Chapter 8

External Sector:
Balance of Payments and Foreign Trade

Over the past three decades, the economies of the developed and the developing nations have become more and more dependent upon each other as sources of supply. The benefits of international trade are enjoyed by all the participants whenever international trade is practiced fairly between nations far from any political domination.

According to Adam Smith [1776], *"between whatever places foreign trade is carried on, it drives two distinct benefits from it. It carries out the surplus part of the produce of their land and labour for which there is no demand among them, and brings back in return for it something else for which there is a demand. It gives a value to their superfluities, by exchanging them for something else, which may satisfy a part of their wants and increase their employments".*

International trade is a must for the development of underdeveloped economies. It is more necessary during the initial stages of development. Developmental imports such as machinery and equipment, which cannot be produced at home, are essential in order to create new productive capacity in the economy or to expand an existing capacity. Maintenance imports, such as raw materials and intermediate goods are also necessary in order to utilize properly the capacity created in the economy. Beside these imports, a developing country is also required to import essential consumer goods which are in short supply at home in the initial period of development.

Foreign trade contributes to economic development in a number of ways, they are:

First: The primary function of foreign trade is to explore means for procuring imports of capital goods, without which no process of development can start.

Second: It is a means of price stability. The demand-supply imbalances, which are likely to be severe in the initial stages of growth, can conveniently be connected through the mechanism of foreign trade.

Thirdly: Foreign trade generates pressures for dynamic change through:
-Competitive pressure from imports
-Pressure of competing for export markets
-A better allocation of resources

Fourthly: Exports allow fuller utilization of capacity, increased exploitation of economies of scale and separation of production patterns from domestic demand.

So far, in the earlier chapters, we focused largely on issues and policies relating to the domestic economy. This has involved the analysis of fiscal and monetary policies and measures; and their impact upon the performance of the national economy. Here, the present chapter examines the role of the external sector in Eritrea's economy during the post-independence era [1992 – 2000] by discussing the following issues:

8.1 Balance of Payments
8.2 Eritrea's Foreign Trade
8.3 Foreign Trade Estimates and Elasticities

8.1 Balance of Payments in Eritrea

Though there is a great tendency to view the balance of payments only as a relation between country's credits and a debit in the international account, in essence, balance of payments is also a reflection of the relation between the aggregate real income and the aggregate real expenditure of the economy. Interpreted in this way, balance of payments deficit is an excess of aggregate expenditure over aggregate income in the economy [Joshi, 1991].

This interpretation of the balance of payments helps to focus attention on the basic and fundamental issues of a persistent disequilibrium on the external account of many developing economies. Hence, this approach also helps in analyzing the viability of the external economy in a country.

The balance of international payments statement is a principal tool for the analysis of the monetary aspects of international trade. In its simplest meaning, the balance of payments may be defined as a statement of all the financial transactions and dealings of a country with the rest of the world.

a. The Structure

Eritrea's balance of payments consists of four major entries:

i. Current Account
ii. Capital Account
iii. Net Official Transfers
iv. Net Errors and Omissions

i. The Current Account

The current account is further split into four parts:

- Trade Balance
- Services Balance
- Net Income
- Net Private Transfers

ii. Capital Account

The capital account presents transfers of money and other capital items and changes in the country's foreign assets and liabilities resulting from the transactions recorded in the current account.

Capital is moved from one country to another in the hope of making a profit, whether it is from higher interest rates in one country or because of expected changes in the exchange rate in another country. The movement of capital from one country to another can be in two forms: short-term money flows and long-term money flows. Short-term money flows is sometimes described as hot money or speculative money. Long term money flows are mainly associated with long-term savings and investment. Foreign companies may choose to invest in a country by building a new factory or by widening its share portfolio by investing in its stock exchange market.

iii. Net Official Finance

The official finance is an entry in the balance of payments made up of net changes in a country's reserves, net transactions with the International Monetary Fund [IMF] and other monetary authorities, and foreign currency borrowing.

The official financing reflects the accommodating transactions needed to cover an overall surplus or deficit in the rest of the accounts and thereby ensures that they always balance in the account scene. However, when there is a negative balance, official financing has to be covered by the government by drawing on the reserves or by borrowing from the IMF or the other financial sources. While on the other hand, when there is a positive balance for official financing, the government can build up its reserves or pay off its loans [Daintith, 1983].

iv. Net Errors and Omissions

As a result of the adoption of double-entry recording system, the sum of all credit entries should, in principle, be exactly equal to the sum of debit entries for a given period. But, in practice as different sources are used for recording different transactions, some transactions are not measured accurately [errors], while others may not be measured at all [omission]. Therefore, equality between the sum of the credit and debit entries is brought about by the inclusion of a balancing item, which reflects net errors and omissions [RBI, 1987].

b. Composition and Growth

A proper study relating to the trends in Eritrea's BOP should trace the trends in the overall balance as well as the components of the BOP. Table: 1, 2 and 3 provide the data on Eritrea's BOP in money terms, as percentage to GDP and annual percentage change respectively. Chart: 1 presents a graphical view of the trends in Eritrea's BOP for the period 1992 to 2000. The study of Eritrea's experience with its BOP from these Tables reveals the following observations:

i. Since its independence, Eritrea has been facing pressures on balance of payments from time to time. Except for the years 1993, 1994 and 1997 when the overall balance was in surplus [707, 522 and 525 million Nak'fa respectively]; Eritrea's

BOP has seen a continuous deficit. The overall deficit increased from –388 million Nak'fa in 1995 to –786 million Nak'fa in the year 2000.

As percentage of GDP, the overall deficit has fallen from 30.1 percent in 1992 to 12.9 percent in the year 2000. The annual percentage change in the overall balance has shown high fluctuations within short intervals.

ii. The overall deficit has been mainly caused by the deficits on current account. In 1993 and 1994, Eritrea enjoyed a surplus in current account to the tune of 173 and 186 million Nak'fa respectively. Apart from these two years, the rest of the years have seen a continuous deficit on the current account. Deficit on current account significantly increased from –113 million Nak'fa in 1992 to –1393 million Nakfa in the year 2000.

As a percentage of GDP, the deficit on current account increased from 5.6 percent in 1992 to 22.8 percent in the year 2000.

iii. The capital account of the BOP has exhibited a continuous surplus throughout 1992 to 2000. It increased from 74 million Nak'fa in 1992 to 604 million Nak'fa in the year 2000. As percentage of GDP, it increased from 3.7 percent to 9.9 percent during the same period.

iv. Net official transfers have significantly increased from 154 million Nak'fa in 1992 to 606 million Nak'fa in the year 2000. As percentage of GDP it has remained in the range 7.7 percent to 14.5 percent throughout 1992 to 2000.

v. The size of errors and omissions has been very high. In general it has shown a rising trend with a steep falls in frequent intervals. Huge errors and omissions indicate the inefficiency and neglect of the concerned authority in preparing the BOP.

c. *Balance of Payments in the Initial Stages of Development*

It is important to note that from the economic point of view, generally the balance of payments must balance.

Eritrea is an infant country in its initial stages of development. The huge deficits on its balance of payment are caused by deficits on current account, which is an ultimate result of continuously growing imports of consumer goods.

Indeed it is a usual phenomenon for Eritrea to have serious difficulties in its balance of payments during the initial stages of development. Almost all countries had passed through this experience during their initial stages of development. This is because; in the initial stages of development the conversion of a predominantly agrarian economy into industrialized economy requires heavy developmental imports such as machinery and equipment, which cannot be produced at home. During this stage, it is also necessary to import technical know-how, maintenance imports such as raw materials and intermediate goods, and essential consumer goods. All these imports are necessary in order to expand an existing productive capacity or to create a new productive capacity in the economy to utilize efficiently the created capacity and to meet consumers' demand for essential goods. Thus due to this heavy imports, the import bill rapidly increases up from year to year.

Table: 1 **Eritrea's Balance of Payments**
In millions of Nak'fa

Years	Current Account [1]	Capital Account [2]	Net Official Transfers [3]	Net Errors & Omissions [4]	Overall Balance [5=1+2+3+4]
1992	-113	74	154	-718	-603
1993	173	1	363	170	707
1994	186	149	491	-304	522
1995	-368	46	447	-513	-388
1996	-872	282	492	-409	-507
1997	-264	476	366	-53	525
1998	-1281	446	526	-857	-548
1999	-1493	525	566	-1069	-667
2000	-1393	604	606	-969	-786

Source. Derived from· Data Provided by Bank of Eritrea, "Unpublished Documents", 2000

Chart: 1

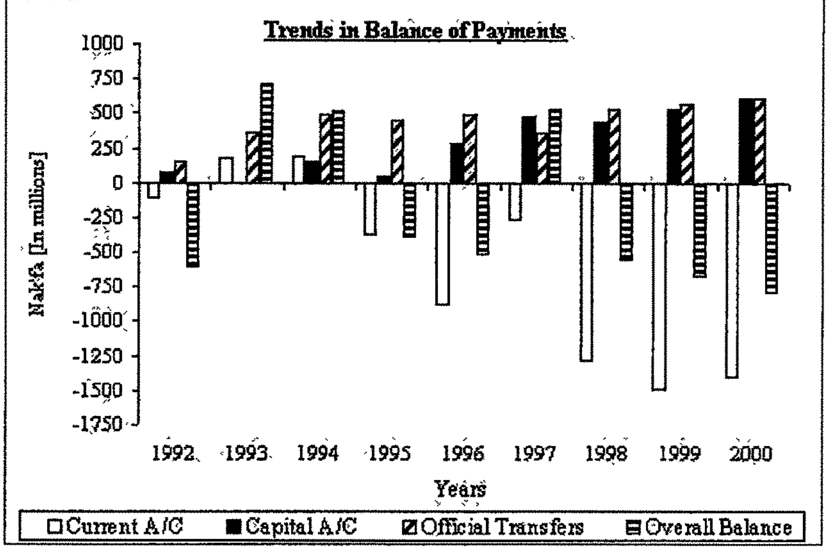

Table: 2	Eritrea's BOP as Percentage to GDP				
Years	Current Account [1]	Capital Account [2]	Net Official Transfers [3]	Net Errors & Omissions [4]	Overall Balance [5=1+2+3+4]
1992	-5.6	3.7	7.7	-35.9	-30.1
1993	6.8	0.0	14.4	6.7	28.0
1994	5.5	4.4	14.5	-9.0	15.4
1995	-10.1	1.3	12.2	-14.0	-10.6
1996	-21.3	6.9	12.0	-10.0	-12.4
1997	-5.9	10.7	8.2	-1.2	11.7
1998	-25.9	9.0	10.6	-17.3	-11.1
1999	-27.2	9.6	10.3	-19.4	-12.1
2000	-22.8	9.9	9.9	-15.9	-12.9

On the other hand, in the early stages of development, the exports of developing countries are highly dominated by primary products and do not generate enough surplus to pay for the constantly pouring imports. As well, most of the domestic industrial products during this stage are totally absorbed by the domestic market and no surplus is left for exports. For these reasons developing countries suffer a persistently large balance of payments deficit in the initial stages of their development.

d. Trends in Eritrea's Current Account

Figures for the current account of the BOP in terms of Nak'fa are shown in Table: 4. Table: 5 presents the figures of the current account of the BOP as percentage to GDP and Table: 6 shows the annual percentage change in the current account of the BOP. Chart: 2 is a graphical presentation of Table: 4. From the study of the current account data the following observations can be made:

i. As it is evident from these data, the current account of the BOP remained on deficit throughout 1992 to 2000, except for the years 1993 and 1994 where it has been on surplus.

ii. Trade balance is an important component of Eritrea's BOP, representing imports and exports of visible goods. Eritrea has exhibited a continuous trade deficit since its independence.

   Trade deficit has increased from –362 million Nak'fa in 1992 to –3575 million Nak'fa in the year 2000. This rise caused the trade deficit as percentage of GDP to shoot up from 18.1 percent in 1992 to 58.6 percent during the same period. The annual percentage change has seen high fluctuations.

   Eritrea is in its initial stages of development, thus, the continuous rise in trade deficit at this stage is a natural phenomenon. The problem lies in the high fluctuations in the annual percent change, which would imply the lack of planning in foreign trade and/or high effects of externalities on foreign trade.

iii. The service balance has always secured a surplus. It has increased from 240 million Nak'fa in 1992 to 533 million Nak'fa in 1993 before falling again to 297 million Nak'fa in 1995. Then after, it has almost remained in the range 302 million Nak'fa to 395 million Nak'fa between the periods 1996 to 2000.

   As a percentage of GDP, the service balance registered a continuous decline from 21.1 percent in 1993 to 5.1 percent in the year 2000. The annual percentage change as well has shown a number of steep falls and rises.

iv. The position of net income has remained poor throughout 1994 to 2000. It has significantly declined from a surplus of 48 million Nak'fa in 1995 to a deficit of 37 million Nak'fa in the year 2000.

v. Net private transfers have always remained on surplus. It significantly increased from 9 million Nak'fa in 1992 to 1905 million Nak'fa in the year 2000. It reached its highest level of 2508 million Nak'fa in 1997.

As a percentage to GDP, net private transfers increased from 4 million Nak'fa in 1992 to 57.9 million Nak'fa in 1995, then after, it started declining from 56.1 percent in 1997 to 31.2 percent in the year 2000.

Table: 3 **B.O.P. Current Account**
In millions of Nak'fa

Years	Trade Balance	Services Balance	Net Income	Net Private Transfers	Balance
1992	-362	240	0	9	-113
1993	-1535	533	0	1175	173
1994	-2245	449	20	1962	186
1995	-2263	297	48	1550	-368
1996	-2889	325	-46	1738	-872
1997	-3143	395	-24	2508	-264
1998	-3511	374	-24	1880	-1281
1999	-3665	302	-30	1900	-1493
2000	-3575	314	-37	1905	-1393

Chart: 2

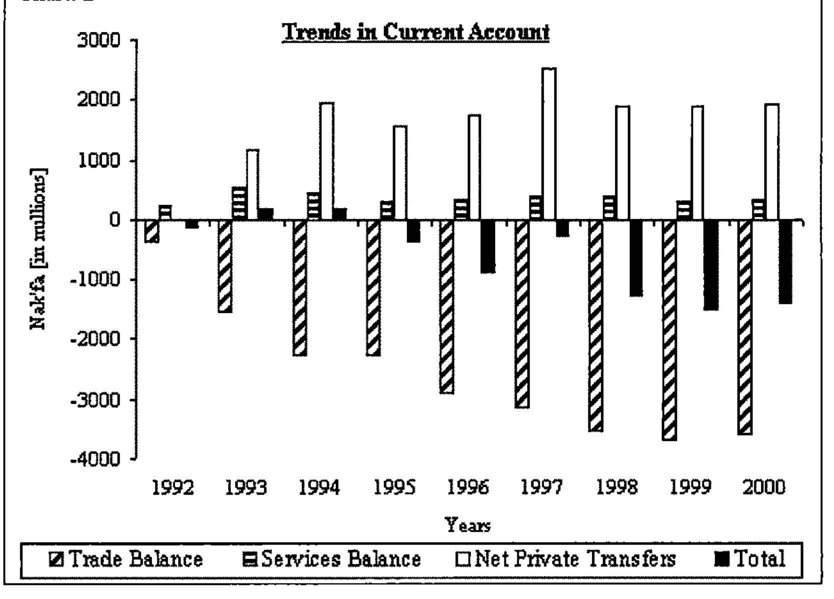

Table: 4	B.O.P. Current Account as Percentage of GDP				
Years	Trade Balance	Services Balance	Net Income	Net Private Transfers	Total
1992	-18.1	12.0	0.0	0.4	-5.6
1993	-60.7	21.1	0.0	46.5	6.8
1994	-66.3	13.3	0.6	57.9	5.5
1995	-61.9	8.1	1.3	42.4	-10.1
1996	-70.7	8.0	-1.1	42.5	-21.3
1997	-70.3	8.8	-0.5	56.1	-5.9
1998	-70.9	7.5	-0.5	38.0	-25.9
1999	-66.7	5.5	-0.5	34.6	-27.2
2000	-58.6	5.1	-0.6	31.2	-22.8

8.2 Eritrea's Foreign Trade

a. Importance of Foreign Trade in the Eritrean Economy

The Eritrean domestic trade consists mainly in the handling of imported goods in addition to small volume of local products. The main constraints of the domestic trade are the low levels of surplus production, the small size of local market, poor communications and low effective demand, which is a direct reflection of the low per capita income and the small size of population. Now or even in the near future, the size of the local market, which is highly determined by the size of the Eritrean population, is not expected to provide a scope for the domestic trade to play an important role in the overall economy of the country. Thus an alternative effort should be directed to develop exports and to secure foreign markets.

Eritrea can easily assume an important position in the areas of international as well as regional trade. During the 1930's, Eritrea had played a significant role in regional and international trade. With its some 2200 active trading companies, Eritrea had become an important transit center linking Europe with the Arabian Peninsula and the hinterland of

East Africa. Manufactured goods, mainly of Italian origin, were imported into Eritrea for the satisfaction of local demand and for re-exports to the Middle East and East African markets. In order to encourage the importation of goods into Eritrea for subsequent re-export, no trade barriers were ever raised by the Italian authorities against Ethiopia and a free trade had existed across the border of both the countries. Moreover, Eritrea was the main supplier of industrial products to Middle East and East African markets, when European exports to these markets had been disrupted during the Second World War [Trevaskis, 1960].

The historical, geographical and social inter-relations between the countries of the Horn of Africa: Eritrea, Sudan, Ethiopia, Somalia and Djibouti can provide a natural base and suitable environment for a wider regional integration that can include Yemen, Saudi Arabia and Egypt. In the past regional trade between Eritrea and its neighbors had been of great importance to the economies of these countries. As well, even today, if the concerned authorities in these countries desire to benefit from these natural factors in view of economic interests, free regional trade could bring a significant economic changes and a substantial increase in the standard of living in these countries. Today, after long years of wars, distress and misery, the nations in the region are in need of peace and economic integration more than any time passed. In this concern, Eritrea could largely benefit from its geographical location and export potential.

b. Eritrea's Foreign Trade Policy

The government of Eritrea announced its first foreign trade objectives and policies in 1994. The following are the short and long-term trade policies and objectives of Eritrea: [Govt. of Eritrea, 1994]

b.1 Objectives of Foreign Trade Policy:

i. To promote economic growth and a healthy balance of payment.
ii. To expand access to sources of raw materials, technology and know –how.
iii. To remove domestic market limitations for marketing of outputs and thereby improve employment opportunity.
iv. To enhance efficiency in production and competitiveness in price and quality and of commodities and services.
v. To promote regional co-operation and economic integration.
vi. To increase attraction of Eritrea to direct foreign investment.

b.2 Short and Long-Term Foreign Trade Policies:

i. To establish liberal internal and external trade regimes with limited intervention that would not contradict the tenets of free trade. This will mean, among other things, liberalizing and simplifying the licensing regime and reducing and eliminating traffic and non-traffic barriers.

ii. To create export based industries and services by providing:

- *Preferential financing*
- *Assistance in international Trade*
- *Information backup (information with regard to new products and processes, foreign market entry requirements, new laws, regulations, etc*
- *Assistance in meeting the rigorous quality standards required by the international market. To this end, there will be facilities (Standard Institute of Equivalents) to measure and verify that world standards are met.*

iii. To actively encourage the participation in regional bilateral and multilateral trade and economic co-operation. Similarly, access to preferential trade agreements and zones will be sought.

iv To assist and encourage the private sector to play leading role in both, the domestic and external markets. The public sectors role will be limited to regulatory functions, selected price stabilization roles and the import or export of critical commodities and supplies, the requirement for which cut across sectors.

v. To help in building the institutional capacity to help make Eritrea a trading nation.

vi To encourage and support the Eritreans living abroad to participate in trading activities.

c. Composition and Growth of Eritrea's Foreign Trade

Foreign trade occupies an important place in the Eritrean economy. Trade balance is an important component of Eritrea's BOP, representing imports and exports of visible goods. As we have seen earlier, Eritrea has exhibited a continuous trade deficit since its independence. In order to provide a clear picture of Eritrea's foreign trade, it is necessary to examine the components of the foreign trade.

Figures for the balance of trade are given in money terms in Table: 5 and percentage to GDP in Table: 6. Chart: 3 is a graphical presentation of Table: 5. A close study for Eritrea's foreign trade data brings the following observations:

i. Since independence, the size or volume of Eritrea's foreign trade, i.e. the sum of exports and imports, has continued to grow significantly. It has increased from 544 million Nak'fa in 1992 to 7,103 million Nak'fa in the year 2000. As a percentage of GDP during the same period, the volume of trade has increased from 27.2 percent to 116.4 percent.

ii. Exports have been improving gradually. The size of exports has increased from 91 million Nak'fa in 1992 to 1,764 million Nak'fa in the year 2000. During the same period, as percentage of GDP, export has increased from 4.5 percent to 28.9 percent.

iii. Imports have been the major cause of Eritrea's deficit trade. During the period 1992 to 2000, imparts have significantly increased from 453 million Nak'fa to 5,339 million Nakfa, which is about 11.8 times.

As percentage of GDP, imports have also increased from 22.6 percent in 1992 to 87.5 percent by the end of 2000.

Table: 5 **Eritrea's Foreign Trade**
In millions of Nak'fa

Years	Exports [1]	Imports [2]	Trade Volume [1 + 2]	Trade Balance [1 – 2]
1992	91	453	544	-362
1993	209	1745	1954	-1536
1994	426	2672	3098	-2246
1995	530	2793	3323	-2263
1996	622	3511	4133	-2889
1997	381	3524	3905	-3143
1998	1016	4527	5543	-3511
1999	1456	5121	6577	-3665
2000	1764	5339	7103	-3575

Chart: 3

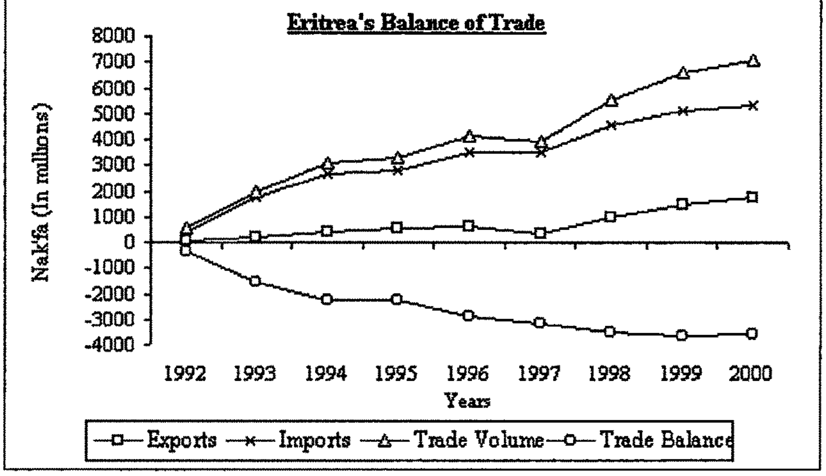

Table: 6	Eritrea's Foreign Trade as Percentage of GDP			
Years	Exports [1]	Imports [2]	Trade Volume [1 + 2]	Trade Balance [1 – 2]
1992	4.5	22.6	27.2	-18.1
1993	8.3	69.0	77.3	-60.8
1994	12.6	78.9	91.4	-66.3
1995	14.5	76.4	90.9	-61.9
1996	15.2	85.9	101.1	-70.7
1997	8.5	78.9	87.4	-70.3
1998	20.5	91.4	111.9	-70.9
1999	26.5	93.2	119.7	-66.7
2000	28.9	87.5	116.4	-58.6

8.3 Foreign Trade Estimates and Elasticities

In this section, we have worked out the trend growth rates of the important external sector variables, the income elasticities of exports and imports and also the import intensity of economic growth.

1. <u>Trend</u>

The semi-log trend equations for export and imports are given below. The co-efficients of the time variable [t] represent the trend growth rates of export and import respectively.

i. Export Growth Rate

$$\textbf{Log exp} = \underset{[17.27]}{\textbf{2.023}} + \underset{[6.638]}{\textbf{0.138}}\ \textbf{t}$$

R square	Adjusted R square	Standard Error	F Value
0.863	0.843	0.161	44.067

ii. Import Growth Rate

$$\textbf{Log imp} = \underset{[22.268\ ]}{\textbf{2.919}} + \underset{[4.470]}{\textbf{0.104}}\ \textbf{t}$$

R square	Adjusted R square	Standard Error	F Value
0.741	0.703	0.180	19.987

As indicated by the above equations, the annual average trend growth rates of exports and imports are 13.8 and 10.4 percent respectively. The exports are increasing at a faster rate than the imports in Eritrea.

2. <u>Trade Elasticities</u>

i. Income Elasticity of Exports

$$\textbf{Log exp} = \textbf{a} + \textbf{b log GDP}$$

$$\textbf{Log exp} = \underset{[-6.24]}{\textbf{-6.182}} + \underset{[8.99]}{\textbf{2.480}}\ \textbf{log GDP}$$

R square	Adjusted R square	Standard Error	F Value
0.920	0.909	0.122	80.975

The elasticity of exports with respect to income, known as income elasticity of exports, is very high in Eritrea at 2.40, implying thereby that Eritrea's exports are very closely related to its GDP growth.

ii. *Income Elasticity of Imports*

$$\textbf{\textit{Log imp}} = a + b \log GDP$$

$$\textbf{\textit{Log imp}} = \underset{[-3.71]}{-3.642} + \underset{[7.21]}{1.974} \log GDP$$

R square	Adjusted R square	Standard Error	F Value
0.881	0.864	0.121	52.096

The elasticity of import with respect to income, known as income elasticity of imports, is also very high at 1.97, implying thereby that the demand for imports in Eritrea is quite sensitive to the overall economic growth.

3. <u>Import Intensity of Economic Growth</u>

$$\textbf{\textit{Log GDP}} = a + b \log imp$$

$$\textbf{\textit{Log GDP}} = \underset{[9.60]}{2.050} + \underset{[7.21]}{0.446} \log imp$$

R square	Adjusted R square	Standard Error	F Value
0.881	0.864	0.057	52.096

Are increasing imports desirable in Eritrea? Do imports contribute to the economic growth of Eritrea? To answer these questions, we have estimated the above equation which indicates the import intensity of economic growth in Eritrea. The coefficient of *log imp* [0.466] is the elasticity of GDP with respect to imports. Here, it suggests that one percent increase in imports in Eritrea contributes 0.446 percent to its GDP. Hence, Eritrea's imports are growth intensive.

8.3 Conclusions

The major findings and conclusions of this chapter are as follows:

i. Since its independence, Eritrea has been facing pressures on its balance of payments from time to time. Except for the years 1993, 1994 and 1997 when the overall balance was in surplus; Eritrea's BOP has seen a continuous deficit.

   As percentage of GDP, the overall BOP deficit has fallen from 30.1 percent in 1992 to 12.9 percent in the year 2000. The annual percentage change in the overall balance has shown high fluctuations within short intervals.

ii. The overall deficit has been mainly caused by the deficits on current account. In 1993 and 1994, Eritrea enjoyed a surplus in current account, whereas, the rest of the years have seen a continuous deficit on the current account. As a percentage of GDP, the deficit on current account increased from 5.6 percent in 1992 to 22.8 percent in the year 2000.

iii. The capital account of the BOP has exhibited a continuous surplus throughout 1992 to 2000. As percentage of GDP, it increased from 3.7 percent to 9.9 percent during the same period.

iv. Net official transfers have significantly increased in the post independence period in Eritrea. As percentage of GDP, it has remained in the range 7.7 percent to 14.5 percent throughout 1992 to 2000.

v. The size of errors and omissions has been very high. In general, it has shown a rising trend with a steep falls in frequent intervals. Huge errors and omissions indicate the inefficiency and neglect of the concerned authority in preparing the BOP accounts.

vi. Indeed it is a usual phenomenon for Eritrea to have serious difficulties in its balance of payments during the initial stages of development. Almost all countries had passed through this experience during their initial stages of development. This is because; in the initial stages of development the conversion of a predominantly agrarian economy into industrialized economy requires heavy developmental imports such as machinery and equipment, which cannot be produced at home. During this stage, it is also necessary to import technical know-how, maintenance imports such as raw materials and intermediate goods, and essential consumer goods. All these imports are necessary in order to expand an existing productive capacity or to create a new productive capacity in the economy to utilize efficiently the created capacity and to meet consumers' demand for essential goods. Thus due to this heavy imports, the import bill rapidly increases up from year to year.

vii. Foreign trade occupies an important place in the Eritrean economy. Trade balance is an important component of Eritrea's BOP, representing imports and exports of visible goods. Eritrea has exhibited a continuous trade deficit since its independence. The trade deficit as percentage of GDP shot up from 18.1 percent in 1992 to 58.6 percent in 2000. The annual percentage change in trade deficit has seen high fluctuations.

Eritrea is in its initial stages of development, thus, the continuous rise in trade deficit at this stage is a natural phenomenon. The problem lies in the high fluctuations in the annual percent change, which would imply the lack of planning in foreign trade and/or high effects of externalities on foreign trade.

viii. Since independence, the size or volume of Eritrea's foreign trade, i.e. the sum of exports and imports, has continued to grow significantly. As a percentage of GDP, the volume of trade has increased from 27.2 percent to 116.4 percent indicating over-dependence on external sector.

ix. Exports have been improving gradually in Eritrea. As percentage of GDP, exports have increased from 4.5 percent to 28.9 percent.

x. Imports have been the major cause of Eritrea's deficit trade. As percentage of GDP, imports increased substantially from 22.6 percent in 1992 to 87.5 percent by the end of 2000.

xi. The annual average trend growth rates of exports and imports are 13.8 and 10.4 percent respectively. The exports are increasing at a faster rate than the imports in Eritrea.

xii. The elasticity of exports with respect to income, known as income elasticity of exports, is very high in Eritrea at 2.40, implying thereby that Eritrea's exports are very closely related to its GDP growth.

The elasticity of import with respect to income, known as income elasticity of imports, is also very high at 1.97, implying thereby that the demand for imports in Eritrea is quite sensitive to the overall economic growth.

However, as the income elasticity of exports is higher than the income elasticity of imports, any given increase in GDP would increase the exports faster than the imports and thereby bridge the deficits in trade.

xiii. *Are increasing imports desirable in Eritrea? Do imports contribute to the economic growth of Eritrea?* To answer these questions, the study has estimated the import intensity of economic growth in Eritrea. The value of this elasticity is 0.466, suggesting that one percent increase in imports in Eritrea contributes 0.446 percent to its GDP. Hence, Eritrea's imports are growth intensive.

xiv. The Eritrean domestic trade consists mainly in the handling of imported goods in addition to small volume of local products. The main constraints of the domestic trade are the low levels of surplus production, the small size of local market, poor communications and low effective demand, which is a direct reflection of the low per capita income and the small size of population. Now or even in the near future, the size of the local market, which is highly determined by the size of the Eritrean population, is not expected to provide a scope for the domestic trade to play an important role in the overall economy of the country. Thus an alternative effort should be directed to develop exports and to secure foreign markets.

xv. The historical, geographical and social inter-relations between the countries of the Horn of Africa: Eritrea, Sudan, Ethiopia, Somalia and Djibouti can provide a natural base and suitable environment for a wider regional integration that can include Yemen, Saudi Arabia and Egypt. In the past, regional trade between Eritrea and its neighbors had been of great importance to the economies of these countries. As well, even today, if the concerned authorities in these countries desire to benefit from these natural factors, in view of economic interests, free regional trade could bring a significant economic changes and a substantial increase in the standard of living in these countries. Today, after long years of wars, distress and misery, the nations in the region are in need of peace and economic integration more than any time passed. In this concern, Eritrea could largely benefit from its geographical location and export potential.

xvi. In today's economic globalization, Eritrea could significantly benefit from its strategic location, if it declares one of its seaports [Port Massawa or Port Asseb] a "Free Trade Zone". This will attract the exchange of imports and exports between the countries in the region, the Middle East, Asian countries and other countries of the world. Thus Eritrea could easily become the passage to the hinterland of Africa where many countries are badly in need for an access to the Red Sea.

Moreover, this tendency towards the establishment of a "Free Trade Zone" would greatly help Eritrea in harvesting the maximum benefits of foreign trade. Also this will definitely allow Eritrea to play an important and leading role in any kind of regional trade blocks that might be established for the benefits and interests of the nations in the region.

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