grocery sector. Most retailers tend to import from a single country/region, mainly due to historical reasons or personal connections. For example, Novis and Bambis prefer to import most of their food products from Europe. Shoa generally sources from the United Arab Emirates. Fantu imports a large portion of its food products from the United States.

In addition to direct imports, most retailers purchase certain imported items from one another or from one of the large importers/distributors, such as Teji International Trading. The main reasons for this sourcing practice are price, capacity, and distribution rights. For example, depending on the type of product, some retailers may prefer to purchase some of their imported

foods from local trading companies, which can bring in a large single-product shipment (for example, breakfast cereal) in multiple containers with more competitive pricing. In addition, some retailers, which are large enough to import, have exclusive contracts with foreign suppliers and act as the de facto distributor in the country, selling certain products to other retailers and businesses.

Source

USDA (2016).

## Wholesale

**61. In the wholesale segment, we observe a high degree of duality between traditional and specialized wholesalers.**<sup>22</sup> Traditional chains are still widely prevalent in Ethiopia. Farmers and traders supply traditional wholesalers, who then sell to individual retailers and processors. But most modern retail stores have their own direct procurement systems and buying centers.

Furthermore, state-owned enterprises are present in Ethiopia's wholesale market. However, Alle, the state-owned and privately managed cash-and-carry wholesaler, which the government set up to create a competitive and market-oriented business environment in the sector before allowing competition from international players, is struggling for relevance (box 2.3).

### Box 2.3

#### ALLE Struggles for Relevance

The state-owned and privately managed business enterprise Alle Bejimla was set up with the primary objective to supply wholesale food and other consumer goods and stabilize prices. The government also expected that Alle would inject a market-oriented and competitive business environment into the wholesale consumer goods supply, which is dominated by a few companies.

With its expansion plans being impeded by various challenges, including the provision of land by government offices, Alle has managed to open only six units across the country, of which three are in the capital. Its plan was to have 36 outlets in three years, a minimum of 12 units annually. Consumers are also yet to witness Alle's contribution to stabilizing food prices.

Source

The Reporter, Ethiopia.

<sup>22</sup> Tschirley et al. (2014) anticipate that this duality between traditional and modern distributors will be preserved over the next 30 years in East Africa. Although they expect profound changes in the composition of what is consumed and at least a tripling of the share of the modern sector, a large share will remain in the hands of the traditional sector.

## Franchising

### **62. The franchising segment is small and mostly limited to foreign firms.**

In July 2016, the Ethiopian Parliament approved a Commercial Registration and Business License Proclamation that allowed registration of franchises. Difficulties in enforcing intellectual property rights, product quality control issues, cumbersome banking regulations, and limited access to foreign exchange make franchising difficult. Despite these challenges, several branded U.S. companies, such as Pepsi-Cola, Sheraton, Hilton, Marriott, Radisson Blu, and Ramada, have franchise operations in Ethiopia. In May 2017, Pizza Hut signed a franchise agreement with the Ethiopian Belayab Food and Franchise Plc to open the first Pizza Hut stores in Ethiopia. The first Pizza Hut store is expected to start operation in the coming six months. Electronic commerce is still in its infancy in Ethiopia and is rarely used. The Government of Ethiopia is preparing a draft national law to govern e-commerce.

## Informality

### **63. Informality prevails despite the emerging diffusion of modern retail stores.**

Despite the growth of the higher-end supermarket segment, the number of traditional small stores that sell local produce remains high in Ethiopia's retail market. In general, the distribution sector includes a few large supermarkets, slightly more large to medium-size wholesalers and retailers, and a much greater number of independent and often informal small retail shops and street vendors. Such informal retailers can be found in urban and rural areas, and are often the primary enterprises engaging in distribution services outside larger cities. Most businesses in the informal sector are engaged in the retail of food

and basic retail household appliances, and are single-shop sole proprietorships. An estimated 70-80 percent of sales in Ethiopia still go through informal enterprises, with only about 20 percent of sales going through formal outlets. Although informal enterprises handle the large majority of sales, turnover is low for most individual informal enterprises and businesses tend to be very small. Enterprises in the informal sector are more limited in their operational capacities than businesses in the formal sector. Lack of access to finance, uneven cash flows, absence of management knowledge, and highly fragmented and inefficient supply chains are key constraints faced by enterprises in the informal sector. Informal retailers are also suboptimal from a governance perspective, since it is difficult or impossible to collect taxes (value-added tax, excise tax, import duties, and so forth) from unregistered businesses without licenses.

### **64. Despite positive developments and optimistic expectations for the sector, modern distribution channels still fail to capture a large portion of the retail market in Ethiopia.**

The distribution sector in Ethiopia has undergone several transformations in the past decade, but the impact on poverty reduction remains uncertain. Many middle-class consumers benefit from a greater variety of goods at affordable prices in modern retail outlets. The modern procurement systems and buying centers established by supermarkets have also improved the lives of participating farmers. However, very poor urban households at the bottom of the income pyramid pay higher prices for basic goods and services than do wealthier consumers—in cash or in the effort they must spend to obtain them—and they often receive lower quality as well. Box 2.4 illustrates the price penalty for sugar and teff affecting poor consumers in Addis Ababa.

## Box 2.4

## The Bottom of the Pyramid Penalty

In informal settlements, retailers buy normal goods from wholesalers or retail outlets and break them down into smaller affordable quantities. For instance, poorer consumers cannot afford to buy the 2-kilogram packet of sugar that retails at about Birr 56 (or US\$2.4) in most shops; however, they can afford to buy a pack of 250 grams at Birr 10 (or US\$0.4). This makes goods affordable for poor households.

Although the smaller quantities are more affordable to poor consumers, they are paying a considerably higher unit price for these products. Table B2.4.1 illustrates this point, where a 250-gram pack of sugar retails at a 43 percent premium, and a 250-gram pack of teff at a 25 percent premium. The poorest members of the society pay more for their essential goods than ordinary Ethiopians.

**Figure B2.4.1** Price Comparison of Selected Products in Informal Settlements

Commodity	Kiosk price for units less than 250 grams (Birr/kg)	Supermarket price (Birr /kg)	Price differential for units less than 250 grams (%)
Sugar	40	28	43
Teff	30	24	25

Some retailers in informal settlements have weight scales. But by and large, the portions are meted out without weighing them. Thus,

the packs found in these retail kiosks weigh sometimes more, sometimes less.

Source

Interviews in Addis Ababa, June 2017.

**65. Moreover, given that the majority of the population depends on agriculture, small-scale farmers have sometimes found themselves marginalized by the distribution sector and its new practices.** Given the high fixed costs associated with participation in modern chains, many small farmers and traders are not able to participate in modern procurement systems

and continue to supply traditional wholesalers, who then sell to individual retailers and processors. As the supermarkets in the highest tier tighten their demands for consistency in volume and quality, small producers and undercapitalized brokers face tougher competition from larger producers and risk being squeezed out of the system altogether.

## Constraints to Distribution Services

**66. In the formal sector, explicit trade barriers and regulatory measures obstruct the entry and limit the operations of distributors.** Typical barriers and regulations affecting distribution services are listed in box 2.5. Formal trade barriers stop countries from importing the necessary services to respond to demands for affordable and quality services

and address the skills shortages and skills mismatches that prevent farmers and small and medium-size enterprises (SMEs) from accessing/benefiting from modern distribution channels. In addition to the explicit trade barriers that limit the distributors' ability to establish themselves in other countries, several other regulatory issues may explain the negative outcomes in the sector.

### Box 2.5

#### Typical Explicit Trade Barriers and Regulatory Obstacles Affecting Distribution Services

##### Formal Trade Barriers

Typical restrictions that affect trade in distribution services differ by mode of supply,<sup>a</sup> but typically include the following for the relevant modes of supply (modes 1,3 and 4) for distribution services:



##### Mode 1

Restrictions on cross-border trade can have negative effects on distribution services, especially those where supply chains cross from the territory of one country to that of another. Such restrictions that could be particularly relevant to distribution services include (i) restrictions on electronic sales, (ii) quotas or economic needs tests that restrict the number of suppliers, or (iii) restrictions on payments and transfer of funds abroad.



##### Mode 3

Restrictions on commercial presence can have negative effects on distribution services, especially where foreign chains are prevalent in domestic markets. Such restrictions that could be particularly relevant to distribution services include (i) limitations on the numbers of permitted suppliers, legal form (including joint venture requirements), foreign equity capital limits, and discriminatory tax/fiscal measures; (ii) restrictions on the legal form of distribution outlets; (iii) nationality requirements on staff, or restrictions on the recruitment of foreign personnel; or (iv) different regulatory frameworks for foreign establishments than those that apply to private outlets.



##### Mode 4

Restrictions on the presence of foreign persons can have negative effects on distribution services. Such restrictions that could be particularly relevant to distribution services include (i) burdensome immigration requirements, (ii) quotas on the number of service suppliers, (iii) nationality or residence requirements, or (iv) labor market tests (for example, horizontal

measures or restrictions specific to the distribution sector that apply to staff traveling across national borders to set up establishments to negotiate arrangements, or provide instruction/training).

### **Domestic Regulatory Barriers**

The typical regulatory measures in the distribution sector generally relate to market access and conduct regulation:



*Market access.* Typical regulations on market access include requirements for setting up and opening a business, such as registration with the trade/regulatory bodies; regulations on the establishment, extension, and location of commercial presence; regulations on specific operations and products; the existence of local monopolies for some products; and impediments to the establishment of large outlets.



*Conduct regulation.* In the distribution sector, the regulations on business practices may have considerable effects on competition between services providers. The main sector-specific measures captured under this category include regulations on prices, shop opening hours, zoning regulations, seasonal sales periods, and the range of products retailers or wholesalers may carry, as well as limitations on advertising and contracts with suppliers. In addition, specific taxes may be applied only to large formal retailers, or small retailers are exempted from certain taxes to protect small local incumbents.

a. Trade in services can take place through four modes: (i) cross-border trade (from the territory of one Member into the territory of any other Member); (ii) consumption abroad (in the territory of one Member to the service consumer of any other Member); (iii) commercial presence (by a service supplier of one Member, through commercial presence, in the territory of any other Member); or (iv) presence of natural persons (by a service supplier of one Member, through the presence of natural persons of a Member in the territory of any other Member). See [http://www.wto.org/english/tratop\\_e/serv\\_e/gsintr\\_e.pdf](http://www.wto.org/english/tratop_e/serv_e/gsintr_e.pdf).

**67. Ethiopia's Investment Code prohibits foreign investment in distribution.** Several international players, such as Walmart or Nakumatt, the Kenyan supermarket chain, have expressed interest in entering Ethiopia's retail market, but FDI restrictions as well as barriers affecting all modes of supply will continue to keep foreign retailers away. Foreign retailers in low-income and emerging economies typically

offer consumers new products, improved product standards and provide a market opportunity for local suppliers of consumer goods, particularly fresh food. OECD (2017) finds that hosting an international retailer increases exports to the home country of the retailer. The empirical findings are backed by case studies documenting how retailers engage with local suppliers of specific products, providing incentives to comply with product and

process standards in export markets. In addition, modern supermarket procurement systems, often championed by foreign retailers, promote healthier and safer production and processing systems also locally. In many cases suppliers to the local affiliate of the retailer over time become regional and sometimes even global suppliers to the retailer. Even when becoming a supplier to a foreign-owned retailer does not lead to exports, it may still open the entire domestic market to the local farmer or food processing plant, providing sufficient scale to invest in product quality and modern technology. At this stage, there are limited opportunities for foreign firms in Ethiopia's distribution sector: FDI restrictions do not include fast-moving consumer goods, and foreign companies can distribute and export their specific products if they are manufactured within the country. But foreign companies are not allowed to engage in the distribution of any imported goods. For example, the Heineken brewery can distribute beer produced locally, such as Heineken or Walia, but is not allowed to distribute imported whisky.

**68. In Ethiopia, new businesses, including all distributors, must register with the commercial registry, notify the authorities, and obtain licenses and permits to engage**

**in commercial activity.** Fees depend on the type of business permit required. Multiple licenses are a significant challenge in distribution services. The revised Commercial Registration and Business Licensing Proclamation eliminates some cumbersome and duplicative requirements, such as the yearly renewal of business registrations and the minimum capital requirements to set up limited liability companies. The law removes the requirement to obtain a "competency certificate" except in technical sectors such as health and environment. The Proclamation now allows registration of franchises and holding companies.

**69. The main restrictions affecting operations in the distribution sector are related to price regulation.** Price controls (maximum prices) exist in Ethiopia for essential goods such as sugar, palm oil, bread wheat flour, petroleum, and petroleum products. Compounding this issue are the cartels that control the prices and flow of certain goods, such as seeds and fertilizers.

**70. In addition to explicit trade barriers and regulatory obstacles, nontariff barriers hamper imports by modern retail chains in Ethiopia.** Nearly all the processed and packaged foods sold at major retail outlets are imported. These products include breakfast cereals, candy, cooking oils (such as soy, corn, sunflower, and olive), rice, powdered milk, condiments (such as mustard, ketchup, and salad dressing), pastas, cookies and crackers, jams and jellies, and fruit juices. The combination of import duties and taxes on processed grocery food items is quite high, with a cumulative tax burden of almost 65 percent.



Specific duties and taxes on processed food items are as follows: import duty (30 percent); value-added tax (15 percent), surtax (10 percent), and withholding tax (3 percent). Furthermore, delays due to bureaucracy and congestion at the ports have a negative impact on the cost of importation and stocking of appropriate inventory levels. Measures concerning regulatory transparency and administrative procedures are also a form of nontariff barrier. These regulations involve publication and communication of the regulatory and licensing regimes, as well as administrative procedures for allocating and renewing licenses. Lengthy customs clearance affects cross-border sourcing of retailers. Finally, excessive visa processing time represents an additional cost, especially when workers or managers need to travel to provide their services, for training purposes and so forth.

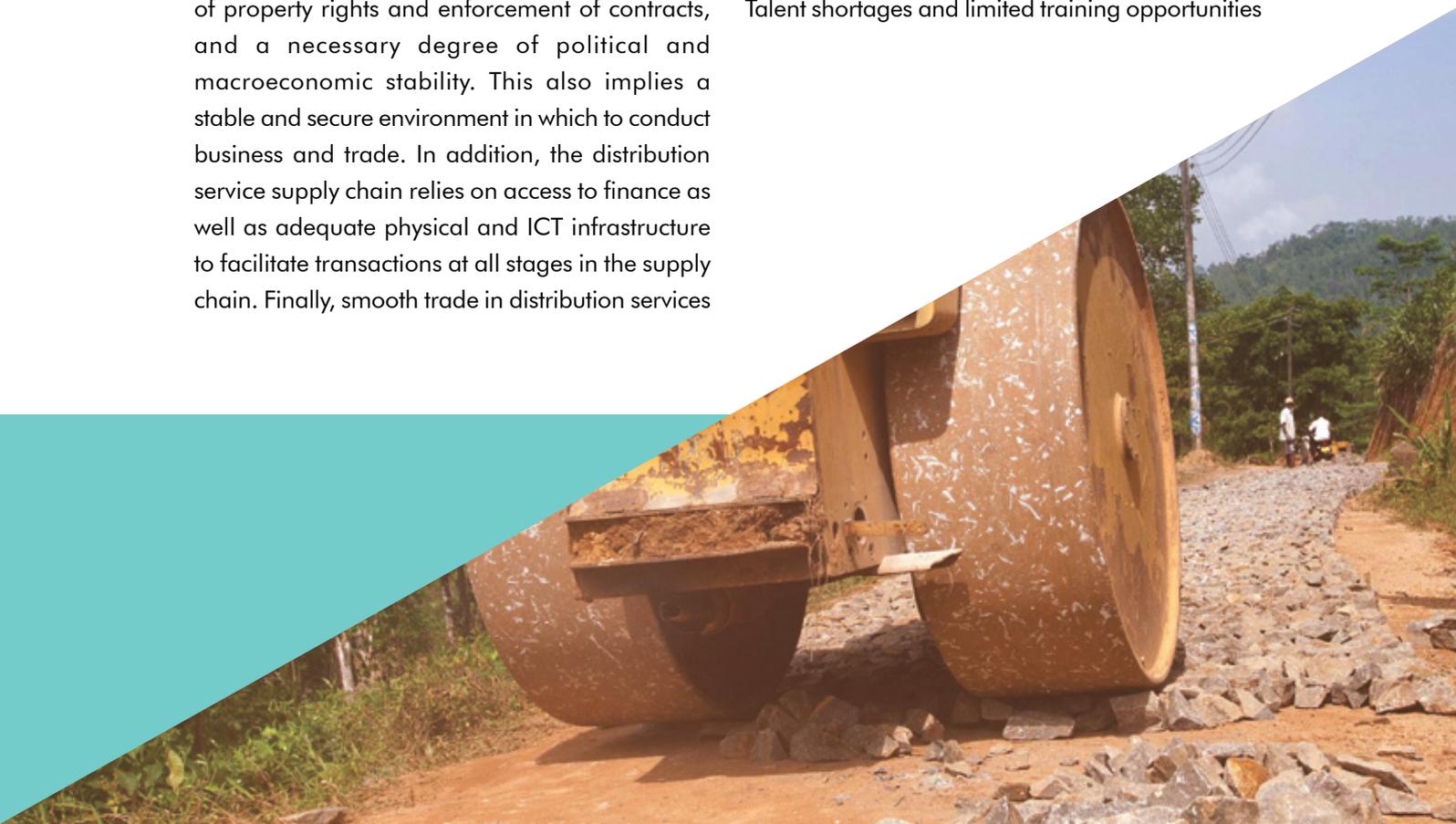
**71. A poor business environment constrains the development of distribution services.**

Underpinning the smooth functioning of the distribution sector are many enabling factors that support the business environment for trade in distribution services. These include the appropriate framework conditions for doing business, which imply, inter alia, rule of law, proper protection of property rights and enforcement of contracts, and a necessary degree of political and macroeconomic stability. This also implies a stable and secure environment in which to conduct business and trade. In addition, the distribution service supply chain relies on access to finance as well as adequate physical and ICT infrastructure to facilitate transactions at all stages in the supply chain. Finally, smooth trade in distribution services

relies on appropriate human resource capacity and skills at all stages of the value chain, as well as the proper flow of information between actors.

**72. Poor infrastructure affects distribution services.** Due to poor road network conditions, especially in rural areas, and traffic congestion in the main cities, distributors are forced to make early deliveries to avoid traffic jams and reduce transportation costs. Cumbersome importation processes due to bureaucracy and congestion at the ports increase the price of imported goods and complicate stocking and inventory planning. Moreover, limited ICT infrastructure limits the potential of e-transactions and e-government procedures, particularly in customs clearance.

**73. Limited human resources restrict the expansion of the distribution sector.** The distribution services supply chain may also be affected by constraints on human resources, which can be particularly acute with respect to the availability of market-relevant skills such as merchandising, category management, and just-in-time inventory management. In addition to the absence of formal training, a limited influx of knowledge about best or good practice in the sector can limit the growth of SMEs in the sector. Talent shortages and limited training opportunities



impede the development of the distribution sector, and the availability of market-relevant skills remains an issue across the distribution sectors in East Africa. Consequently, most formal distribution businesses rely on training on the job. Further, there is limited influx of knowledge on best or good practice in the sector. Lack of access to specialized training has led to slow growth and late adoption of modern retailing techniques. For example, many large supermarkets are only beginning to understand the value of and adopt modern retailing techniques such as merchandising, category management, and just-in-time inventory management.

## Distribution Services in Value Chains

**74. To illustrate more broadly the opportunities and challenges for producers and consumers in Ethiopia, the case studies explore the role of distribution services in the dairy, teff, sesame, and textiles value chains.** These case studies (i) explore the role of distribution services as intermediate inputs and tasks in value chains in these sectors, and (ii) show how distribution services affect structural transformation defined from a new angle.

**75. Although most definitions of structural transformation focus on sectoral changes,<sup>23</sup> more recent literature broadens this view.** It is in this context that the proposed analysis aims to contribute to the debate, by focusing

on transformational productivity growth within existing sectors. This more recent literature considers structural change generated by the movement of factors of production between firms and reallocation of resources from lower to higher productivity activities within the same sector (see, for example, Hsieh and Klenow (2009, 2012) and Page and Shimeles (2014)). Indeed, in a world dominated by complex and fragmented production processes, development can be achieved by (i) functional upgrading, that is, by moving to higher value-added tasks, and (ii) process upgrading, that is, by specializing in the tasks and activities of comparative advantage and putting more technology, know-how, and auxiliary services into such tasks that ultimately translate into value addition and higher productivity.

**76. This means that improvements and shifts in production within each sector are an important element of development, and transitioning from an agriculture to manufacturing is not the only avenue, as traditional development views suggest.** It means instead increasingly embracing higher value-added production or more productive activities in the same sector or type of commodity, or transitioning from informal production to formal activities with the assistance of more technology, services, and know-how as well as better links to input and output markets. For the case studies, this means looking at how services (specifically distribution services) can facilitate the

<sup>23</sup> Traditional definitions of structural change (or structural transformation) emphasize the “reallocation of production factors/resources/economic activity across sectors,” and more specifically from low-productivity to high-productivity ones. For example, Rodrik and McMillan (2011) explain that the countries that manage to pull out of poverty and get richer are those that can diversify away from agriculture and other traditional products. As labor and other resources move from agriculture into modern economic activities, overall productivity rises and incomes expand. More specifically, they describe the two key dynamics in the process of structural transformation: the rise of new industries (that is, economic diversification) and the movement of resources from traditional industries to these newer ones. As such, structural transformation entails the rise of new, more productive activities and the movement of resources from less productive activities to these newer ones, raising overall productivity. Similar views on structural transformation defined as “the shift of resources from low-productivity to high-productivity uses” and “the reallocation of production factors (resources) across the broad agriculture, manufacturing, and services sectors” are found in the early literature. See, for example, Lewis (1951), Kuznets (1955), Chenery (1986), Kuznets (1966), Kongsamut et al. (2001), and Ngai and Pissarides (2007).

movement into higher value-added activities, such as production and export of processed milk (ultra-heat treated (UHT) processed milk), cheese, or sesame oil.

**77. Initial attempts to explore the role of services in changing the features of Global Value Chains (GVCs) evaluated the role of services as intermediate inputs.** Over the past decade, an extensive literature has documented the cost and quality impacts of services inputs on the competitiveness and growth performance of the economy (see Francois and Hoekman (2010) for a summary of key findings). The Swedish National Board of Trade (2013, 2010) considers the role of services in enabling GVCs: the “servicification”<sup>24</sup> of manufacturing, defined as the increased use of services in manufacturing in production processes and sales. It looks at services as intermediate inputs, but also discusses

the role of services as tasks in value chains, and their impact on upgrading and moving up the value chain.<sup>25</sup> Therefore, this analysis attempts to clarify the role of distribution services (as inputs and tasks) in the dairy, sesame, teff, and textiles value chains.

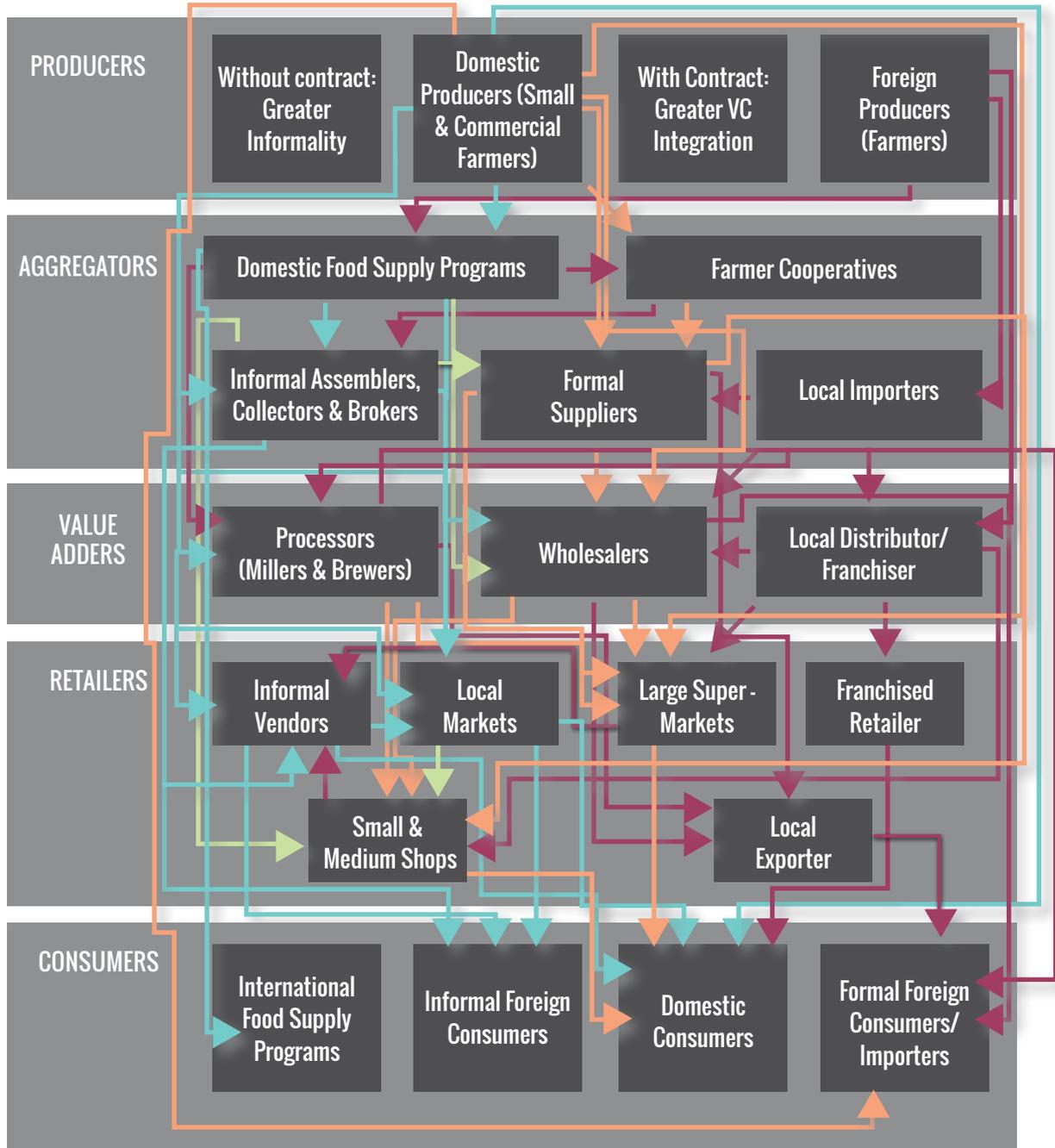
**78. To illustrate the role of distribution services in value chains and structural transformation, we depict a value chain in key food staples such as grains, such as teff, wheat, barley, corn, sorghum, and millet.** The value chain shown in figure 2.16 is based on fieldwork and interviews conducted in Ethiopia in 2016–17. The results of the analysis provide a snapshot of the steps through which food staples move from producer to consumer, as well as the key actors and institutions involved along the way.



<sup>24</sup> This is a term coined by the Swedish National Board of Trade. Earlier attempts to define the evolving role of services were undertaken by Reiskens et al. (2000), who introduced the “servicizing” concept; Bryson and Daniels (2010), who refer to the “manuservice economy”; and Vandermerwe and Rada (1988), who introduced the “servitization” concept.

<sup>25</sup> First, many examples illustrate how services act as “connectors,” play an important intermediation role, and generate strong complementarities across all types of markets. For instance, Low (2013) describes how modern communication and transport technologies have enhanced the tradability of services, leading to their incorporation into supply chains as traded inputs and bundling into composite products, such as “business functions.” Kommerkollegium (2013), based on evidence from the Organisation for Economic Co-operation and Development, identifies the business services sector as a good example of the fragmentation of production, with an important role for enabling GVCs in goods and services. Second, services tasks are important for upgrading and moving up the value chain. Saez et al. (2014) and Taglioni and Winkler (2014) show that the complexity and transaction intensity of GVCs require high-quality intermediate inputs, including services inputs, for effective coordination. Maglio et al. (2010), Demirkan et al. (2011), Allee (2008), and Low (2013) complement this approach by considering the role of networks; technology; entrepreneurship; and intangible assets, such as human knowledge, more efficient internal structures and processes, business relationships, trust, or reputation in generating innovation and creating GVCs.

Figure 2.16 Role of Distribution in Value Chains



## Key Actors and Activities

**79. Although the distribution services value chain may differ slightly with respect to the particular food staple in question, there are enough similarities between these products that a “consolidated” value chain can be presented,** as the one in figure 2.16. Actors and institutions involved at each stage of the distribution process include, inter alia, producers, aggregators,

bulkiers, and accumulators, value adders, retailers and franchisers, and consumers. Drawing on the WTO’s definition<sup>26</sup> of distribution services, and based on interviews conducted in the region, anecdotal evidence suggests that the actors and institutions involved at each stage of the distribution process include, inter alia, the following:

### Producers

**80. Producers tend to be households or SMEs.** Most producers choose to farm as a business; however, some households farm for subsistence and sell surplus crops if and when they are available.

Producers sell their crops to: (i) consumers directly at local markets; (ii) informal assemblers or collectors, who on-sell crops to more formal aggregators, wholesalers, or processors; or (iii) cooperatives, community-based organizations, or domestic food supply programs.

Producers also sell to processors such as millers or brewers, wholesale buyers, or other more formal suppliers for domestic and internal consumption. In these cases, producers often operate under the auspices of prearranged contractual arrangements (described in box 2.6), which are formal or informal in nature, and specify the terms and conditions on which crops will be bought.

By eliminating information asymmetries, especially with respect to pricing, as well as other market failures, the contractual arrangements can ensure more efficient market allocation with less waste and better prices for consumers and producers. Importantly, those engaged in contractual arrangements with farmers provide valuable inputs that producers use to plant, grow, and harvest their crops. These include seeds, which can be procured locally or imported from abroad, as well as the fertilizers and pesticides, which are used to grow the crops to maturity. A final input that is often provided in the production of these food staples is the

<sup>26</sup> Providers of distribution services generally fall into four categories: retailers, wholesalers, franchisers, and commission agents. Retailers in the formal and informal sectors sell goods for personal or household consumption. Wholesalers sell merchandise to retailers or other businesses. Franchisers sell specific rights and privileges related to operating a branded business, for example, the right to use a particular retail format or trademark. Finally, commission agents trade on behalf of others in that they sell products that are supplied and usually owned by others to retailers and wholesalers.

availability of farm equipment, including basic tools such as hoes, slashers, and axes, as well as more complex machines such as trucks, tractors, and water pumps. These inputs can come from a variety of providers, including outgrower companies, farmer cooperatives, community-based organizations, agro-dealers, NGOs, government, seed companies, or processors/buyers with a contractual link to the producers.

### **Aggregators, Bulkiers, and Accumulators**

#### **81. Once crops are grown and harvested, they are sold to consumers, informal vendors, local markets, middlepersons, or informal brokers, assemblers, or collectors.**

The latter are small- or large-scale entities that can collect and store crops for a period of time, and who help to market and on-sell crops to larger aggregators and wholesalers (photo 2.1). These “middlepersons” and other traders and brokers can play an important intermediating role by helping to bridge the gap between small farmers in rural and disconnected markets with buyers in other parts of the country and abroad. However, the profit-driven nature of these transactions necessarily drives up the price of the staple crops and increases the gap between producer and consumer prices.

**82. Although most small farmers—particularly those who do not have prearranged contracts—sell their products directly to consumers at local markets, it is also common for them to sell items to more formal third-party suppliers, such as traders or brokers, on a contractual basis.** Likewise, farmers’ cooperative unions may buy directly from

producers. Such arrangements occur with or without previously arranged contracting arrangements, and provide an important intermediating role in distributing crops domestically and internationally (photo 2.2). Typically, cooperatives are formed by a group of members, usually producers, who subsequently store, market, and distribute crops to wholesalers, millers, processors, and retailers. Farmer cooperatives also provide credit to small and mid-size farmers, as well as critical inputs such as seeds, fertilizers, and harvesting equipment, which many small members may not have.

**83. Finally, the public sector may intervene through domestic food supply programs, such as the Ethiopian Grain Trade Enterprise or Ethiopia Commodity Exchange, or international programs such as the World Food Program.** These NGOs help buy, market, and manage strategic reserves, which can ensure food security so that emergency needs are met and the focus is on economic and social development objectives. As necessary, such programs may supply food staples for domestic markets, or look to sell these crops abroad if demand and prices warrant.

*The public sector may intervene through domestic food supply programs*

## Value Adders

**84. Processors and distributors, as well as wholesalers, often buy crops from middlepersons and aggregators, or directly from farmers with whom they have contractual arrangements** (photo 2.3). These entities vary in size, from local village hammermills, to large-scale millers, food processors, breweries, and animal feed manufacturers. Processors play an integral role in transforming raw ingredients into food or other useful products, which can be marketed and sold to consumers. Key activities involve grinding, mincing, milling, macerating, liquefaction, emulsification, cooking, brewing, pickling, pasteurizing, preserving, and canning and packing food products.

**85. Likewise, wholesale companies may add value through processing, packaging, and selling products in bulk, rather than directly to consumers.** Wholesalers, processors, and distributors often work together as channel partners who sell to large and small retailers and, subsequently, to consumers. Contractual arrangements with producers can help these processors and wholesalers to guarantee consistent flow of supplies, proper economies of scale, reduced transactions costs, and standardization of products. Although processors and wholesalers may supply food staples for domestic markets, they also sell to regional or international markets through international exporters and distributors.



## Retailers and Franchisers

**86. Retailers include vendors, local markets, small shops, and kiosks, which operate on a largely informal basis** (photo 2.4). Likewise, retailers often include more formally organized operations, such as medium-size, privately owned retail shops and large supermarket chains, which may be franchises linked to larger wholesalers.

There is significant variability across countries in East Africa. For instance, Ethiopia relies on traditional central markets and small retailers to provide these products. In other countries, such as Kenya, there is the presence of foreign supermarkets and large franchised retailers from other countries in Africa, Europe, or South Asia.

## Consumers

**87. At the end of the supply chain are the individual consumers of these food products** (photo 2.5). Poor households spend a larger proportion of their food budgets on staples in comparison with total food expenditures. End consumers can also include informal foreign consumers, who cross borders to buy crops at

foreign markets, as well as more formal foreign consumers and importers. Finally, international food supply programs, such as the World Food Program can be important international consumers of domestic crops, for onward distribution to institutions such as hospitals, schools, and other public agencies, which provide food to their clients.

### Box 2.6

#### Benefits of Contractual Arrangements

A recent pilot study was conducted by the World Bank's Trade and Competitiveness Global Practice on international value chains related to food staples (maize, sorghum, and cassava) in Ghana, Kenya, and Zambia (World Bank 2016). A key finding was that farmers in these countries often participate in contract schemes managed by agroprocessors, buyers, cooperatives, or community-based organizations, as well as directly with processors and wholesalers. These contracts can be formal or informal, and can

As a result of these contractual arrangements, whereby producers have a prearranged market for their crops, perception surveys have highlighted several benefits for producers, including the following:

- Greater access to technology and inputs, including seeds, fertilizers, irrigation, and harvesting

stipulate various terms of engagement between the producer and buyer, including the following:

- Specific types and quantities of crops to grow
- Guidelines on quality standards that the crops must meet to be purchased
- Price guarantees with respect to various crop categories
- Inputs that producers should use, including seeds and fertilizers
- Extension and post-harvest services, as well as training provided by buyers.
- Larger output volume, higher yields, larger plots, fewer crops lost, and fewer crops consumed
- More transparent and guaranteed pricing in line with current market prices
- Increased sales and greater revenues from crop sales.

## Relational Dynamics

### 88. From the supply chain analysis, several relational dynamics emerge on the roles played by key actors and institutions.

A first key observation is that supply chains for such staple crops are often nonlinear, and instead involve a complex web of vertical and horizontal connections. For instance, farmers may sell products to market vendors (retailers), which are then bought by brokers and resold to processors. Subsequently, suppliers may buy back processed products and resell them to small shop owners, and onward to consumers. The backward and forward linkages mean that there is not one standard path through which staple crops are distributed, and suggest that there are many opportunities for value addition, depending on the end use of the product.

Second, and relatedly, the supply chain presented above suggests that actors often take on multiple roles and value-adding activities may take place across the value chain. For instance, all actors may play a role, however big or small, in storing, processing, packaging, marketing, wholesaling, and retailing products. As such, aggregators are not bound to merely transporting crops, as they may also bundle them and market them to particular buyers and markets. Likewise, brokers and suppliers may also separate, sterilize, sort, and package crops, above and beyond the intermediating function they provide between producers and wholesalers.

A final observation that emerges from the supply chain analysis is that farmers “on contract” with cooperatives, formal suppliers, wholesalers, processors, and large retailers have a greater opportunity for their products to enter formal value chains, whereas those without contracts are less likely to have entry points into national and international value chains. The intuition behind this is that the actors who add the most value to staple crops are formal suppliers, millers, and wholesalers. These actors are often responsible for transforming staple crops into higher value-added goods, such as flour, cornflakes, and snack foods in the case of maize,

or porridge and beer in the case of sorghum. To create such higher value-added products, processors and wholesalers often need crops of a certain quality standard at certain moments in time and, as a result, engage in contractual relationships with producers or other suppliers. By guaranteeing their sourcing via contracts, it is more likely that these higher value-added products can enter regional and international export markets. Conversely, as suggested by the value chain diagram in figure 2.16, it is more likely that producers without contracts will see their crops bought by food supply programs or informal brokers, or sold directly at local markets—making it much less likely that they will join regional and international value chains.



## Case Studies: Dairy, Teff, Sesame, and Textiles



### DAIRY

**89. Ethiopia's dairy production can be broken down into four main systems:** (i) commercial farms, (ii) peri-urban and urban, (iii) rural dairy smallholders, and (iv) pastoral and agro-pastoral.

Commercial farms, which are usually government farms or privatized government farms, and peri-urban and urban producers are located close to population centers. Commercial and peri-urban/urban dairy farmers are the most important for the processing component of the sector, but also sell directly to consumers. Both use more advanced and commercial feed inputs. Commercial farms are also more likely to use more advanced cattle breeds through artificial insemination and employ better animal health practices.

Rural dairy smallholders dominate milk production in Ethiopia, accounting for at least 95 percent of milk production. The greatest portion of rural dairy smallholders are in the Ethiopian highlands, and produce almost exclusively for domestic milk consumption and sale to immediate neighbors. Rural smallholders tend to own between one and five cows. Rural dairy smallholders are too remote and do not have access to cold chain logistics to connect to processors, which tend to locate near population centers. However, excess milk is used for household processing into ghee, butter, and cheese.

Pastoral and agro-pastoral producers are found in most other rural areas, such as the Southern Nations, Nationalities, and Peoples' Region. They depend on moving seasonally to follow natural pasture, and produce for subsistence consumption or sale to immediate neighbors.

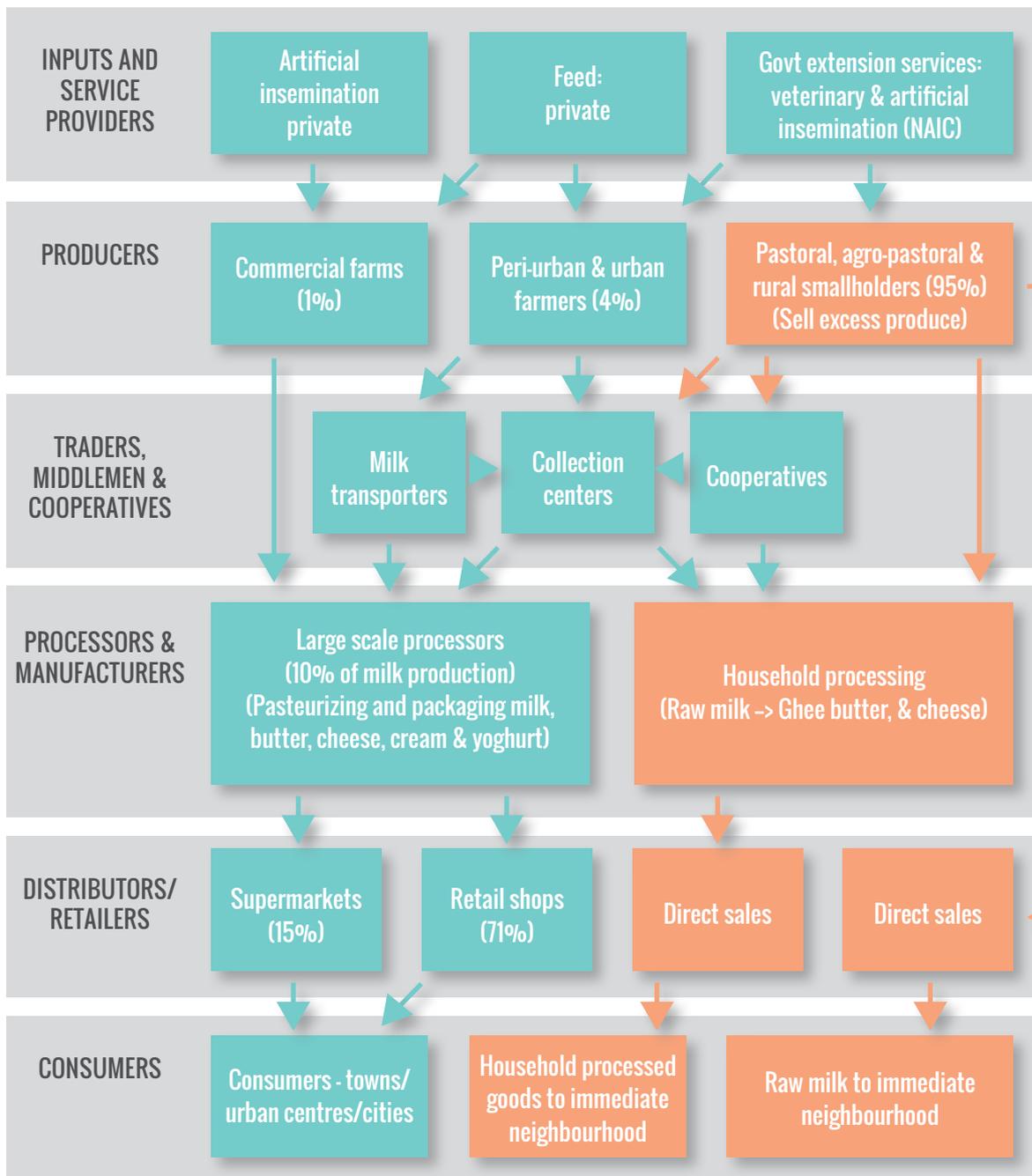
**90. Household processors dominate the dairy market.** There are around 32 processors in Ethiopia, which can be grouped into large processors and household processors. Large processors are very few in number, and include Sebeta Agro-Industry (Mama Dairy), Family Milk,

Etete Milk Processing Company, and Lame/Shola Dairy, which was until recently government owned. Operations tend to be quite vertically integrated, with large processors having their own dairy farms, collection centers, transport, and retail shops, but also combining this with outsourcing

through specialized firms. The sector appears to be of interest to international investors, with Ete Milk recently enjoying a large investment by private equity firm 54 Capital, and Velocity Dairy, a very large proposed Dutch investment almost coming to fruition. There are also several slightly smaller “medium-size” processors, such as the Elemtu

Integrated Milk Industrial Company, which operates similarly, but with smaller operations and tending to be less vertically integrated. Household processing concerns the production of ghee, butter, and cheese, mostly for subsistence purposes, with excesses sold to immediate neighbors. The Ethiopian dairy value chain map is depicted in figure 2.17.

Figure 2.17 Dairy Value Chain



Note Orange squares denote the informal sector, which comprises over 95 percent of the dairy value chain in Ethiopia.

## Producer Challenges in the Dairy Sector

**91. Access to quality feed is a major challenge affecting producers.** The challenges affect rural and pastoral/agro-pastoral, and urban/peri-urban producers differentially.

Pastoral and agro-pastoral smallholders are usually far from main cities and towns. As such, they lack access to commercially marketed feed and rely instead on opportunistic types of self-produced feed. There is a lack of awareness of, and seeds for, high-value fodder crops, such as elephant grass and alfalfa, which are widely used in the East African Community. These rural producers also have limited access to concentrates for feed, due to logistical and price reasons, and lack trust in commercial suppliers.

Urban and peri-urban producers use concentrates and agroindustrial byproduce, such as sugarcane and oilcake, but without sufficient roughage, as they have very limited land resources from which to draw. Without land resources, they cannot sufficiently produce their own feed. Commercial feed is also expensive, and a lack of regulation erodes trust in its quality. Value-added tax is charged on feed, which exacerbates its affordability. Furthermore, there are currently few incentives behind the production of commercial feed, due to the small and disperse geography of dairy producers. Overall, it is estimated that at most 5 percent of dairy producers might use improved feed and concentrates, with at least 90 percent relying on their own self-produced feed.

**92. There is very limited provision of veterinary health services available to rural producers.**

Slightly better provision is available to urban and peri-urban producers. In each case, the quality of drugs and services is poorly regulated. Commercial farms employ better private sector veterinary services. Rural and urban smallholders tend to rely on government veterinary extension services. Artificial insemination (AI) services are of very limited availability and, where they are available, tend to be of poor quality and high cost. AI provision interacts with market failures in the provision of animal health and feed, as farmers will not invest in expensive AI breeds if veterinary services and quality feed are unavailable for livestock. Smallholder farms usually rely on the public provision of AI (National Artificial Insemination Center); medium and larger farmers use private AI providers. There is a risk that the public sector crowds out the development of better private sector AI providers.

**93. The overwhelming majority of milk production relies on low-capacity indigenous**

**breeds.** This contrasts with Kenyan dairy production, which has incorporated higher-yielding animals as somewhat of a colonial legacy. In Ethiopia, about 3-5 percent of livestock are crossbreeds, and six million of 13 million are in Kenya. However, the Ethiopian varieties tend to produce naturally higher-fat milk, facilitating a stronger household processing industry for butter, ghee, and cheese.

**94. The demand-side pull for dairy producers has considerably differential impacts, depending on producer location.**

This is a result of very limited cold chain logistical services for rural producers, and causes two very opposite, but negative, impacts on the sector. Urban and peri-urban producers face excess demand, enabling producers to supply poor quality and adulterated milk, with little incentive for quality upgrading. By contrast, rural smallholder and pastoral producers have very limited access to markets, and as such lack a “pull” market to incentivize production

beyond subsistence consumption and the sale of excess produce to immediate neighbors. Several interviewees highlighted these demand issues, emphasizing that any measures to boost milk production in rural areas must be accompanied by facilitating access to markets for a complementary “pull” incentive. Important here is the lack of cold chain logistics and chilled collection centers. In addition to feed, animal health, and AI interventions, farmers need a market for milk offtake.

**95. The cross-cutting challenge for milk producers is access to affordable inputs, including access to quality feed, veterinary services, and AI services.** To address such challenges, one expert proposed an electronic “voucher” system for buyers and sellers of inputs and outputs to interact. The voucher system has two benefits: (i) it can be used to help connect distributors with buyers, and (ii) it can operate like a savings and credit service, enabling access to products when buyers and sellers are out of cash. Such a system is reportedly being developed by the Agricultural Transformation Agency in Ethiopia for fertilizer, improved seed distribution, and grain output marketing.

#### **Processor Challenges in the Dairy Sector**

**96. The key processor challenges relate to the sufficient sourcing of quality raw milk.**

When asked how they ensure that they always have the quantities and qualities of required raw milk, one processor tellingly answered “impossible.” Processors in Addis Ababa highlight this issue, with quality being among the top challenges. Lamenting this, one processor stated that they had “tried to introduce a premium for quality milk by rejecting substandard milk, but farmers know that if I don’t buy their milk another processor will, so there is little incentive for farmers to improve quality.” Furthermore, traditional household milk consumption tends to be less concerned by adulterated milk, and consumers just boil whatever milk they receive, and as such compound the adverse quality incentives. This traditional sector of the market accounts for 95 percent of the raw milk market.

**97. Quality issues very much interact with, and are explained by, the other processor challenges,** such as farm size, variable demand and supply, adulteration of raw milk, underutilization of dairy inputs, and lack of contractual arrangements between processors and producers and the value of cooperatives.

**98. Farm size is a key constraint in Ethiopia’s dairy sector.** Larger farms are better placed to provide higher quality milk supplies to processors, owing to greater use of quality private sector veterinary services, improved feed, and superior cattle breeds. However, the larger farms in Ethiopia

*Eliminating obstacles to distribution services can link rural producers to markets for inputs, increase sales, and reduce post-harvest and storage losses*

are very limited, accounting for an estimated only 1 percent of total milk production. As a result, processors must augment their sources with milk from medium- and small-scale producers.

**99. Ethiopia's fasting culture presents an unusual dairy challenge.** During fasting days, Orthodox Christians, representing around 45 percent of the Ethiopian population, practice fasting and in doing so avoid the consumption of dairy and meat products. As such, consumer demand for milk oscillates considerably between the fasting and non-fasting seasons. This causes a real challenge for processors, who must modulate their production and sourcing accordingly. In the words of one processor, "I can buy very good quality milk during fasting, but not at all after fasting." Moreover, raw milk production has its own seasonality. Production

is greatest during the rainy seasons, and becomes relatively scarce during the dry seasons. Raw milk prices reportedly rise as much 30 percent during the dry seasons.

**100. The compounding seasonality of production and demand presents a challenge along the value chain (box 2.7).** Processors recognize that producing powdered milk or ultra-high temperature (UHT) processed milk could help to smooth sourcing and demand variability, but first requires higher quality milk supplies as well as new machinery. The quality requirements are deemed "very demanding" and importing the requisite machinery would be prohibitively expensive for most established processors. One processor suggested that less than 10 percent of raw milk meets UHT quality requirements.

### Box 2.7

#### Dairy Fasting and Rainy Seasons in Ethiopia

The main rainy season is from July to September, with a short rainy season in March and April. The main fasts are the Great Lent fast from February 20 to April 15, Fast of the Prophets

from November 25 to January 6, Johan's Fast from February 6 to 9, Apostles Fast from June 5 to July 12, and Assumption of the Virgin Mariam fast from August 7 to 12.

	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec
Rain			■	■			■	■	■			
Fasting		■	■	■		■		■				■

**101. In urban areas, demand for raw milk reportedly exceeds supply in most seasons.** Producers and vendors can sell poor quality milk to processors who have limited alternative supplies. Resultantly, there is reportedly a high level of adulteration in raw milk supplies, as suppliers seek to bulk up their milk with water

and wheat powder. This filters down the value chain, making it more difficult for processors to meet milk quality standards.

**102. Better contractual arrangements between farmers and processors, including support for input services, was identified**

**as a means for improving quality.** Most dairy farmers underutilize input services and products such as feed, AI, and veterinary services for animal health. This cascades down the value chain to affect the quality of the milk obtained by processors. Usually large processors are not involved in the provision of services. Their arrangement is just to buy milk and they prefer to specialize only in their own area of processing. Useful lessons can be learned from the Kenyan franchising arrangements in which improvements to different parts of the value chain, such as input suppliers, can be achieved through the franchising of successful businesses. Franchising has enabled successful business models, including those of input suppliers, to expand their good business methods and practices across Kenya. Although this could be encouraged in Ethiopia, it would depend on successful businesses desiring to operate a franchising model.

**103. Cooperatives were identified as being much better in supplying services, such as feed and veterinary drugs, to farmers.** A processor who highlighted that cooperatives are better at supplying services indicated that he did not fully understand why cooperatives were not utilized more broadly in Ethiopia, but indicated that he prefers, where possible, to work through cooperatives to ensure that his farmers have access to feed and veterinary drugs, as this helps him achieve higher quality milk inputs.

**104. Processors additionally face more general, cross-cutting business environment challenges.** These include electrical supply variability, in which fluctuating voltage and cutoffs can damage equipment, lose time, and add to generator expenses. Water supply intermittency is another source of frustration. High import duties add expenses for inputs that cannot be sourced locally, including packaging, yogurt machines, specialized packaging ink, flavorings, and spare parts. Access to foreign currency for



## Access to foreign currency for imports remains a top concern

imports remains a top concern—processors sometimes have to wait six months for dollars.

**105. Beyond this, there also appears to be a challenge with policy coordination.** The government maintains a large footprint in different parts of the industry, although it has been privatizing operations in the past decade, including Mama Dairy, the largest milk processor, and several commercial farms. There is a need for more coordination between the government and processors during the formation of dairy sector policy.

**106. Any interventions that aim to improve dairy production in rural areas must be accompanied by strategies to link rural producers to markets for inputs and the sale of raw milk.** This would also support processors in accessing better quality raw milk supplies. Assisting processors to make UHT and powdered milk could help smooth the demand and supply fluctuations associated with the rainy seasons and fasting periods. However, this is unlikely to happen until quality issues can be resolved. UHT and powdered milk also have greater potential for regional exports in the Horn of Africa.

## **Dairy: Conclusion and Recommendations**

**107. The single greatest challenge for dairy in Ethiopia is channeling milk production into commercial markets.** Rural and pastoral milk production, which accounts for over 95 percent of total milk production, is delinked from markets for selling produce and purchasing inputs. As such, there is little market “pull” for producers to increase the quantity and quality of production. This is compounded by the absence of cold chain logistical services and transport infrastructure. There is limited access to dairy production inputs, such as feed, artificial insemination services, and veterinary services. This is somewhat of a collective action failure, as farmers will not invest in expensive artificial insemination cattle breeds without the market to export their produce or inputs to support these breeds.

**108. The principal challenge faced by processors is reportedly in sourcing quality milk supplies.** Large commercial farms produce milk of good quality; however, processors must also rely on urban and peri-urban producers who are less able to meet quality requirements. Since there is reportedly excess demand for raw milk near population centers, such producers have little incentive to improve quality. Milk tends to become adulterated up the value chain, as the household market for raw milk is less averse to poorer quality, and urban producers have little incentive to improve quality. Issues with quality are compounded by the seasonality of milk production and demand: production increases in the rainy seasons and demand fluctuates with fasting periods. Finally, processors also face general business environment challenges, including access to foreign currency, high import tariffs, electricity and water supply variability, and lack of consultations during policy formation. Nevertheless, the sector appears to be attracting international investors, who seem more interested in expanding their own extension services to producers. The sector has been characterized by excessive government ownership in the past,

but privatization of processing and farming operations has occurred in the past decade. The government remains involved in the inputs section of the value chain.

**109. International investors in the dairy sector seem, ostensibly, cognizant of the upstream challenges and the benefits of addressing the market failures.** One international investor is setting up contractual arrangements for cooperatives to access quality feed and veterinary services, to be paid back upon delivery of milk. Within this program, the investor also aims to purchase a chilled tanker for collecting milk and provide educational services.

**110. Several processors recognized the potential for dairy exports within the Horn of Africa, and in particular Somalia, South Sudan, and Djibouti.** This would only be possible with the production of UHT or powdered milk in Ethiopia, and remains a way off. Kenya is also a highly competitive regional competitor. UHT requires higher quality milk supplies, which are largely unavailable in Ethiopia due to the poor provision of upstream dairy inputs, including feed quality, veterinary services, and animal health, alongside midstream transportation issues and the prevalence of milk adulteration risks before supplies reach processors. The current value chain lacks incentives for the improvement of quality: there are no premiums between different qualities of milk and no milk quality checks. This derives from limited supplies in urban areas, where processors are located, making processors “quality takers.” As such, dairy demand in Somalia is met with exports in dairy livestock directly. This contrasts with the successful development of a regional dairy market in the East African Community. Here, dairy products are traded between Kenya, Uganda, Rwanda, Tanzania, and Burundi. Within this context, Uganda, for example, has increased its East African Community dairy exports from negligible amounts in 2006 to more than US\$15 million in 2014.



**111. The Ethiopian government favors a private sector-led transformation of the dairy sector, by introducing international investments and opening up investment opportunities.** It would be useful to engage in

policy collaboration between the public and private sectors for better dissemination of the Ethiopian Livestock Master Plan, which determines a clear direction for collaboration between the public and private sectors and discusses investment plans.



## TEFF

**112. Teff, the main ingredient for injera, the daily staple food for more 50 million Ethiopians, is of vast importance for the consumption as well as production sides.** Teff is important for food security across the country, as well as for the livelihoods of many smallholder farmers. In Ethiopia, 6.3 million smallholder farmers use 20 percent of the cultivated area (2.7 million hectares in the country) to produce teff (Minten et al. 2013a). These farmers can be found across the country, in all its ecological zones. The market is highly fragmented, with many smallholder farmers, several layers of

traders, many processors, and a large, mostly urban population as the consumer market.

**113. An important feature of teff is the different quality types that are produced: traditionally, the distinction has been made between red, mixed, and white.** Red is of the lowest quality, and white teff is of the highest quality. More recently, an additional distinction has been introduced: magna teff (“super white”), which is of even higher quality than white teff (Minten et al. 2013a). The supply chain for teff in Ethiopia is depicted in figure 2.18.

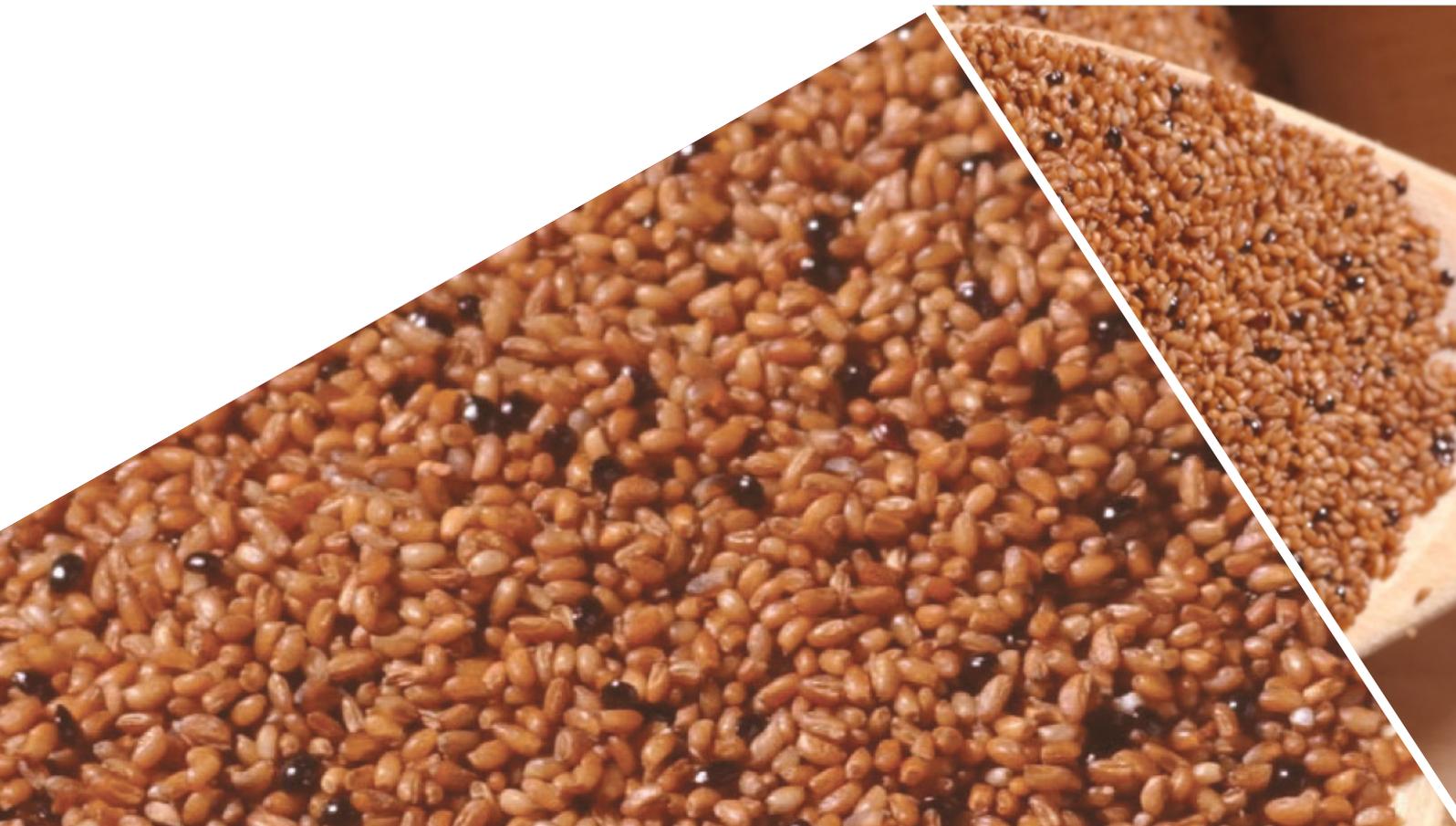
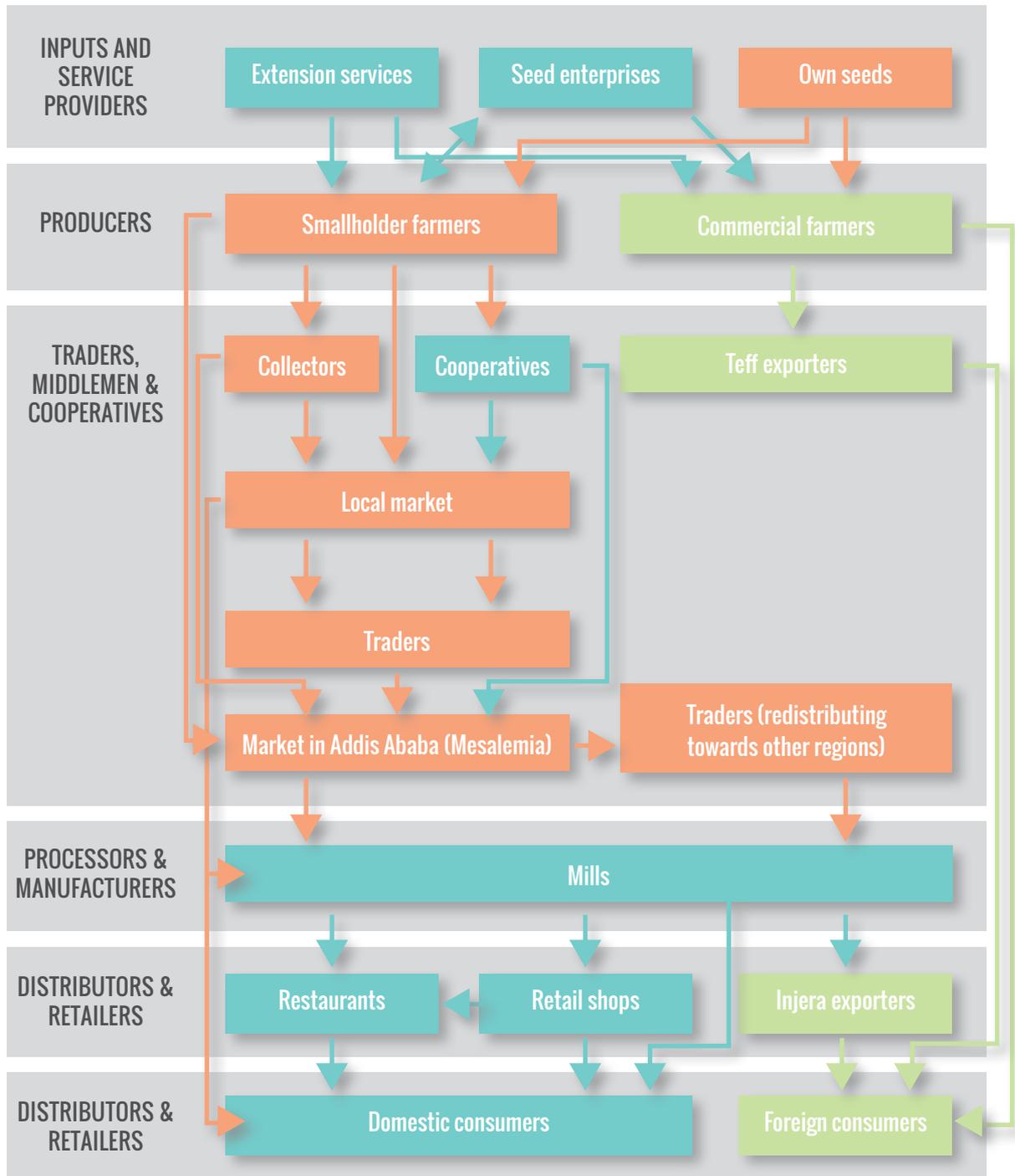


Figure 2.18 Supply Chain of Teff in Ethiopia



## Inputs

### **The smallholders who produce teff have access to several inputs, most importantly seeds and fertilizer.**

In addition, several extension services are available. As reported by Minten et al. (2013a), the use of modern inputs (improved seeds, chemical fertilizer, herbicides, and pesticides) has increased significantly over the past decade.

Although some farmers use the best seeds from their previous harvest, some of the interviewed farmers indicated that they buy seeds from commercial seed companies. If a farmer decides to get seeds from a commercial seed company, the farmer is obliged to sell all the harvested teff back to the company.

## Producers

### **Teff is predominantly produced by smallholder farmers (6.3 million throughout the country; Minten et al. 2013a).**

Many of these farmers own some land and often rent additional land. They use injera as their main dish (for breakfast, lunch, and dinner) and therefore a significant part of the harvest is not sold (for most of the interviewed farmers, self-

consumption of teff is in the range of 10 to 30 percent).<sup>27</sup>

In addition, the Agricultural Transformation Agency has granted 48 commercial farmers licenses to grow teff, with a goal to export it (Secorun 2016). However, this project is still in a pilot phase and therefore not expected to affect the teff market in the near future.

## Trade

### **Before teff reaches its destination at processing mills, several layers of traders, middlepersons, and cooperatives form a key component of the teff supply chain.**

Farmers have essentially three channels through which they can sell their teff: directly at a local market, to collectors/traders, or through a cooperative.<sup>28</sup> In many cases, there is a collector who buys teff directly from a farmer at the farm. This collector sells to a larger aggregator, who in turn sells to another aggregator. This process might be repeated several times before it reaches the local market. Many consumers or processors (mills) buy

their teff directly from the local market. However, some traders buy from the local market (or from farmers directly) to transport it to a larger urban center, in particular Mesalemia market in Addis Ababa. This is the key distribution center for teff in the capital city. Every day, trucks full of teff arrive and the teff is sold to traders at Mesalemia. Over the past year in particular, some redistribution toward other regions has occurred: in that case, private agents or government agencies buy full trucks of teff that can be brought to other regions. Government agencies use this strategy to address the emergency in several regions.

<sup>27</sup> Minten et al. (2013b) find that for a sample of 1,200 farmers the average self-consumption of teff is 64 percent, possibly indicating that the farmers we spoke with sell relatively a lot of their production.

<sup>28</sup> This excludes a possible fourth channel: selling back to commercial seed enterprises in case they bought seeds from such a company.

## Processing

### **To process teff for injera production, it needs to be grinded at a mill.**

Many small mills exist, mostly in urban areas. These mills provide a service and grind the teff bought by consumers or buy teff directly and sell the grinded teff. The major challenge for mills concerns electricity: the high cost for the electricity input “socket” that

is required for the machinery,<sup>29</sup> lack of a steady supply of electricity, and high cost of electricity. However, although such concerns might lower competition over time, from observation and other research (Minten et al., 2013), we can conclude that there has been an increase in the number of mills and competition is therefore growing.

## Distributors

### **Many consumers buy their teff directly from mills and bake injera at home.**

However, there is an increasing demand for ready-made injera. This injera is sold in certain

cereal shops. In addition, major clients are restaurants that buy teff from mills or injera from cereal shops. Finally, a handful of injera exporters sell to several European and American markets.

## Consumers

### **Nearly all injera in Ethiopia is consumed domestically.**

Since the government banned teff exports a few years ago, there are almost no exports. Although there are some

legal exports to Israel (for its Ethiopian Jewish population), there are also some informal exports, especially to Eritrea, Sudan, and the Republic of Yemen.

## Key Challenges in the Supply Chain for Teff

### **114. The key challenge in the teff supply chain is increasing the usage of modern inputs, especially improved seeds.**

Although important progress has been achieved in increasing the usage of fertilizer, herbicides, pesticides, and improved seeds, a lot remains to be done. Interviews with farmers indicate clearly that the quality of seeds is key for a farmer’s market power, in qualitative and quantitative terms. As described by Minten et al. (2013c), a

clear demand among farmers for improved seeds is present: only three years after the introduction of the new quncho seed, almost a third of their sample was already using this type of teff seeds. Although there seems to be a clear demand, there has been little investment in improved seed varieties: only around 20 varieties have been introduced since the 1950s (Fufa et al. 2011). In addition, consumers’ increased demand for higher quality teff further underscores the importance of enabling farmers to satisfy this demand.

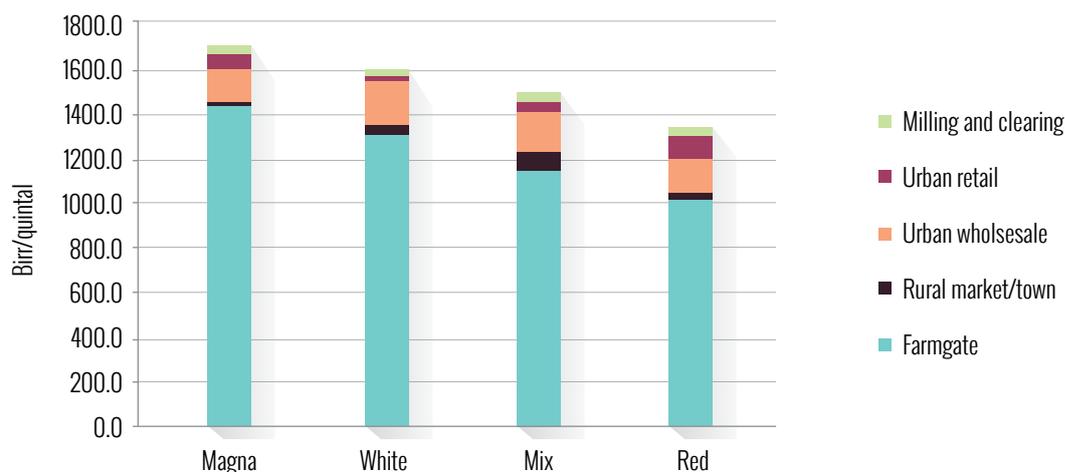
<sup>29</sup> Some of the mill owners whom we interviewed indicated that such an input socket can cost in the range of Br 200,000 to Br 250,000 (±US\$8,500 to ±US\$11,000). In addition, it can take several years before the socket is installed.

## Beyond this key challenge, several issues are specific to the distribution services:

**115. High fragmentation and many layers of collectors and traders.** Is there a potential role for cooperatives? Many layers are present between the smallholder farmers who produce and the mills that process teff. Although intermediary agents play a key role in distribution, they also take a markup. Many argue that cooperatives could play a key role in reducing the number of layers in distribution, but this needs to be carefully considered with the evidence at hand. Some argue that the number of layers is not so high (Minten et al. 2013b). In addition, the markup is relatively

small compared with the farmgate price, as can be seen in figure 2.19. Across the different qualities of teff, the markup range is roughly 16 to 24 percent of the final price. This seems to be confirmed by our interviews: many of the farmers do not feel that there are too many layers between them and the market.<sup>30</sup> Although our evidence is anecdotal, the farmers and mill owners indicated a similar price structure.<sup>31</sup> In addition, the number of layers has been decreasing over time, which shows that cooperatives are not necessarily needed to reduce the number of layers.

**Figure 2.19** Teff Price Structure, by Quality, October to November 2012



Source: Minten et al. 2013b.

**116. Cooperatives can help farmers smooth across time.** Many farmers indicated that the key difficulty for them is to sell their harvest as late

as possible. Most teff is harvested in December, and prices are high between June and September, especially toward September when seeds are in

<sup>30</sup> Of course, many indicated that they would like to a larger share of the market price, but a feeling of unfairness does not exist among the interviewed farmers.

<sup>31</sup> The price range for farmers depends significantly on the time sold and the quality of the teff. The interviewed farmers around Debre Zeit, who generally sell high-quality teff, indicated a price in the range of Br 1,670 to Br 2,330 per quintile. The price at mills at the time of the interviews was around Br 2,200 per quintile. The price range of farmers might be slightly exaggerated upward. Taking Br 1,670 as the lowest price for farmers, this still gives a price markup of 24 percent, which is in line with the findings of Minten et al. (2013b).

high demand due to the seeding season. Price differences between December and the period from June to September can be substantial (prices can increase in one year from Br 14 to Br 20 per kilogram). Cooperatives can buy teff from farmers in December for a low price and sell the teff in the summer for a high price, giving farmers an initial advance in December and the additional profit from the summer later. However, implementation of cooperatives is very important. On the one hand, one of the interviewed farmers who was a member of the cooperative was very happy with it. He emphasized the additional profit, as well as the possibility to acquire seeds through the cooperative. On the other hand, other farmers were unaware of cooperatives or did not trust the people who made up the board of the cooperative. Building trust and reputation by having an inclusive approach is therefore very important and is one of the key determinants of whether a cooperative will be successful.

### Teff: Conclusions and Recommendations

**117. The key challenge in the teff supply chain is increasing the usage of modern inputs, especially improved seeds.** Although important progress has been achieved in increasing the usage of fertilizer, herbicides, pesticides, and improved seeds, a lot remains to be done. Interviews with farmers indicate that the quality of seeds is key for a farmer's market power,

in qualitative and quantitative terms. As described by Minten et al. (2013c), a clear demand among farmers for improved seeds is present; however, there has been little investment in improving seed varieties: only around 20 varieties have been introduced since the 1950s (Fufa et al. 2011). In addition, consumers' increased demand for higher quality teff. Two factors are driving a higher demand for better quality. First, part of the population is becoming more prosperous and therefore demanding higher quality teff. Second, this trend is expected to continue, as urbanization will continue and more people will be able to afford higher quality teff. This further underlines the importance of investing in availability and access to improved seed varieties.

### 118. In terms of distribution services in teff value chains, the challenges are twofold:

(i) the many layers of traders point to the potential for cooperatives to integrate vertically the supply chain for the benefit of smallholder farmers, and (ii) cooperatives could also play a role in helping farmers reduce early sales and allow them to get the full price for their produce. However, implementation needs to be very carefully considered: currently many farmers seem to be unaware of the existence of cooperatives. If they are aware of the cooperatives, the farmers sometimes decide not to join, because they do not trust cooperatives based on previous bad experience.



### SESAME

**119. Sesame is a cash crop that serves as an important source of income for many farmers throughout the country and enables the country to receive foreign exchange.** Sesame has been the second source of foreign exchange after coffee. More than 576,000 hectares are used to grow sesame, with most of the production in



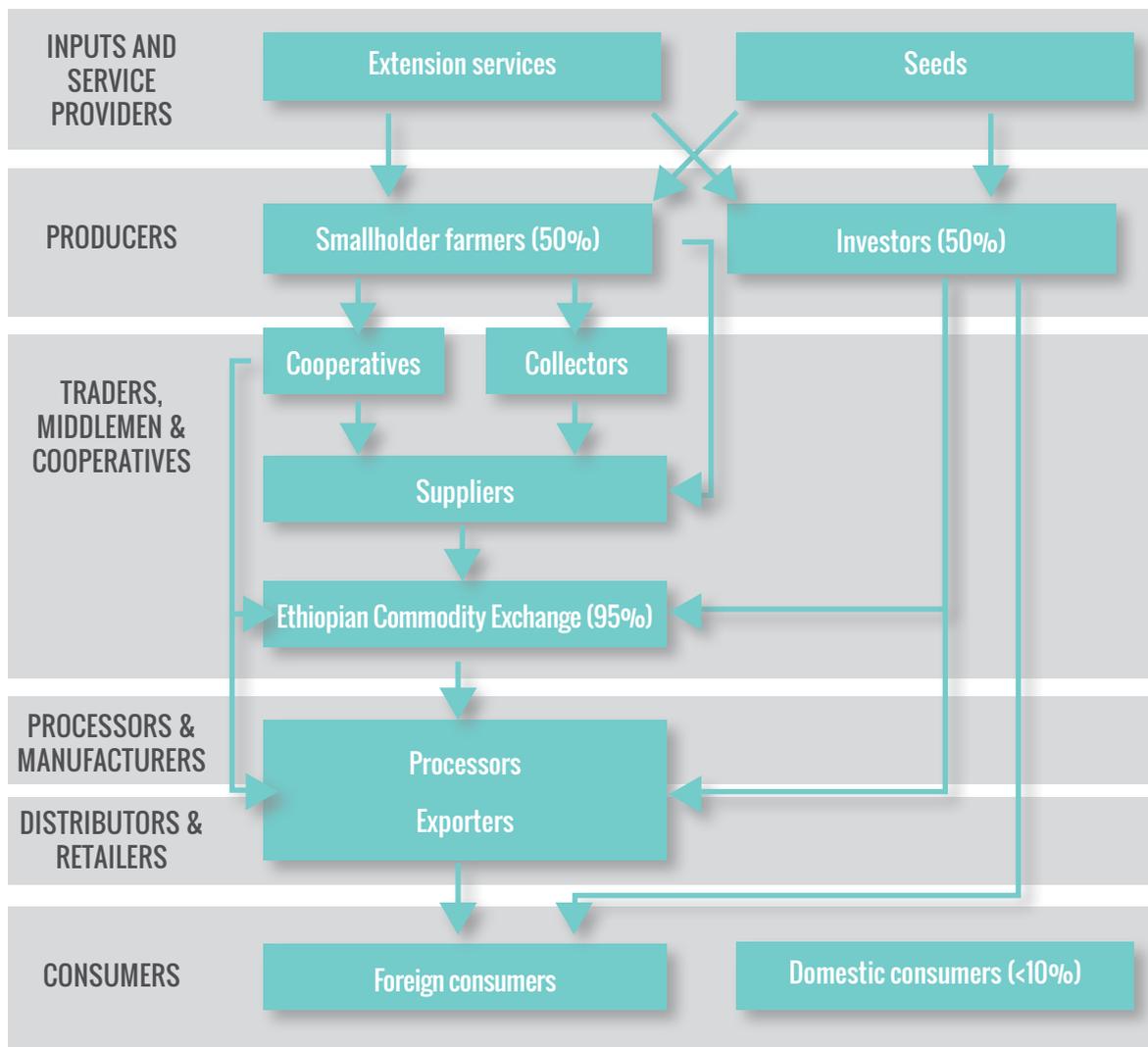
Tigray (41 percent) and Amhara (40 percent), and to a lesser extent in Oromia (10 percent) and Beningshangul-Gumuz (9 percent). More recently, production has started in the Southern Nations, Nationalities, and Peoples' Region and Afar (Ministry of Agriculture et al. 2015).

**120. Different types and qualities of sesame are produced in Ethiopia, each named**

**after the region in which it is produced.**

The best quality is from Humera, characterized by its good aroma, taste, and high oil content. The other common types are the Wollega (which also has a high oil content and is used mainly for crushing) and Gondar types (Ayana 2015).<sup>32</sup> The supply chain for sesame in Ethiopia is depicted in figure 2.20.

**Figure 2.20** Supply Chain of Sesame in Ethiopia



<sup>32</sup> Exporters indicated that these standards are known among importers in the specific markets for Ethiopian sesame. Following a literature review and interviews, it seems that there are no formal international standards concerning sesame: every market demands particular characteristics for optimal processing. For example, since Japanese processors produce high-quality sesame oil, they require high-quality sesame: among other things, they demand a particular color, moisture percentage, and acid value (USAID 2010).

## Inputs

**Sesame farmers have access to several inputs, in particular, seeds and extension services.**

Most seeds are taken from the previous harvest or imported from Sudan. In

terms of modern inputs, the Centre for Development Innovation (2013) notes that there is still a low adoption of fertilizer.

## Producers

**There is roughly a 50-50 split in production between smallholder farmers and investor farmers.**

Since harvesting sesame is a labor-intensive activity and the production occurs in areas that are not densely populated, one of the key challenges

that smallholders face is finding skilled labor for a reasonable price. During the short harvest period, they often have to pay a high premium for labor to be able to harvest all the sesame (Ministry of Agriculture et al. 2015).

## Trade

**Some farmers are organized in cooperatives, but the majority sells their sesame to collectors.**

Collectors aggregate several times and sell it to a supplier. To be able to sell sesame at the Ethiopian Commodity Exchange (ECX), suppliers need to be a member of ECX. These suppliers often have warehouses and bring sesame in bulk to ECX warehouses. At the warehouses, the sesame is cleaned and graded. Most of the investment farmers

supply to ECX or bypass ECX and sell directly to exporters. Although some bypassing occurs, ±95 percent of all sesame is traded through ECX.

ECX is trying to achieve further vertical integration of the supply chain by organizing farmers into farmer cooperatives, but currently only a small group of the farmers are members of a cooperative.

## Processing

**Very little processing is done by firms in the Ethiopian sesame sector.** There are a few, mostly foreign-owned firms that have recently started

processing. For a more elaborate discussion on this, see the subsection on Developments in the Supply Chain.

## Exporters

**Most exporters buy their sesame from ECX and need to be a member of ECX to do so.** Before exporting sesame, these exporters

process the sesame as well to have the produce qualified for exports. This mostly concerns cleaning and packaging.

## Consumers

**Nearly all the Ethiopian sesame is exported (estimates are at least 90 percent).** There is a small domestic

market, but most of the refined oil consumed in Ethiopia is imported, mostly from Southeast Asia (Ayana 2015).

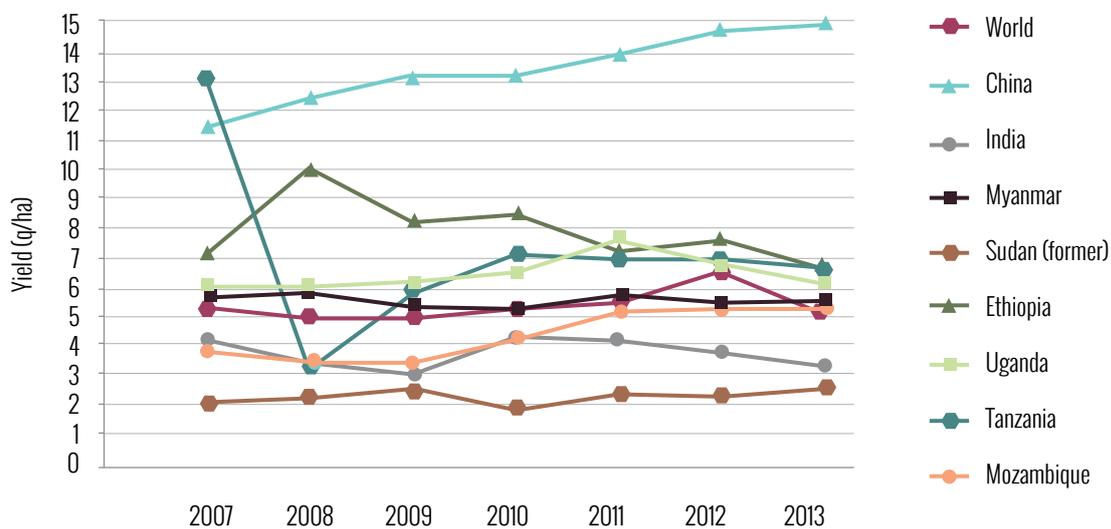
### Key Challenges in the Sesame Supply Chain

Although there is a wide range of challenges in the sesame sector,<sup>33</sup> two stand out:

**121. Relatively low and decreasing sesame yield.** Although sesame yield in Ethiopia is roughly at the global average, two trends stand out. First, China's yield is currently double the yield registered in Ethiopia, indicating that major improvement in yield might be possible. Second,

Ethiopia's yield has been decreasing over the past years, while other (African) competitors have increased their yield and are overtaking or have overtaken Ethiopia (figure 2.21). The challenges underlying the low yield include the lack of skilled labor and the resulting use of unskilled seasonal labor, lack of adoption of seed varieties, as well as soil degradation and increase in diseases and insect pests because of monocropping (Ministry of Agriculture et al. 2015).

Figure 2.21 Yield of Sesame in Major Sesame-Growing Countries, 2007–13



Sources Ministry of Agriculture et al. 2015; FAOSTAT 2015.

### 122. Recent global sesame price volatility and the inability of the Ethiopian sesame sector to adjust compound the sector's challenges.

Throughout conversations with sesame exporters, the most common issue that was raised was the decrease in international sesame prices over the past years and its volatility (box 2.8.). Sesame exporters are currently selling sesame at a loss,

mostly to obtain access to foreign exchange to finance their importing business. Exporters argue that farmers have become used to historically high prices and are not willing to adjust prices down. A failure to do so will eventually lead to exporters quitting the sesame business, further weakening Ethiopia's international trading position in sesame.

<sup>33</sup> For an overview of all the challenges across the supply chain in sesame, see the chapters on "Systemic Bottleneck" chapters in Ministry of Agriculture et al. (2015).

### Box 2.8

#### Ethiopian Sesame Competitiveness through the Eyes of an Exporter

One of the interviewed exporters explained the international sesame pricing issue in the following way: “For one metric ton of sesame, we are currently paying Br 25,000 at ECX. In addition, we pay Br 5,000 for cleaning and

processing costs at ECX, leading to a total price of Br 30,000/metric ton. Thus, the total cost is approximately US\$1,300/metric ton. Since the international sesame price is US\$1,050/metric ton, we lose US\$250 on each metric ton.”

#### Challenges in the Distribution of Sesame

**123. High post-harvest and storage losses.** Post-harvest, over 30 percent of the sesame is lost throughout the marketing process (Centre for Development Innovation 2013). This loss happens during the stacking and threshing, transportation (from and to different warehouses), and storage (due to increases in pest damages). In addition, quality is often affected by handling and storage methods (Ministry of Agriculture et al. 2015). For illustration purposes, in the example in figure B.5, the total loss is approximately 20 percent. With an estimated loss of over 30 percent due to marketing problems, this means that the Ethiopian sesame exporting business would become a profitable business again if the sector could eliminate all the post-harvest and storage losses.

**124. Lack of support for exporters in case of default of foreign buyers.** In an effort to improve price information availability in the sesame supply chain in Ethiopia, ECX publishes the prices of sesame online every day, on 108 physical price screens throughout the country, and through a phone number. Thus, farmers have more accurate knowledge about the price and therefore get more value for their produce. However, some foreign buyers use this improvement in information negatively: they will check the price of

Ethiopian sesame when their shipment arrives and might default on the shipment if the price is much higher than the most recent price. Since shipment takes significant time, this price difference can be substantial. Although the improvement in price information is a major achievement of ECX, it is important that export firms receive legal support from the government to enforce contracts with foreign buyers to counter such problems.

#### Sesame: Conclusions and Recommendations

**125. Some firms, mostly foreign, have started to experiment with processing sesame in Ethiopia.** However, there is much more potential for this and it is key for the sesame sector in Ethiopia to increase value addition domestically and make the industry internationally competitive. Adding significant value is also a major opportunity to obtain more foreign currency. A wide range of processing possibilities are available for sesame: (i) edible oil, (ii) confectionary biscuit and bakery, (iii) tahini, (iv) halva, (v) sesame flour and seed sprouts, and (vi) pharmaceutical ingredients (Ayana 2015). Although some of this processing will lead to only little value addition, some has the potential to double the value of sesame (Ministry of Agriculture et al. 2015). However, it is important that clear quality standards need to be developed, since certain types of

processing require different types of quality. In addition, many firms lack access to finance to start processing activities, which require highly capital-intensive machinery.

**126. Sesame is a key export product for Ethiopia, with over 90 percent exported to countries such as China, Jordan, and Israel.** However, Ethiopian sesame is currently uncompetitive and a rather unprofitable export business. Although Ethiopia has been one of the leading sesame producers and exporters, in recent years, competition has increased, especially from other African countries. Countries like Niger and Togo have gained a significant part of the Chinese sesame market, which might further

threaten the position of Ethiopian exporters. To regain competitiveness, several issues need to be addressed: (i) a wide range of options need to be considered to improve the yield of sesame, which has been decreasing over the past years; (ii) post-harvest and storage losses need to be reduced (if all these losses could be eliminated, sesame exporting would turn into a profitable business again); and (iii) further vertical integration, through cooperatives, has the potential to improve the competitiveness of sesame in the international market. Finally, more recently, some foreign firms have started sesame processing. Retaining value within Ethiopia could be an important venue through which export earnings could be increased significantly.



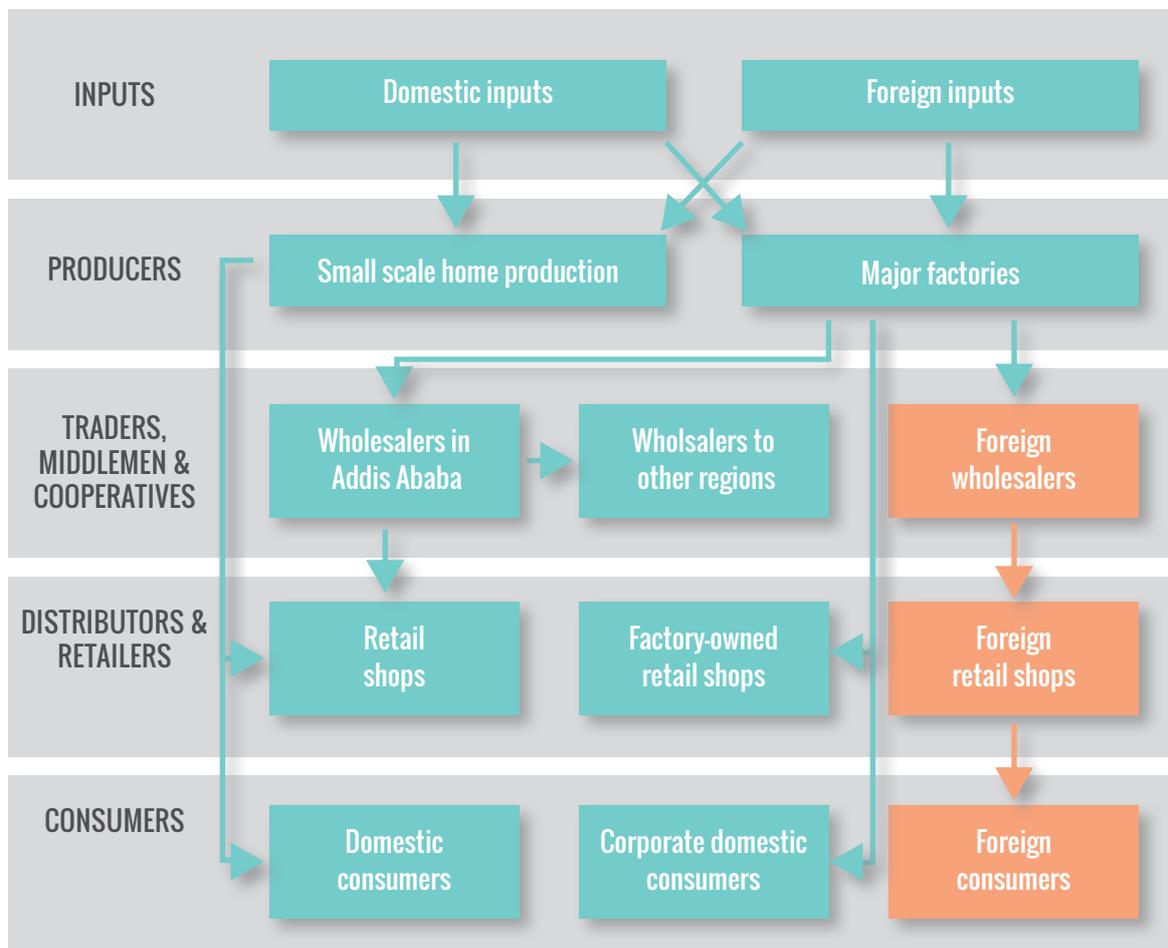
## TEXTILES



**127. Textile production is an upcoming market in Ethiopia with major developments underway.** The construction of large industrial parks has the potential to transform this industry, providing jobs to many

and increasing the availability of foreign exchange (figure 2.22.). However, many domestic firms face stiff competition when entering the international market. They also face significant competition domestically from cheap imported clothing.

Figure 2.22 Supply Chain of Textiles in Ethiopia

**Inputs**

**Although some textile factories use domestic inputs, the vast majority of inputs come from abroad, in particular, from China, India,**

**and Pakistan.** A major problem is the delay in shipment and the quality of these inputs.

**Producers**

**In addition to some small-scale home production (mostly by women), most of the formal production is dominated by tens of textile factories.** These factories

differ significantly in the destination of their products: many of the Ethiopian-owned factories focus on the domestic market, and some of the foreign-owned are more focused on exports.

**Traders**

**Factories generally have wholesalers in Addis Ababa or abroad.** Most of these factories do not own their own retail shop: only the biggest, established firms own retail

shops. Many firms also supply directly to larger corporate firms (for example, other factories that need clothing for their workers). Some of the smaller firms supply directly to retail shops.

Wholesalers in Addis redistribute some of their clothing toward other regions via other wholesalers. This redistribution mostly happens in Merkato.

**Distributors** **Most retail shops are small and can be found anywhere and in any form.** Some of the retail shops in the city center of Addis have a prime location; others in Merkato are small and approach informality.

**Consumers** **Beyond the domestic and foreign consumer markets, factories also produce directly for corporate customers.** The extent to which a factory can export depends strongly on the quality produced.

### Key Challenges in the Supply Chain

**128. International competitiveness is highly affected by the low quality of inputs, the time it takes for inputs to arrive, and the high cost of inputs due to the import tax.** Firms obtain most of their inputs from abroad (China, India, and Pakistan). The key problem is that these inputs are often of low quality, making it difficult for Ethiopian clothing to compete on the international stage. In addition, it often takes several months for these inputs to arrive, due to transport and customs. Although there is little to gain in reducing sea transport time, it is expected that the revived Djibouti Railway will improve land transportation time. However, to make full use of the advantage of the railway improvement, the delays in customs clearance need to be addressed. Since it takes three to four months for inputs to arrive after ordering, firms often have little negotiating power in case the quality is low: they simply have to produce the clothing with the given inputs.

**129. To a certain extent, the high price of inputs is due to the high import tax.** High import taxes reduce the potential for major exports, as Ethiopian textiles will not be able to

become internationally competitive. Reducing or completely removing these import taxes could strengthen the Ethiopian textile industry, by increasing exports and enabling textiles to be a potential source of additional foreign exchange.

**130. Challenges related to finance, infrastructure, and technical knowledge are particularly pronounced in the textile sector.** Although these issues affect many industries, it is important to highlight them, since these are some of the key binding constraints in the textile sector. In terms of finance, many firms fail to obtain loans from private banks or the Development Bank of Ethiopia. If they can obtain such loans, they are at extremely high rates. Although progress has been made in improving technical knowledge, most notably through the expansion of textile technical and vocational education and training and related special degrees at Bahir Dar University, firms still have difficulty finding qualified people at all levels. Infrastructure issues, especially related to electricity, severely affect the ability of factories to produce and deliver orders on time: a failure to do so leads to bad relations with wholesalers, something that could have severe consequences, especially for foreign wholesalers.

### **Challenges in the Distribution of Textiles**

**131. Lack of quality and a perception about low quality lead to distribution issues.** Many firms fail to export because of the failure to adhere to international standards. In addition, some firms might be able to produce high-quality clothing but lack awareness about the international standards for exports.

**132. A missing link is that many firms would like to export but fail to establish contacts with foreign buyers.** Beyond quality, some firms that believe the quality of their clothing meets international standards fail to find international markets. There needs to be more interaction between textile producers and potential foreign buyers. However, to a certain extent, the failure to find international markets might be intertwined with the quality problem.

### **Textiles: Conclusions and Recommendations**

**133. The key development within the textile sector is the development of major industrial parks, such as Hawassa Industrial Park, where major international brands have started or will start operation.** Although many of these industrial parks are government-owned, some have been developed by the private sector. As indicated by Weldesilassie et al. (2017, 123), three industrial parks are currently fully operational, two have finalized construction and are ready for operations, five are under construction, and 11 more are planned. In addition, since the publication of this report, several parks have started operation or are (almost) ready for operation. Firms in these industrial parks have a mandate to produce only for export.

**134. However, the industrial parks are not perceived as an opportunity to support knowledge transfer.** Although the Ethiopian

Textile and Garments and Manufacturing Association has organized knowledge- and experience-sharing events, there has been little cooperation between firms from industrial parks and domestic firms.

**135. Textiles production is expanding rapidly in Ethiopia, mostly due to the active government policy on the opening of several industrial parks.** In domestic production, however, a major quality problem prevents the industry from expanding domestically and abroad. Nearly all inputs are imported, which are often expensive (partially because of a high import tax), of low quality, and arrive after a long period. Since firms have no other options, these expensive, low quality inputs must be used, which drives the firms out of the international market. The resulting low quality of Ethiopian textile products makes it difficult for Ethiopian firms to find a foreign market: the “missing link.” Domestically, this problem perpetuates a low-quality perception, also hampering domestic growth. Although industrial parks, such as Hawassa Industrial Park, are not perceived as a threat to the domestic industry, due to its export-oriented approach, they could provide an opportunity for knowledge and experience sharing.

### **Summary**

**136. These case studies show that although distribution services have an important role to play in each value chain, they are only one part of the story.** Although eliminating obstacles to distribution services can help link rural producers to markets for inputs and the sale of raw milk, or reduce post-harvest and storage losses, binding constraints such as limited access to finance or lack of skills would need to complement reforms in the distribution sector to reduce the prices paid by consumers for these products, facilitate the movement into higher value-added activities (such as cheese or sesame oil), and increase exports.

## 2.4. Recommendations for the Future of Distribution Services

**137. The analysis reveals that services matter for Ethiopia’s economic growth and development, but performance needs to improve for the sector to become truly transformational.** Many modern services remain underdeveloped in Ethiopia. Although the strategic services are excessively controlled (for example, services that are considered to be of strategic importance are allowed to operate only as strict public monopolies—for example, telecom, power,

and air transport—or through limited domestic private ownership—for example, the financial sector), other so-believed wasteful services, such as professional services or health services, are neglected, resulting in almost no policy discourse on the role of the services sector in determining the national competitiveness and limited reform. Traditional services such as distribution services also witness high regulations and prohibit the presence of foreign services suppliers and investment.

**138. The disconnect between the reality on the ground and the ambivalent policy stance arises from various sources.**

First, “services” are treated in isolation and not as part of an interconnected chain of value addition from production to final consumption. Yet, the case studies presented in this report show that since supply chains are a series of linked international markets for goods and services, with policies in one market provoking ripple effects in the markets along the whole value chain (Low 2013), participation in international value chains has important implications for policy interventions. Policy formulation needs to treat goods and services together, as there are significant links between the two sectors. Moreover, such links call for modal neutrality—trade and regulatory policies that enable services firms to provide services through all modes of supply without impeding a switch from one mode of supply to another. Furthermore, regulatory coherence, simplicity, and efficiency need to be maximized to enable countries and firms to become competitive at the task level. Finally, since there has been a recent increase in the importance of value chains organized at the regional, rather than global, level in driving GVC participation and upgrading in a handful of industries (Staritz, Gereffi, and Cattaneo 2011), addressing integration at the regional level is critical.

Second, that many services are now tradable and can be a source of export-led growth and export diversification has not yet been part of the policy discourse—because it is a recent phenomenon and because of the assumption that the comparative advantage of a low-income country like Ethiopia lies in agriculture and labor-intensive manufacturing. Although Ethiopia’s services exports are currently dominated by traditional services, exports of modern services such as communication or business services are beginning to emerge, and their role in export diversification and earnings should not be neglected.

Third, there is a genuine concern among policy makers that the state of regulation and the regulatory capacity of the government are relatively weak to support further liberalization of services. And finally, there is a worry that opening services sectors that operate under a monopoly would lead to declines in revenue and more outflow of foreign exchange in the form of profit repatriation—putting further pressure on the beleaguered exchange rate.

**139. Although wholesale policy reform in services is not feasible, several steps can be taken to increase efficiency and attune services policy to be more supportive of development.** Countries throughout the region are moving toward integrating their services markets, and there may be long-term costs to Ethiopia if left behind in services, with negative consequences for manufacturing and processed agricultural products. Starting with nonstrategic sectors, such as distribution services, could be a

good entry point into the world of services reforms. The case of distribution services can be illustrative of the opportunities for exports and the benefits from greater services openness and the policy reforms and approaches that will be required for these to be realized. This sector can provide the base for a broader discussion of services trade policy reforms. The following list is not exhaustive, but it provides some initial reform guidance for this important sector.

*Raising awareness about the importance of distribution services for the formal and informal sectors* in Ethiopia is an important first step in designing a comprehensive reform strategy that is linked with national development plans. The sector urgently requires a broad development strategy and recognition as a key economic driver to facilitate its growth to the next level. The importance of a formal distribution sector that contributes heavily to economic growth and is currently the second leading (formal) employer has been acknowledged in Ethiopia. Steps must be taken to raise awareness about the importance of the sector in a consistent way on the basis of detailed economic performance analyses and benchmarking exercises, while incorporating the informal sector into the landscape of distribution services. The large size of the informal sector underscores the importance of distribution strategies that can efficiently reach households at the bottom of the income pyramid and integrate small-scale farmers into the distribution system. Economic policies should address the root causes of informality, which can be a significant barrier for foreign operators to enter the distribution market in Ethiopia.

*Taking steps to relax explicit trade barriers, eliminate regulatory obstacles, and address informality issues.* With distribution services closed to foreign participation, Ethiopia remains behind all East African countries and other comparators in removing explicit trade barriers. Box 2.7 provides a summary of experiences with the liberalization of distribution services, which may provide some guidance for possible reform in Ethiopia. Furthermore, the lack of regulation, onerous regulation, and unequal enforcement of regulation pose serious problems to competition and affect formal firms, including foreign operators, in the distribution sector. Reforms should focus on developing the necessary regulatory frameworks for distribution services, including rules and regulations affecting the business environment, eliminating disproportionate entry requirements such as

lengthy registration procedures, multiple licenses, or inadequate zoning regulations. Price controls represent a serious impediment to competition and should be removed.

*Addressing the concerns of the poorest households and facilitating the inclusion of smallholders in modern distribution chains should be a priority in Ethiopia.* The majority of the population and a significant percentage of the income remain at the base of the pyramid. Possible policy actions to meet the needs of the poorest households and expand their access to basic products at affordable prices include the following:

- Facilitate the creation of organized market outlets for small-scale operators, to encourage their graduation from the informal sector.

- Facilitate access to financial services in the informal sector. Several case studies in Africa show that increased access to credit by micro and small enterprises has contributed to the growth in the distribution sector, particularly in the informal segment.

- Provide support to traditional and informal operators to acquire market-relevant skills. For example, training courses focusing on basic hygiene standards, merchandising, sampling, or promotion techniques offered in the slums could improve the skills of retailers in wet markets, kiosk sellers, or hawkers. There are several examples of innovative solutions to localized conditions, relying on consumer behavior and private-public partnerships with commercial potential (see box 2.9 for an example).

- Encourage horizontal coordination—such as farmer associations and cooperatives—to increase the bargaining power of small farmers, allow for economies of scale, and lower marketing and negotiation costs. Given the mixed experience with such associations, a case-by-case approach is warranted that emphasizes soft skills and contextualized management structures.

- Increase the participation of small farmers in modern chains by exploiting the widespread duality between traditional distribution chains and modern procurement systems. Rather than bypassing traditional wholesale systems and increasing the gap between traditional domestic markets and the formal processing sector, encourage the upgrading of traditional wholesale systems to support the interaction between the modern and traditional systems. The focus should be on improving basic safety standards, increasing the traceability of products, and reducing spoilage rates in the traditional markets. This can improve the structure of wholesale markets and enable upstream linkages with producers and downstream linkages with retailers and processors.

*Distribution services can be a good entry point into the world of services reforms*

**Addressing skills issues in the distribution sector.** A strong distribution sector will require local know-how and talent. At first, companies will need to bridge the gap by using a mix of local and international employees. In parallel, investments in developing and retaining local talent are required. Developing local training programs and putting in place apprenticeship opportunities will be critical for achieving long-term success.

**Addressing infrastructure constraints (for example, roads, ports, and so forth).** Steps must be taken to address the infrastructure and insecurity concerns raised by the business community. The removal of nontariff barriers that hamper the imports of distributors should be on the policy agenda of all East African governments.

### Box 2.9

#### Strategies for Reforming Distribution Services

Strategies for reforming distribution services range from full liberalization to a more gradual approach. In many developing countries, reform strategies started by gradually expanding market access to foreign firms. As a first step, foreign distributors are allowed to accommodate customers at the higher end of the market. The second step entails allowing foreign firms to enter the wholesale market. In other countries, domestic retailers dominate the market and foreign suppliers cater to the needs of the high-income percentiles of the population (UNCTAD 2005b).

Countries also attempt to relax restrictions and regulations governing distribution services and foreign direct investment (FDI) to benefit from technological diffusion and raise the efficiency of these services. Developing and developed country experiences show that reforming distribution services concentrates mainly on increasing competition in local markets through the elimination of anti-competitive barriers that affect the performance of distributors in local markets and hinder their expansion. FDI is a major tool that can promote competition

among distribution firms in domestic and international markets. Hence, reform measures should mainly concentrate on reducing the constraints on the establishment of domestic and international firms and their operations (Baily 1993).

Liberalization also means promoting trade in services in line with General Agreement on Trade in Services (GATS) rules and making commitments for more reforms. Several developing countries promote liberalization of trade in distribution services as part of their GATS commitments. Moreover, they commit to fulfilling their commitments gradually over a specified period. Under GATS, World Trade Organization members identified their policies that have a negative impact on distribution services and made specific commitments to eliminate or at least relax some of them, as part of their efforts to promote trade liberalization. Several other restrictions imposed on these services, for specific social objectives, remain outside the scope of GATS. These restrictions include zoning restrictions, licensing requirements, limits on store size and

opening hours, and investment hurdles and other requirements on foreigners wanting to trade in the domestic distribution sector. Ideally, these restrictions would be removed through unilateral reform or tackled as part of regional regulatory cooperation.

Countries usually complement reform efforts with improvements in the business climate and support of small and medium-size

enterprises. Reform measures also concentrate on improving supply chains and logistics that are closely related to distribution services. Moreover, improving logistics, especially those related to agriculture and food products, is one of the priorities of the reform agenda of distribution services in many countries. These reform measures allow consumers to have a wider range of choices of better quality products at much more affordable prices.

**140. Guidance on the implementation of reforms can be provided by an in-depth political economy analysis that looks at structural, institutional, stakeholder, sectoral, and global drivers.**<sup>34</sup> For instance, in the case of distribution services, key institutional drivers relate to the role of informality in the market as well as more formal institutions/regulations. Endemic informality may dis-incentivize SMEs from formalizing, and hence participating in value chains, as they would face high regulatory compliance costs and lose competitive advantage to informal producers.

**141. Stakeholder drivers would encompass the full array of actors and regulators across the value chain, including farmers/producers, wholesalers, retailers, agents, and so forth.** It will be necessary to examine the preferences and interests of various economic actors—such as distribution outlets, farmers, consumers, regulators, and policy makers—and their key role in pushing or shaping the reform process, by shedding some light on the economic opportunities generated by reform and regional integration and the cost of maintaining the status quo. A key stakeholder issue is the limited and asymmetrical information at every stage in the

distribution service supply chain. For instance, small producers who do not operate on contracts often have limited information on weather, crop pricing, or other relevant information. Likewise, distributors are often unable to gather information on their market share and performance, which creates challenges for developing marketing strategies and new products, as well as forecasting and strategic planning. Rent seeking and elite capture may lead to the perpetuation of uncompetitive practices (for example, price controls, domestic ownership requirements, and so forth) that seek to limit foreign firms entering the market, and hence the potential to participate in value chains.

**142. In terms of sectoral drivers, various issues will likely arise across the retail versus wholesale sectors.** Modes of trade can have a large impact on political economy problems that emerge and the types of reforms that are pursued. Moreover, additional sectoral issues may emerge as “countries’ willingness to make commitments in services are often inhibited by the horizontal fragmentation of power either between branches of government (executive vs. legislative) or within them (trade ministries vs. other ministries or agencies), and in some countries the problem is further exacerbated by the vertical fragmentation

<sup>34</sup> See Annex A for details on the political economy analysis.

of power (national governments vs. subnational units of government)” (OECD 2012). Given this dynamic, a critical issue is the difference in the levels of regulations between product categories and sectors. Divergent sectoral regulations (for example, market access, conduct regulations, standards, and so forth) may result in barriers for certain types of products to enter value chains. For instance, food staples (including maize, sugar, and cooking oil) and petroleum products can be subject to price controls at the discretion of the government, whereas the prices of other classes of products are unregulated. Although price controls are designed to prevent wide fluctuations, they can give rise to a variety of problems and perverse consequences. For instance, powerful producers or trade associations may lobby for a certain price control to remain in place, long after its usefulness as a social protection has ended, which may increase producer rents but hurt consumers, particularly the poor, who are highly dependent on food staples. Likewise, some

sectors are subject to greater conduct regulations, such as pharmaceuticals and alcohol producers. Although quality, labeling, packaging, and advertising restrictions may serve a public interest, they may also result in an unfair advantage to these producers in comparison with other products and sectors of the economy.

**143. Several global/international drivers can have a particular impact on the domestic political economy of distribution services, including** (i) foreign investment, which can provide evidence on the intentions and interests of external investors and firms—especially those facing external competition—which affect how they lobby governments; (ii) international legal measures and sanctions, which can impact trade, financial, and travel restrictions; (iii) reputational pressures on stakeholders, which can relate to the influence that international organizations, Regional Economic Communities, or international business groups have on trade in distribution services; and (iv) external skills and ideas, which relate to international practices and ideologies on doing business.

**144. Taken together, these drivers can provide a useful framework to conceptualize the political economy of distribution services reform and help identify feasible measures with the greatest benefits.**



# Problem-Driven Political Economy Analysis

Annex

# A



**Building on the regulatory analysis on distribution services, this annex addresses the larger political economy of reform in the sector.** Although there are many political economy methodologies available, a particularly useful framework is offered by using a “problem-driven” governance and political economy approach, developed by the World Bank (Fritz et al. 2009) (box C.1). At the core of this approach is a focus on a particular problem, opportunity, or vulnerability that needs to be addressed. Such a methodology allows for a better understanding of specific issues and challenges, rather than developing broad overviews, to generate useful findings and implications (Fritz et al. 2009).

**A problem-driven approach can be especially useful in understanding the**

**underlying political economy determinants and constraints to the distribution services sector.** Given the nature of the sector and the potential transformative effects it can have on the regional and national economies of the member states, it is essential to tease out the key drivers that contribute to the development, regulation, and future prospects of distribution services. Accordingly, this analysis is not about identifying one major bottleneck, but rather understanding the political economy decisions of a myriad of challenges and frictions, and perhaps suggesting which dimensions could be addressed. Such an approach will provide insight not only into challenges that result in necessary reforms not gaining traction, but also into potential opportunities that may unlock key road blocks in the reform process.

#### Box A.1

##### Distribution Services Political Economy Conceptual Framework<sup>35</sup>

- *Structural drivers.* Structural drivers are factors that are beyond the control of the government and reflect deeper features of the respective countries, such as resource endowments, geographic position, levels of development, or population dynamics, which may affect a country’s institutional setup. Such issues may additionally stem from the types of colonialization and decolonialization that a country experienced, as well as other historical processes that have shaped the political, social, and cultural institutions that affect actors’ incentives. In many cases, these issues cannot be changed in the short-to-medium run, and define a country’s status quo situation. At the same time, structural issues can have a large impact on the opportunities that a country has with respect to its bargaining position, as well as with respect to the exogenous risk that it faces in a global system. For example, structural issues may make an economy more exposed to commodity price shocks, currency fluctuations, or other macroeconomic fragilities.

<sup>35</sup> This political economy framework for conceptualizing trade in distribution services is based on governance, regional integration, trade, and political economy literature: • Problem-Driven Governance and Political Economy Analysis (Fritz, Kaiser, & Levy, 2009); • Arguing a Political Economy Approach to Regional Integration (Byiers, Vanheukelom, & de Roquefeuil (2013); International Drivers of Corruption: A Tool for Analysis (OECD 2012)

- Institutional drivers.* Institutional drivers, which can be seen as the “rules of the game,” are a combination of the formal laws and regulations, as well as less formalized customs and institutions. Understanding the formal and informal institutions is essential, as they provide a clearer picture about the context in which actors operate, but also identify “levers of change” in existing systems. At the institutional level, mapping can be a valuable instrument in understanding structural political economy factors. Such an exercise includes analysis of informal institutions, such as kinship structures, traditions, and social norms, as well as formally codified institutions, such as laws, regulations, and agencies. Importantly, as noted by Fritz et al. (2009), it is necessary to understand the relationship between formal and informal institutions and ascertain whether they have complementary, accommodating, substituting, or competing relationships.
- Stakeholder drivers.* Actor/stakeholder drivers involve analyzing the divergent interests of government agencies, political parties, nongovernmental organizations, business associations, traditional associations, and producers and traders of certain products, as well as external actors such as donors, foreign investors, and international organizations. At the stakeholder level, mapping can provide vital information on the various types of parties involved—whether they are individuals or specific groups, such as government officials of a ministry, agency, civil society organization, business association, or political party. Once key stakeholders are identified, the problem-driven literature suggests that they can be categorized in several ways to understand their interests as demand-side versus supply-side actors, reform champions versus reform opponents, or winners versus losers from certain reforms.
- Sectoral drivers.* As noted by Byiers et al. (2013), a sectoral approach is necessary for several reasons. First, different sectors have differing levels of political salience and visibility at the national level and, accordingly, will incentivize politicians or service providers in different ways. Second, depending on information asymmetries, more visible policies make it easier to attribute credit or blame. Third, the balance of power between policy makers and other actors is important, as monopoly services can reduce state incentives for oversight and improved performance. Last, sector services that are frequent, predictable, or area-based may make it easier for citizens or other groups to mobilize collectively (Byiers et al. 2013, 12).

- *Global drivers.* Certain global dynamics or processes may shape domestic institutional and political incentives, which may have positive or negative impacts on domestic institutions and governance arrangements (Byiers et al. 2013, 12). In particular, the Organisation for Economic Co-operation and Development approaches these drivers based on the effects they have on corruption and governance at the state level. These effects could include (i) sources of rents and unearned incomes, (ii) opportunities and constraints to conceal and move illicit assets, (iii) foreign investment, (iv) global and regional security threats and responses, (v) international legal measures and sanctions against domestic elites, (vi) reputation pressures on political elites from regional and international actors, and (vii) external ideas and skills (OECD 2012). Importantly, these issues should take into account not only current exigencies, but also their potential to affect governance in the future.

**Taken together, the drivers present a unique and customized framework to conceptualize the political economy issues of distribution services.** The conceptual framework addresses a range of governance, trade, regional integration, and political economy concepts.

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