The Challenges of Debt Sustainability in Africa

African Forum and Network on Debt and Development

The Case of Ethiopia

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From the vision and the mission statements and from our objectives, it is clear that the Debt crisis, apart from being a political, economic and structural issue, has an intrinsic link to human rights. This forms the guiding philosophy for our work on Debt and the need to have African external debts cancelled for poverty eradication and attainment of social and economic justice. Furthermore, the principle of equity must of necessity apply and in this regard, responsibility of creditors and debtors in the debt crisis should be acknowledged and assumed by the parties. When this is not done, it is a reflection of failure of governance mechanisms at the global level that protect the interests of the weaker nations. The Transparent Arbitration mechanism proposed by AFRODAD as one way of dealing with the debt crisis finds a fundamental basis in this respect.

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Assessing the Impact of the PRGF on Social Services in Selected African Countries

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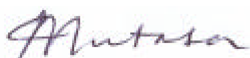
Preface

The World Bank (WB) and the International Monetary Fund (IMF), as the leading lending agencies, have been under mounting pressure to deal with a wide range of debt sustainability challenges. The challenges have refused to subside. Instead they continue to stimulate urgent need for a new debt sustainability framework and debt management orientation that can allow for the borrowing economies to break the vicious circle of unending distress. The Heavily Indebted Poor Countries (HIPC) framework and the 2005 G8 Debt deal which is generally a compromise of the US and UK proposals are yet to shake down into a coherent strategic compact (with the poor countries of the borrower economies) capable of addressing unsustainability challenges facing the debt burden of all the poor economies of the South.

In the recent past; the Bank and the Fund have paradoxically demonstrated a generous willingness to admit the 'systematic over-optimism' of the previous International Financial Institutions' debt sustainability calculations and measures. From time to time, creditors have however, failed to put sufficient political will, resources and serious analysis into the debt reduction operations. Debt reduction targets are set and reset arbitrarily - writing off 30 percent, then 50 percent, and so on-rather than based on serious assessments of the needs of each country.

In order to operationalize debt sustainability existing frameworks such as HIPC and the Country institutional Policy Assessment (CPIA) need a revisit. One way of looking at resolving the Third World debts would be by first securing an agreement on the working definition of debt sustainability. This implies revisiting the concept of debt sustainability as given by the IMF, identifying its short-falls and seeking ways of redressing them so as to enable the initiative to work better for the poor countries. In so doing, the issues of both domestic and external debt, conditionalities, domestic revenue as well as the role of external shocks in the fiscal and monetary policies of the poor country become very important.

This case study looks into the debt sustainability issue taking cogniscence of the domestic debt issues facing the African government (s) at national level. It argues that debt sustainability should not be defined as just meeting the debt indicators as given by the international financial institutions, but it should help the country to break from its debt burden-both external and domestic and be on the path to development. Thus the study among other things advocates for a holistic definition of debt sustainability and the agreement on indicators that a developing country is comfortable to work with than just focusing on of exports earnings to the net present value of all future debt servicing payments. In short, Debts are should be considered 'sustainable' when the debt service burden leaves the Low income countries (LICs) with sufficient funds to meet their human rights obligations under the internationally agreed Millennium Development Goals (MDGs).



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List Of Abbreviations/Acronyms

ADLI	Agricultural Development Led Industrialization
AfDB	African Development Bank
CPIA	Country Policy and Institutional Assessment
DSF	Debt Sustainability Framework
ESDP	Education Sector Development Policy
EPRDF	Ethiopian People's Revolutionary Democratic Front
ESAF	Enhanced Structural Adjustment Facility
ESDP	Education Sector Development Policy
EU	European Union
GDP	Gross Domestic Product
GNI	Gross National Income
HDI	Human Development Index
HIPC	Highly Indebted Poor Countries
HSPD	Health Sector Policy Development Program (HSPD)
IDA	International Development Association
IMF	International Monetary Fund
LIC	Low Income Country
MDG	Millennium Development Goals
MDRI	Multilateral Debt Relief Initiative
MoFED	Ministry of Finance and Economic Development
NPV	Net Present Value
ODA	Official Development Assistance
PRGF	Poverty Reduction and Growth Facility
PRSP	Poverty Reduction Strategy Program
SDPRP	Sustainable Development Poverty Reduction Program
UN	United Nations
UNDP	United Nations Development Program
VAT	Value Added Tax
WB	World Bank

Executive Summary

The development challenges facing sub-Saharan Africa are deep-rooted and numerous. In the case of Ethiopia, they include acute poverty (44.2% of its population below the poverty line); historically low economic growth (averaging 2.6% over the last four decades); the spread of HIVAIDS infecting about 10.6% of the adult population; underdeveloped infrastructure and lack of provision of social services, ranging from health to education.

The loans and grants received by Ethiopia from the various bilateral and multilateral institutions have, therefore, focused on addressing the above multi-faceted development challenges. This study examines the extent to which the Ethiopian public and publicly guaranteed debt is sustainable, to identify the likely challenges in terms of socio-economic trade-off the country faces in attempting to make its debt sustainable in the foreseeable future, and to make an assessment as to how its attempt to address poverty reduction and meeting the MDGs is likely to be accomplished in view of the country's debt burden.

In an attempt to critically assess the challenges of debt sustainability in Ethiopia, this report begins with a brief outline of the country's background and reviewed the state of the Ethiopian economy and the major government policy initiatives undertaken in recent years. This is followed by the evolution of the Ethiopian debt and the implementation of the HIPC initiative in Ethiopia. Then the paper examined the various approaches to debt sustainability before delving into analyzing the sustainability of the Ethiopian debt. Two approaches are used to evaluate the sustainability of the Ethiopian debt: the first approach relied on the evaluation of the multilateral institutions (The IMF and World Bank) in which their staff have regularly carried out Ethiopia's debt sustainability analysis using various parameters; and the second is based on the author's analysis, using a model based on the evaluation of the fiscal balance of the country.

Ethiopia's Indebtedness and Debt Relief

In historical terms, the size of Ethiopia's debt significantly increased after the fall of the Imperial Regime in the mid 1970s. The magnitude of the debt in 1975 was only US$371 million. By 1998, the total debt stock was $9,812 million, about 150 per cent of GDP. Approximately, 54% of that total debt was contracted for defence purposes and helped neither in improving the productive capacity of the economy nor in alleviating poverty.

The accumulation of debt caused a number of concerns. The amount of debt that had been accumulated by Ethiopia was huge relative to the size of its economy, as measured relative to its GDP. Secondly, the economic growth performance of Ethiopia had been modest, at best, to make the accumulated debt sustainable. Thirdly, even if it were willing to pay, the opportunity cost of doing so would have had severe socio-economic and possibly political consequences on the Ethiopian people. Finally, the international pressure on lenders to grant debt relief had been mounting during the 1990s, spearheaded by institutions like the Jubilee 2000.

Owing to its huge debt burden, severe poverty and willingness to carry out the prescribed reforms, Ethiopia became eligible for debt reduction under the HIPC initiative and reached completion point in 2004. Its total nominal debt stock at the end of fiscal year 2002/2003 was about $6.8 billion (or $4.5 billion in net present value (NPV) terms), 246% of exports. The total debt relief committed in NPV terms by the time it reached the completion point was US$1,275 million or about 47% of its total official external debt.

Debt Sustainability

On the whole, the current Ethiopian debt seems to be sustainable under plausible assumptions of (a) economic performance as good as recent years, and (b) non-excessive flow of new loans. While some distress tests suggest the presence of risk if either some of the assumptions of contracting new loans are excessive and /or the economy is hit by a severe drought. The country which is designated as a "medium CPIA" as opposed to a high risk country is likely to maintain a sustainable debt under the scenarios envisaged. On the other hand, the HIPC indicators show that the Ethiopian debt is unsustainable.

As it is based on historical performance and Ethiopia has had a volatile primary export sector, though it has been robust in recent years.

As far as fiscal sustainability is concerned, though Ethiopia's GDP has been volatile, ranging from -4 to 12 % up to 2002/03, with an average of about 11% in the last four years, for any GDP growth between 2 to 10% the government can afford to run a primary budget deficit. For instance, for GDP growth rates that range between 2 to 10%, the government can afford to incur a primary balance deficit that ranges between around 3 to 7% of GDP. Further, the primary balance required for debt sustainability is only about 3% of GDP. Hence, in the very unlikely scenario that no donor concessional loans will be forthcoming during the post-HIPC era, the required primary balance deficit to ensure debt sustainability is below the historical average, and no serious fiscal constraint will emerge provided the economy grows by about 5% or above.

Concern regarding Ethiopia's Debt Position

There are a few concerns regarding the conclusion that Ethiopia's debt is sustainable.

- Though accumulating debt is not always necessarily bad, what matters is the size of the debt relative to the size of the economy since servicing the debt has significant opportunity costs and possibly adverse social consequences. These include lower expenditures on health, education and transport expenditures (the three main government targets in its PRSP) and other social provisions. For example, Ethiopia allocated about US$390.79 million for various sectors ranging from agriculture and food security to various social provisions in 2005/06, which dropped to US$357.47 in 2006/07. The country went on to spend US$107.72 and $99.45 for servicing the debt during the above years, respectively. The implication is that the opportunity cost of servicing its debt was an approximately 28% increase in development expenditures.
- It is clear that no optimal benefit has been derived from the accumulated debt if the attendant (save the good economic growth of the last years) performance of the economy is the appropriate yardstick by which it should be justified. This is evidenced by the low overall standard of living of the country and the low social indicators, as compared to other African countries.
- The economic performance that has been registered in the last few years is exceptionally vulnerable since the economy is dependent on agriculture and the latter on the vagaries of nature. Further, aid to Ethiopia has not been used to guide the economy away from dependence on nature, such as via irrigation schemes to ensure food security.

1.0 Introduction

1.1 Country Background

In the last four decades, the Ethiopian economy went through radical policy regime shifts. The economy was under a feudal mode of production with some pockets of modern sector industries until the mid 1970s. Following the 1974 popular uprising and the coming of the military regime into power, the economic policy regime shifted to a centrally planned economy in line with socialist doctrines of economy policy. Since 1991, the economy has been re-oriented towards a market oriented liberal economic structure.

But despite the adoption of the liberal economic regime for the last fifteen years or so, the progress made so far is modest due to a combination of endogenous and exogenous factors. In particular, partly due to population pressure and partly due to overall weak economic growth until the last few years, improvement in per capita income has been insignificant over the years. Between 1960/61-2003/2004, the respective average growth rates of GDP, overall per capita income, per capita income in agriculture and non-agriculture were 2.6, 0.1, -1.2 and 0.8 per cent (EEA, 2005). It should also be noted that the average growth rate of GDP over the last four decades is almost equal to the growth rate of the population, and hence not surprising that the overall change in GDP per capita over the period was modest.

In relative terms, though yearly fluctuations still persist as dominant characteristics of the economy, average growth rates and hence GDP per capita has slightly improved in recent years. On average, the economy performed better during the current regime (1991/1992-2003/04) relative to during the preceding military regime (1974/75-1990/91). The economy grew by an average of 4.5 per cent and GDP per capita by 1.6 per cent during the current regime against 2 per cent and -0.5 during the previous regime. In particular, the economy performed at an impressive rate of about 10.6% in the last four years. This could, at least partially, be attributed to the liberalization measures undertaken during the last decade and conducive weather conditions in the last few years.

The liberalization measures undertaken since the early 1990s range from privatization of various previously government owned enterprises to deregulation of both the foreign trade regime and domestic prices. A lot of public enterprises have been either sold to the private sector or transferred to the employees with government initial support. The rationale of reversing the ownership structure of the public institutions to private hands is to encourage the private sector to play a significant role in the economy in line with the usual argument that a market economy is more efficient in contrast to the public sector.

But despite the liberalization measures undertaken in the last decade and improvements in some aggregates, the structure of the Ethiopian economy has only changed slightly. The mainstay of the economy is still traditional agriculture, as has been the case for decades. It accounts for about 47%t of GDP in the last 5 years. Though no accurate data is available it is also believed that it accounts for about 80%t of employment and about 80 to 90% of export earnings. The contribution of the industrial sector is small and has shown no appreciable change in recent years. It has averaged about 14% of GDP in the last five years. Owing to the recent liberalization measures, the service sector has registered a relatively significant change, which increased its contribution to GDP from 38% in 1990 to 47% in 2003 (WB, 2005).

Social indicators in Ethiopia also reveal that the country is among the least developed not only due to income poverty but also using the broader definition of under-development. The country was ranked 170th out of 177 countries in 2004 and 2005 based on UNDP's measure of Human Development Index (HDI). Despite recent economic growth, the 2007/08 HDI ranking of countries puts Ethiopia at 169th out of 177 countries. This is mainly due to the unavailability of health facilities, education opportunities and utilities and low road density.

1.2 Government Strategy and Development Challenges

Following the fall of the Imperial regime in 1974, the Ethiopian economic policy changed from that of a liberal to a centrally-planned economy. The Military government that took over nationalized most economic activities ranging from agricultural land to manufacturing enterprises. This persisted for 17 years leading, coupled with a long internal war, leading to serious macroeconomic imbalances, as reflected in the indicators.

When the Military government was replaced in 1991, the then new government, Ethiopian People's Revolutionary Democratic Front (EPRDF), made a 'U' turn in economic policy relative to its predecessor. The government signed on structural adjustment program sponsored by the Breton Woods institutions, which encompassed a more liberal and market oriented economic policies. Among the notable policy changes that have been undertaken include: devaluation of the domestic currency, removing price controls, liberalizing trade, privatization of public enterprises and opening up the economy for foreign investment.

Further, it formulated an aggregate development strategy and sector specific strategies that complement as a way of addressing the country's development challenges in general and state of poverty in particular. The core development strategy is formulated under what the government called Agriculture Development Led Industrialization (ADLI). This policy was supposed to both orient the future long term growth of the economy and to reduce poverty by utilizing the rural based resource of the economy. Since the majority of the people live in the rural areas engaged in agriculture, the policy aimed to improve the lively-hood of the rural population by enhancing rural productivity and hence ensuring food security. Other core components of the strategy include i) justice system and civil service reform, ii) governance, decentralization and empowerment, and iii) capacity building.

Within this broad strategy, the government designed sector specific strategies. The sectors that the government focused on included infrastructure expansion and provision of social services. In particular, expansion of education, health, road networks, electricity and telephone services were given priority. At a specific policy level, agricultural policy focused on extension packages that included provision of fertilizers, selected seeds, and other farm inputs and facilities with the aim of enhancing agricultural productivity. Similarly, the Education Sector Development Policy (ESDP) aimed at expanding primary and secondary school enrolment, narrowing gender gap, reducing illiteracy, and expanding overall education coverage. Similarly in the health sector, the Health Sector Development Policy (HSDP) targeted primary health care expansion in the rural areas and provision of sanitation facilities.

The above sector-focused policies were anchored on the government's objective of ensuring macroeconomic stability. In particular, price stability and exchange rate stability have been given priority as evidenced by the (on average) prudent monetary and fiscal policies that have been followed over the last decade. Appreciable emphasis has also been given to improve the tax structure ranging from foreign taxes to the recently implemented value added tax (VAT), while increasing expenditures on what the government identified as "poverty oriented expenditures". These expenditures have been targeted to ensure food security, expand the provision of education, health, roads and sanitation facilities.

The above strategic objectives and policy frameworks have been in focus in the government's development agenda and in the process of implementation, with varying degrees of success and intensity, since 1992. But they received additional emphasis and resources that go with the policies when, as will be discussed in Section Two below, the accumulated debt has reached an unsustainable level and the country applied for a debt relief under the Highly Indebted Poor Countries (HIPCs) initiative.

1.3 Poverty Reduction Efforts

In 2001/2002, the government published its interim Poverty Reduction Strategy Paper (PRSP) which was followed by the full PRSP whose acceptance by the multilateral and bilateral institutions helped the country to receive both debt relief and financial assistance via the HIPC initiative. The country reached the completion point in 2004 and is now in the process of preparing the PRSP-II. In the first phase of the PRSP, entitled Sustainable Development Poverty Reduction Program (SDPRP), all the core objectives and the sectoral focus of the government were incorporated as the main components of the program.

In implementing these programs and pursuing the above strategies, the government has had a relatively conducive internal political environment except the eruption of hostilities with Eritrea in 1998 and the continued unsettled border demarcation since 2000. It is worth noting that before 1991, the country was under continued internal turmoil in which huge amount of resources (both human and material) were allocated to support the war effort. Consequently, the economy suffered from such a lengthy war and instability as reflected in the almost negligible GDP growth and deterioration in infrastructure while military expenditure was very high.

Similarly, in addition to internal peace, Ethiopia has had a relatively favourable donor support since the regime change in 1991. Following Ethiopia's adoption of the structural adjustment programmes, the IMF increased its financial support under the Enhanced Structural Adjustment Facility (ESAF). Following the termination of this programme in 1999 and its replacement by the Poverty Reduction and Growth Facility (PRGF), Ethiopia benefited from both direct support and reductions in its debt stock via the HIPCs initiative. Other multilateral institutions such as The World Bank (WB), The European Union (EU), and the African Development Bank (AFDB) have also significantly increased their financial and technical support and became important development partners during the reform period that is unfolding.

1.4 Statement of the Problem

In sum, the development challenges that face Ethiopia are deep-rooted and numerous. They include acute poverty, with 44.2% of its population below the poverty line; economic growth has averaged 2.6% over the last four decades; the spread of HIVAIDS affects 10.6% of the adult population; there is a lack of infrastructure development and extensive provision of social services ranging from education to health.

The loans and grants received from the various bilateral and multilateral institutions have, therefore, focused on addressing the above multi-faceted development challenges. At sector level, food insecurity, the stagnant industrial sector, and weak infrastructure have received donor focus and attention during the ongoing reform period. Similarly, the weak social provisions (like education and health) and the low private sector participation have also been singled out as priority sectors. In this context, the research aims to examine the extent to which the Ethiopian public and publicly guaranteed debt is sustainable, to identify the likely challenges in terms of socio-economic trade-off the country faces in attempting to make its debt sustainable in the foreseeable future, and to make an assessment as to how its attempt to address poverty reduction in particular and meeting the MDGs in general is likely to be accomplished in view of the country's debt burden.

Specifically, the research aims to:

- Give an update of Ghana's HIPC experience and examine the nature and scope of the debt relief realized.
- Describe and critically assess the IMF's debt sustainability analysis of Ghana.
- Ascertain as to whether the DSA calculated has taken into consideration Ghana's strategy for poverty reduction and the MDGs, and make a determination as to whether a balance has been struck between financing for development and poverty reduction that does not impair future generations with a heavy debt burden.

To examine these issues, the remainder of the paper is organized as follows. Following this brief introduction, Chapter Two highlights the evolution of Ethiopian debt and the HIPC initiative. It will also briefly discuss the impact of the initiative on debt relief and on the related objectives of poverty reduction in particular and meeting the MDGs in general. Chapter Three will review the main approaches to debt sustainability by emphasizing the extent to which these approaches and the indicators they use have adequately served the purpose of capturing the dynamic paths of debt in the poor countries. Chapter Four presents an analysis of debt sustainability in Ethiopia employing various techniques of analyses including based on what the International Institutions (like the IMF and World Bank) have carried out previously.

And, finally, Chapter Five summarizes the findings based on the analyses carried out in this paper and evaluation of relevant government officials and multilateral institutions. This section will also present the policy implications for poverty reduction programs that are being pursued by the government.

2.0 Evolution Of Ethiopian Debt And The Hipc Initiative

Ethiopia's indebtedness significantly increased in the 1980s. This mainly related to the arms procurement due to the internal war that was going on at the time. By 1998 the total accumulated debt outstanding was about US$9.8 billion or about one and a half times the size of the then GDP. To address the huge accumulated debt the current government started negotiating with its creditors in 1992. Consequently, a total of US$372.89 million was agreed to be both cancelled and rescheduled. In addition to these 'London Terms' or Enhanced Toronto Terms', the second round negotiations with the Paris Club Creditors for debts contracted before 1989 resulted in debt reduction on 'Naples Terms'. Thereafte, owing to its huge debt burden, severe poverty and willingness to carry out the prescribed reforms, Ethiopia became eligible for debt reduction under the HIPC initiative and reached the decision point in November 2001 and completion point in 2004. Under the initiative, the total debt relief committed in NPV terms by the time it reached the completion point was US$1,275 million or about 47% of its total official external debt.

2.1 Evolution of the Ethiopian Debt

Ethiopia is still one of the highly indebted countries, even by the standards of HIPCs of Sub-Saharan Africa. In historical terms, the size of the debt significantly increased after the fall of the Imperial Regime in the mid 1970s. The magnitude of the debt in 1975 was only US$371 million. Total debt outstanding in 1998 was $9,812 million or 150% of GDP. The largest share of this debt was owed to the World Bank Group (IDA).

But before 1991, in contrast to the composition of the present debt, the share of Multilateral Institutions in the total debt during the previous Derg regime was only 16.8%. Fifty-four per cent of that total debt was contracted for defence purposes and helped neither in improving the productive capacity of the economy nor in alleviating poverty. The major share (76.4%) of the debt was owed to bilateral creditors, in which the Former Soviet Union alone accounted for about 78% of the total bilateral debt (Teklu, 2000).

The macroeconomic performance indicators imply the non-allocation of funds towards economic development projects. The data depicts a negative GDP growth rate per capita, huge external imbalances and very low Human Development Index during the period. The debt was unpaid and accumulated over the years which, according to Ministry of Finance estimates, the total outstanding debt in 2000 amounted to about 150% of GDP or 940% of exports, and scheduled debt service was 54% of current export earnings (Teklu, 2000).

To cope with its unsustainable debt, Ethiopia began negotiations with its creditors in 1992. Consequently, a total of US$372.89 million was agreed to be both cancelled (US$101.60 million) and rescheduled (the remaining US$271.29 million). In addition to these 'London Terms' or Enhanced Toronto Terms', the second round negotiations with the Paris Club Creditors for debts contracted before 1989 resulted in debt reduction on 'Naples Terms'. Accordingly, a 67% reduction on the net present value of the eligible debt was applied, which resulted in a total debt relief of US$164.8 million (constituting 24.3 per cent cancellation and 75.7 per cent rescheduling). Hence, the total debt relief obtained through the two negotiations amounted to US$537.7 million (consisting of 26.3% cancellations and 73.7% rescheduling). But this was not enough.

> ***Even after the debt relief is accounted, in 1997/98 scheduled debt service accounted 46% of government revenue excluding grants and 56% of the current expenditure. Similarly, scheduled debt service was 54% of export receipts of the year....The external debt burden level of Ethiopia has been still greater than the sustainability ratios set forth by the World Bank and IMF (Teklu, 2000, p. 28).***

The accumulated debt stock in particular has been of serious macroeconomic concern since the 1980s. Among the main reasons for this concern were that the amount of debt that had been accumulated by Ethiopia was huge relative to the size of its economy, as measured relative to its GDP. Secondly, the economic growth performance of Ethiopia had been modest, at best, to make the accumulated debt sustainable. Thirdly, even if it were willing to pay, the opportunity cost of doing so would have had severe socio-economic and possibly political consequences on the Ethiopian people.

Finally, the international pressure on lenders to grant debt relief had been mounting during the 1990s, spearheaded by institutions like the Jubilee 2000.

With similar factors replicated in many sub-Saharan African countries, the donor community, the IMF in particular, were prompted to design a scheme whereby poor countries that fulfil certain conditions will be granted a debt relief under what is known as the Highly Indebted Poor Countries (HIPCs) initiative[1]. By December 2007, a total of 41 countries have qualified and became eligible for debt relief via the HIPIC initiative. Out of this, 19 African countries[2] reached the final stage or what is called the completion point, while nine countries[3] reached between the decision and completion points. Another 9 African countries were categorized as pre-decision point. The expected outcomes of such debt relief are adequate economic growth performance that would enable countries to achieve a sustainable debt burden following a partial debt relief and at the same time to reduce poverty in their respective countries via what are termed pro-poor policies.

2.2 The HIPC Initiative and Debt Relief

According to IMF figures, Ethiopia's total nominal debt stock at the end of fiscal year 2002/2003 was about $6.8 billion (or $4.5 billion in net present value (NPV) terms). This debt was huge relative to the size of the economy and the performance of exports. That is, it constituted what was then 100% of GDP or about 246% of exports. After the scheduled debt relief under the initiative was applied, the IMF projected that Ethiopia's outstanding debt in NPV terms will be reduced to $3.9 billion or 90% of the current GDP in nominal terms. The total debt relief committed in NPV terms by the time it reached the completion point was US$1,275 million or approximately 47% of its total official external debt.

The stock of the Ethiopian debt significantly declined due to the relief granted through the HIPC initiative. As Table 2.1 and Table 2.2 indicate, the outstanding debt both in absolute value and relative to GDP significantly declined after 2004, after Ethiopia reached the completion point. For instance, actual debt stock declined to about 50% of GDP in 2004/05 and 2005/06. IMF (2007) projections suggest that debt to GDP ratio is likely to decline further to a very low level by 2011. Similarly, the absolute level declined to about $2,306 million by 2005/06 (almost half of its level in 2004/05).

Table 2.1 Ethiopia: Selected Debt Indicators (as % of GDP unless otherwise indicated)

	2003/4	2004/05	2005/06	2006/07*
External Debt	77.7	52.9	44.9	13.9
Domestic Debt	35.8	34.2	35.0	30.1
Total Debt	113.6	87.1	79.8	43.2
NPV of Public Sector debt	126.2	32.2	35.5	35.6
NPV of External debt to export %	126.2	32.2	35.5	40.6
External debt-service to GDP%	6.3	4.0	5.0	4.4

Source: IMF (2007) Country Report No. 07247
*IMF (2007) Staff Projections.

In addition to the HIPC initiative, the Multilateral Debt Relief Initiative (MDRI) was also launched in 2006 with the aim of supplementing the HIPC initiative by further granting or cancelling the outstanding debt of the poor countries. Under the MDRI, IDA is expected to provide about US$37 billion in debt relief over 40 years. This is in addition to approximately US$17 billion of debt relief already committed by IDA under the Enhanced Heavily Indebted Poor Countries (HIPC) Initiative (IMF, October, 2007).

[1] For detailed discussion of the HIPC initiative and conditions attached to it see Boote and Thugge (1997) and Cohen(2000).
[2] Post Completion African countries are: Benin, Burkina Faso, Cameroon, Ethiopia, The Gambia,
Ghana, Madagascar, Malawi, Mali, Mauritania, Mozambique, Niger, Rwanda, Senegal, Sierra Leone,
Tanzania, Uganda and Zambia.
[3] These are Brundi, Central African Republic, Chad, Republic of Congo, democratic Republic of Congo, Guinea and Guinea-Bissau.

The MDRI debt cancellation process used some of the above indicators to establish whether a country qualifies for debt relief or not. For instance, the amount of debt relief that a poor country requires at the decision point in order to reach the final stage of completion point is judged by the amount which brings down its debt-to-export ratio to 150%.

Accordingly, Ethiopia received an additional US$2,337 million from the MDRI initiative in addition to the US$1,278 million it received from the HIPCs initiative which brought the amount of total debt relief it received by the time it reached the completion point to US$3,616 million. As will be explained later, both the above initiatives contributed a lot to the reduction of the Ethiopian debt stock and hence to the likelihood of its sustainability.

Table 2.2 External Debt Outstanding by Sources of Financing (2005/ 2006 & 2006/ 2007)

Financing Sources	DOD as at 30/06/2006		DOD as at 30/06/07		Change	
	Million USD	%	Million USD	%	Million USD	%
Multilateral	4,884.68	81.78	1,186.26	51.43	-3,698.42	-75.71
o/w IDA	3,488.22	58.40	615.04	26.66	-2,873.18	-82.37
o/w AfDB/F	1,092.98	18.30	247.62	10.73	-845.36	-77.34
Official Bilateral	796.82	13.34	807.84	35.02	11.02	1.38
Paris Club	335.79	5.62	368.70	15.98	32.91	9.80
o/w Russia	162.44	2.72	162.44	7.04	0.00	0.00
Non-Paris Club	461.03	7.72	439.14	19.04	(21.89)	(4.75)
Commercial	354.15	5.93	312.60	13.55	-41.55	-11.73
Out of which EAL	323.31	5.41	281.18	12.19	-42.13	-13.03
Total	**5,973.10**	**100.00**	**2,306.70**	**100.00**	**-3,666.40**	**-61.38**

Source: Credit Administration Department of the Ministry of Finance and Economic Development (MoFED), 2008.

2.3 Debt relief and Poverty Reduction

The next question that should be asked is: has Ethiopia used the debt relief to improve the welfare of its citizens? If so what have been the achievements so far? On the whole, despite the dismal performance of the economy and low social indicators for decades, the improvements recorded in the last few years has been good. Even though it is difficult to ascertain causality with any degree of precision, but the fact that the economic improvement followed or coincided with the debt relief and the implementation of the Poverty Reductions Strategy Paper (a pre-condition for the debt relief) may suggest the latter contributed to the economic performance registered during the last four years. The improvements viewed both in terms of simple macroeconomic growth and in terms of an overall economic development (broadly defined to include economic welfare and social wellbeing) have been substantial. For instance, the Ethiopian economy grew by an average of about 10.6% per annum during 2003/04 -2005/06, and according to IMF (2007) Medium Term Projections, the economy will grow by an average of about 8% per annum until 2010/11 while the government is optimistic that it would maintain the 10% GDP growth rate it has registered in the last four years. This growth was led by the growth in the agricultural sector, which significantly benefited from the allocation of the loans given to Ethiopia over the years and from the debt relief.

Attempts to meet the MDGs have registered mixed results compared to set targets. In particular, the progress made in designing and implementing the programs contained in the first Poverty Reduction Strategy Paper particularly related to the education sectors is significant. All the indicators that measure the provision of education services surpassed their target by an appreciable margin. While the provision of road services has improved, the indicators of health provisions failed to meet the set targets during the first phase (2003-2005) of what was referred to as the Sustainable Development Poverty Reduction Program (SDPRP) period.

Table 2.3 Percentage Share of Poverty Oriented Expenditures of Total Expenditures

Poverty Oriented Sectors	2001/02	2002/03	2003/04	2004/05
Education	14.2	16.1	20.4	18.7
Health	5.9	4.9	4.3	4.8
Agriculture and food Security	9.2	8.1	13.4	16
Water and sanitation	2.8	2.9	2	3.4
Roads	10.7	9.9	9.6	16.6
Total Poverty Oriented Expenditures	42.8	41.9	49.6	59.5

Source: Ethiopia: SDPRP- Annual Progress Report, MOFED, March 2005

The other aspect related to the commitment of the government in its PRSP or in what is locally referred the SDPRP, is its budget allocations towards the various activities. In line with its commitment to these programs, the total budget allocated for what is called 'poverty oriented expenditures' has also increased by a significant margin. For instance, as indicated in Table 2.3, by 2004/05, the share of poverty oriented expenditures in the total budget reached about 60 per cent from about 43 per cent at the beginning of the program. Further, according to the recent PRSP or what is called 'A Plan for Accelerated and Sustained Development to End Poverty' (PASDEP) budget, poverty oriented expenditures constituted about 62.9% of total spending in 2006/07 and planned to be 76.3% in 2007/08 (MoFED, 2007).

In particular, the shares of education and roads increased by 4.5 and 6 percentage points, respectively, in 2004/05 relative to 2001/02. And the shares of education, health and roads constituted 33%, 11% and 24% of the total poverty oriented expenditures in fiscal year 2006/07. The respective planned figures for 2007/08 are 33.2%, 12% and 25.6% of the same total. Relative to the 2006/07 budget, the 2007/08 budget allocations are 23.2 percentage points higher for education, 32.2 percentage points higher for health and 32.8 for roads.

Having reviewed the debt relief and some of the progress made in meeting some of the MDGs using the debt relief, it is important to ask whether the remaining debt stock and what has been added to it is sustainable, given the country's precarious level of development, and how do the fiscal constraints interface with Ethiopia's attempt to meet the MDGs. It should be emphasized that the most important rationale of the HIPC initiative was that, once these countries are granted the partial debt relief, in addition to reducing poverty, they would also achieve a sustainable debt burden. But issues related to the efficacy of the HIPC initiative, the performance of the countries during the post-HIPC period and hence the status of the poorest countries in terms of meeting the Millennium Development Goals (MDGs) has prompted both state and non-state actors to revisit the issue of debt sustainability.

3.0 Debt Sustainability Analysis

Following the debt relief given to Ethiopia via the HIPCs and the multilateral Debt Relief (MDRI) initiatives, Ethiopia's debt burden has significantly decreased in the last three years. More specifically, it declined from a high of 150 of GDP in 1998 to a low of about 13% by 2006/07. And, therefore, unless Ethiopia's policy makers re-engage themselves into a huge debt burden in commercial terms, and the growth of the economy is hit by adverse shocks, plausible degrees of indebtedness and economic performance of the economy seems to suggests that the debt burden that exists at the moment is sustainable. The sustainability analyses carried out in this paper using plausible economic growth and debt burden suggests that the fiscal policy implications of the debt burden is not that high and hence sustainable. Other studies also support the conclusion that the Ethiopia's current debt burden has declined to a sustainable level.

3.1 Approaches to Debt Sustainability: A Review

At a conceptual level, debt sustainability is achieved "if it is expected to be able to meet its current and future debt-service obligations in full, without recourse to debt relief, rescheduling of debts, or the accumulation of arrears, and without unduly compromising growth" (Kitabire and Kabanda, 2006). This is the conventional approach which both multilateral and bilateral donors seem to use when assessing the sustainability of a given country's debt. Therefore, the issue of concern is how the expectation that a given country will do so are formed or measured and whether and how the opportunity cost(s) of making the debt sustainable are assessed.

The first and the most common method used to assess debt sustainability until the early 1990s was the one formulated by the WB and the IMF in relation to the HIPC initiative. These measures are anchored on assessing debt burden in terms of (a) the stock of nominal debt expressed in a single currency (usually in US$), (b) the stock of debt measured in terms of net present value (NPV) terms, and (c) annually or multi-annually due debt-service payment(s). These indicators are used to find the extent of the burden as compared to various denominators. Among the most commonly employed debt burden ratios were

> the total debt outstanding to GDP or GNI ratio …the total debt outstanding to exports of goods and non-factor services… (and) public debt outstanding to GDP or GNI….The present value of debt to GDP or GNI and the present value of debt service to exports" (Kappagoda and Alexander, 2004, p. 23) .

The above indicators of debt burden and hence its sustainability were supplemented by some fiscal indicators which included the ratio of debt (domestic and foreign) service payments to government revenue, the ratio of public debt (domestic and foreign) outstanding to government revenue, and the ratio of the average rate of interest on government loans to the rate of growth in government revenue (ibid, p.24). These indicators are supposed to gauge the extent to which the flow of government revenue is robust enough to accommodate the flow of debt payments.

As indicated above, the HIPCs and the MDRI initiatives relied heavily on few key variables for debt burden and its sustainability analyses. Further, debt sustainability under the HIPC initiative focused its attention on public and publicly guaranteed external debt while ignoring domestic debt even though it poses a serious threat in many low income countries (Kappagoda and Alexander, 2004). In Addition, Kappagoda and Alexander (2004), further argued that private sector external debt could be significant in some countries, and hence ignoring it, as the HIPC initiative does, could mislead the debt sustainability assessments in many poor countries.

Other issues of concern in carrying out the debt sustainability analyses include:

- The assumptions made about the growth of GDP and exports tend to be more optimistic; it more often than not ignores a country's historical performance in favour of more recent figures.
- The magnitude of the domestic debt component is given less attention in these assessments.
- The earlier HIPC initiative paid less attention to the specific country policy environment and institutional capacity to carry out its future debt obligations.

Due to the above and similar shortcomings, the revised Debt Sustainability Framework (DSF) proposed some changes in both the choice of debt burden indicators and sustainability measures.

> The proposed DSF chose five – three stock and two flow – indicators for consideration from among the debt indicators …and unlike in the HIPC initiative where a single indicator –debt to exports – was used the DSF paper selects three debt ratios to judge debt sustainability" (Kappagoda and Alexander, 2004, p. 6). .

Other considerations in the analyses of debt sustainability are the policies that a given country follows and its institutional capacity to carry out these policies. The inability to maintain a sustainable debt or having a debt distress are caused by high accumulated debt as measured by an absolute amount or relative to GDP, export or government revenue, weak institutional capacity or poor policy environment in a country, which will increase the probability of a debt distress due to inefficient use of resources, and external shocks that affect the country which hinder the country to service its debt without having to compromise its planned development goals.

According to Kitabire and Kabanda (2006), the new DSF is anchored on Country Policy and Institutional Assessment (CPIA) and some HIPC initiative bench marks. Countries are classified as high, medium or weak performers on the bases of the scores of the CPIA and HIPC threshold indicators. It is worth noting that under the DSF, the debt sustainability threshold of a medium CPIA performer are broadly equivalent to those used in the HIPC initiative in percentage terms (Kitabire and Kabanda, 2006, p.13).

Table 3.1 Comparison of DSF Thresholds and HIPC Initiative Benchmarks

	NPV debt/Export %	NPV debt/GDP %	Debt service/ Export %	NPV public debt/ Revenue %	Debt service/ Revenue %
Weak CPIA performers	200	50	25	300	35
Medium CPIA performers	150	40	20	250	30
Strong CPIA performers	100	30	15	200	25
HIPIC benchmarks	150		15 -20	250	

Source: Kitabire and Kabanda, 2006

In sum, the DSF approach is clearly considered more appropriate as indicator of debt sustainability relative to the earlier proposed under the HIPC initiative for at least the following reasons:

- It focuses on the ability of the country to pay its debt based on the country's relevant and appropriate policy environment and institutional capacity.
- It focuses on the ability of the country to carry the debt burden without compromising its long term goals.
- It includes both publicly guaranteed external and domestic debt.

In light of the above approaches and using the above sustainability thresholds, the following section will examine the sustainability of the Ethiopian debt.

3.2 The Sustainability of Ethiopian Debt

3.2.1 Review of previous Assessments

Before an attempt is made to evaluate the dynamic path of Ethiopian debt and hence gauge its sustainability, a review of the previous analyses carried out, mainly by the international institutions (The IMF and the WB) is in order. In that respect, previous evaluations based on both the HIPC initiative benchmarks and the more recent DSF analyses will be reviewed.

In general, according to the most recent IMF evaluation, Ethiopia's ability to carry out its debt burden has improved significantly in recent years. To put it in the words of IMF:

> ***In recent years Ethiopia has benefited from significant debt relief, which has helped to ensure that its debt is sustainable...As of the beginning of 2006/07, the net present value (NPV) of debt in relation to output stood at 6 percent and to exports at 36 percent far below the threshold suggested by the debt sustainability framework (DSF) developed by the World Bank and the Fund... the NPV of debt to exports is projected to reach about 60 percent in five years and then hold there over the long run; this is well below the prudent threshold (150 percent of exports). The NPV of debt to GDP is projected to level out at about 15 percent by 2025/26, also well below the prudent threshold of 40 percent of GDP. Debt service is manageable throughout the period, rising only to 3 percent of exports in 2025/26 (IMF, 22/5/07, p.1).***

After stating the above observations, however, the IMF report stressed its areas of concern for Ethiopia's debt sustainability. It noted that for Ethiopia, the two most extreme stress tests involve (i) applying one half standard deviation shocks to growth, exports and grants and (ii) new borrowing at less favourable rates (ibid, pp.2-3). Applying these distress tastes in 2006/07 and 2007/08, the IMF staff estimated that the ratio of debt to exports peaks at about 155 percent in 2010/11 and eventually levels out at 95 percent in 2025/36 (ibid, pp.2-3). According to these estimates, therefore, even the scenario of contracting debt at less favourable terms does not seem to violate the established threshold, though it increases it by about 50 percent, which is a huge increase relative to the figures stated above.

Despite the above concerns, according to the most recent DSF-based sustainability analyses, Ethiopian debt is below the sustainability threshold. And, therefore, as indicated in Table 3.2, the Ethiopian debt stock has significantly declined and seems to be in good shape on the whole. As Table 3.1 shows, with "medium" CPIA ratings, the country's debt is considered sustainable according to the low income country (LIC) baseline assessment, even though the distress test is "high".

On the other hand, the HIPC indicators show that the Ethiopian debt is unsustainable. The difference in the two assessment indicators lies in that the HIPC indicator uses NPV of debt to export ratio which takes into account the average of the last three years while that of the DSF uses the current year NPV to export ratio. Clearly with a volatile primary export sector, it makes a difference which ratio one uses, as export growth has been robust in recent years compared to the last three years. That is to say, that the HIPC indicators reflect long-term debt sustainability and the DSF emphasis current debt sustainability.

Table 3.2 Comparison of LIC Sustainability Analysis and HIPC Analysis

	CPIA rating	LIC baseline	LIC risk assessment	Latest HIPC indicators	HIPC nine year forecast
Burkina Faso	Medium	Sustainable	Moderate	Unsustainable	Unsustainable
Tanzania	Strong	Sustainable	Moderate	Unsustainable	Sustainable
Uganda	Strong	Sustainable	Moderate	Unsustainable	Unsustainable
Rwanda	Medium	Sustainable	High	Unsustainable	Unsustainable
Ethiopia	**Medium**	**Sustainable**	**High**	**Unsustainable**	**Unsustainable**
Ghana	Medium	Sustainable	Moderate	Unsustainable	Unsustainable

Source: Kitabire and Kabanda, 2006, Table 2, p. 15.

Also noted, is that despite medium to strong CPIA ratings, a broad array of African countries debt stock is deemed unsustainable, given their historical performances. This points to the fact that these countries are commodity dependent and extremely vulnerable to price and demand shocks. This further underscores the point of how African countries came to being highly indebted, as the structure of their economies have not changed so hasn't the underlying reasons for debt distress.

However, even considering the scenarios of contracting non-concessional loans or taking the historical values (rather than the current values) of the relevant macroeconomic aggregates, the Ethiopian debt, though higher than the base line scenario, seems to be still below the threshold indicators. That is, even under the above stated most stress tests, Ethiopia's public and publicly guaranteed external debt indicators will remain below the base case scenario between 2006-2025 (IMF, 22/5/07, Fig. 1-3, pp. 5-7). Recent studies[4] carried out (mainly by multilateral institutions) indicate that on the whole the Ethiopian debt is sustainable when viewed relative to the DSF indicators.

The remaining part of the study attempts to further examine the extent to which the existing debt burden allows the country to continue to engage itself in poverty reduction programs in general, and the MDGs in particular, using its fiscal policy instruments. More specifically, the paper will further examine: (1) what are the fiscal implications in terms of deficit/surplus position of the country under different growth scnarios? (2) If incurring deficit, how high an amount is required under various economic growth scenarios for it to maintain a healthy fiscal balance? And (3) what are the fiscal and social (such as poverty reduction) implications (in terms of trade-offs) of attempting to maintain debt sustainability? These are crucial questions for a country like Ethiopia, whose economic capacity to finance basic social provisions is limited and has been dependent on foreign financial flows to meet even its basic socio-economic needs.

3.2.2 Debt Sustainability and Fiscal Policy

In line with recent arguments that debt sustainability has also to capture the institutional capacity and the country's commitment to development goals such as the MDGs, the paper attempt to address these questions by using the debt sustainability framework developed by Edwards (2002). This framework examines the required fiscal policy path to achieve sustainability of total public (both foreign and domestic) debt. His model is suited to project the fiscal stance which is consistent with sustainable public sector debt levels during the post-HIPC era. The model has an advantage to investigate these issues because it (a) considers alternative donor responses in extending loans during the post HIPC era; (b) it examines the sustainability path using various alternative growth scenarios; and (c) it computes the fiscal policy path that is consistent with a sustainable debt burden.

The average GDP growth rate in Ethiopia has been around 5.5% in the last ten years, and its future growth rate is projected by the IMF to be around 7% or more. The yearly growth rates had been very volatile ranging from -4 to 12 % up to 2002/03, with an average of about 11% in the last four years. Hence, alternative growth rates that range from 2 to 10% are used to capture this volatility.

As shown in Table 3.3, it is clear that for any GDP growth between 2 to 10% the government can afford to run a primary budget deficit[5] even though the amount would vary depending which growth rate is realized. For instance, for GDP growth rates that range between 2 to 10%, the government can afford to incur a primary balance deficit that ranges between around 3 to 7% of GDP. It has to be noted that the budget deficit in Ethiopia is currently at about 5% of GDP and averaged about 6% of GDP during the last 10 years. It is also worth noting that, on the whole, the required primary balance to maintain a sustainable debt is within the average deficit and growth rates observed in the economy. Moreover, the primary balance required for debt sustainability is only about 3% of GDP. Hence, in the very unlikely scenario that *no* donor concessional loans will be forthcoming during the post-HIPC era, the required primary balance deficit to ensure debt sustainability is below the historical average. That is, the government can afford to incur a deficit under all growth scenarios. In other words, no serious fiscal constraint will emerge provided the economy grows by about 5% or above.

[4] IMF in its Country Report No. 07/247(2007), The World Bank and the IMF (2006) noted that the recent Ethiopian debt is sustainable even under distress scenarios even though a moderate risk still exists.

Table 3.3 Debt Sustainability(partial availability of concessional loans)

Year	Alternative Growth Rates						
	2%	3%	4%	5	6%	7%	10%
1	3.45	3.99	4.52	5.04	5.56	6.08	7.59
3	3.43	3.96	4.49	5.01	5.52	6.03	7.52
4	3.40	3.95	4.47	4.99	5.50	6.01	7.49
5	3.42	3.94	4.46	4.97	5.48	5.99	7.46
6	3.41	3.93	4.45	4.96	5.46	5.96	7.43
7	3.40	3.92	4.43	4.94	5.44	5.94	7.41
8	3.40	3.91	4.42	4.93	5.43	5.92	7.38
9	3.39	3.90	4.41	4.91	5.41	5.90	7.36
10	3.38	3.89	4.40	4.90	5.39	5.88	7.34
Steady State	2.69	2.69	2.69	2.69	2.69	2.69	2.69

Source: author's Calculations

Considering this scenario is interesting in illustrating what debt sustainability would look like if the existing state of dependency continues. But, it has to also be noted that it is unrealistic to assume that donors will continue assisting countries like Ethiopia indefinitely. Instead a more plausible assumption is that donors are likely to reduce their aid flows, if nothing else for the simple reason that as dependency continues what is referred to as "Aid Fatigue" will set in before long if it has not already. Further, the primary motive of the HIPC initiative is that once the indebted countries received debt forgiveness, they will maintain a sustainable debt in the future on their own, without resorting to concessional loans.

The next issue to be addressed is the evolution of the concessional loan over time under the two scenarios considered for alternative real GDP growth rates. As is evident from Table 3.4, the yearly decline in the ratio of subsidized loans to GDP is very gradual. For instance, for any GDP growth rate of 10%, it takes about ten years to bring the ratio of debt to GDP to about 15%. But in the more realistic (at least in historical terms and believed to be the minimum required for achieving the MDGs) growth rate of 7%, it takes about 10 years to bring the ratio of debt to GDP to around 20%.

Table 3.4 Evolution of Debt (no new loans)

Year	Alternative Growth rates						
	2%	3%	4%	5%	6%	7%	10%
1	45	45	45	45	45	45	45
2	43.02	42.59	42.17	41.75	41.33	40.92	39.71
3	41.13	40.31	39.51	38.73	37.96	37.21	35.05
4	39.32	38.16	37.03	35.93	34.87	33.84	30.93
5	37.59	36.11	34.70	33.34	32.03	30.77	27.29
6	35.93	34.18	32.51	30.93	29.42	27.98	24.09
7	34.35	32.35	30.47	28.69	27.02	25.45	21.26
8	32.84	30.62	28.55	26.62	24.82	23.14	18.76
9	31.40	28.98	26.75	24.70	22.80	21.04	16.55
10	30.01	27.43	25.07	22.91	20.94	19.14	14.61

Source: author's Calculations

This second scenario considered (which assumes that new additional subsidized loans will be available) shares with the first case in that the decline in the share of debt to GDP ratio is gradual. Due to the accumulation of new loans, even in the very optimistic case of a 10% real GDP growth rates in the next ten years, the share of debt to GDP will remain above around 30% for about 10 years.

It is important to note that, under the scenarios considered, the time frame in which the debt to GDP ratio will converge to zero takes a long time. For instance, under the scenario in Table 3.4, the debt to GDP ratio will range from about 6 to 0.2% of GDP for respective growth rates ranging from 2 to 10% for over 50 years. On the other hand, for the scenario presented in Table 3.5, since new loans are also added, in 50 years, the ratio of debt to GDP will only decline in the range of 4 to 26% for growth rates ranging from 2 to 10%.

Table 3.5 Evolution of Debt (new loans)

Year	Alternative Growth Rates						
	2%	3%	4%	5%	6%	7%	10%
1	45	45	45	45	45	45	45
2	44.55	44.33	44.11	43.89	43.67	43.45	42.81
3	44.11	43.67	43.24	42.81	42.38	41.96	40.72
4	43.67	43.02	42.38	41.75	41.13	40.51	38.73
5	43.24	42.38	41.54	40.72	39.91	39.12	36.84
6	42.81	41.75	40.72	39.71	38.73	37.78	35.05
7	42.38	41.13	39.91	38.73	37.59	36.48	33.34
8	41.96	40.51	39.12	37.78	36.48	35.22	31.71
9	41.54	39.91	38.35	36.84	35.40	34.01	30.16
10	41.13	39.32	37.59	35.93	34.35	32.84	28.69

Source: author's Calculations

A few points are worth emphasizing.

§ The above analysis is not to suggest that accumulating debt is necessarily bad. What matter is the size of the debt relative to the size of the economy since servicing the debt has significant opportunity costs and possibly adverse social consequences. These include lower expenditures on health, education and transport expenditures (the three main government targets in its PRSP) and other social provisions. For instance, as indicated in Table 3.6, Ethiopia allocated about US$390.79 million for various sectors ranging from agriculture and food security to various social provisions in 2005/06 and US$357.47 in 2006/07. Similarly as indicated in Table 3.7, Ethiopia spent US$107.72 million and $99.45 million for servicing the debt during the above years, respectively. This means that, the amount spent to service the debt during the two respective years was about 28% of the total spent for achieving the MDG goals for which the expenditure was allocated. That is to say, what was spent for servicing the debt could have enabled the country to increase its ability of meeting the MDGs by about 28%.

Table 3.6 Gross Disbursement by Economic Sectors, USD millions

Sectors	Fiscal Year 2005/2006		Fiscal Year 2006/2007	
	Amount	%	Amount	%
1. Agricultural & Food Security	31.38	8.03	33.79	9.45
2. Elec Light & Power Product	163.61	41.87	131.82	36.88
3. Water and Irrigation Related	12.25	3.13	26.08	7.30
4. Transport and communication	44.82	11.47	1.96	0.55
5. Infrastructure	25.22	6.45	56.90	15.92
6. Education & Capacity building	19.77	5.06	51.38	14.37
7. Health	22.56	5.77	6.35	1.78
8. Socio-cultural, welfare and Rehabilitation	4.86	1.24	10.80	3.02
9. Emergency Recovery & Recon	54.62	13.98	33.69	9.42
10. Financial Sector	9.90	2.53	3.07	0.86
11. Tourism	1.80	0.46	1.63	0.46
TOTAL	390.79	100.00	357.47	100.00

Source: Credit Administration Department of the Ministry of Finance and Economic Development (MoFED), 2008.

Table 3.7 **Actual External Debt Service by Major Creditors Group, USD millions**

Creditors	FY 2005/2006	FY 2006/2007						
	Principal	Interest	Total	Principal	Interest	Total	% of total	% Change
Multilateral	23.80	14.83	38.63	12.84	12.06	24.90	25.04	(35.54)
IDA	5.83	8.33	14.16	0.58	5.74	6.32	6.35	(55.37)
ADB/ADF	9.52	5.09	14.61	8.16	4.79	12.95	13.02	(11.36)
Others	8.45	1.41	9.86	4.10	1.53	5.63	5.66	(42.90)
Paris Club	3.67	3.17	6.84	2.06	6.84	8.90	8.95	30.12
Non-Paris Club	7.80	0.79	8.59	5.02	0.41	5.43	5.46	(36.79)
Commercial (EAL)	39.58	14.08	53.66	43.65	16.57	60.22	60.55	12.23
TOTAL	74.85	32.87	107.72	63.57	35.88	99.45	100.00	(7.68)

Source: Credit Administration Department of the Ministry of Finance and Economic Development (MoFED), 2008.

§ Since we are mainly examining the debt accumulated to finance the to-date accomplished economic activities, it is clear that an optimal benefit has not been derived from the accumulated debt if the attendant (save the good economic growth of the last years) performance of the economy is the appropriate yardstick by which it should be justified. This could be evidenced by the low overall standard of living of the country in general and the low social indicators in particular stated in Appendix 2. As both national and international economic indicators attest, Ethiopia is poor both compared to other African countries and compared to the alleged natural resources it posses. And the debt flows that have obtained over the years may have made some difference but definitely not helped her escape the poverty trap.

While it is true that Ethiopia has not benefited as much as it could have form the procured debt over the years. But according to recent official figures, the government claims that it has made some headway towards meeting the MDGs. For instance, in its attempt to meet goal one (Eradicating Extreme Poverty and Hunger), in addition to registering robust economic growth in the last few years, the government claims that the percentage of people who are below the poverty line decreased from 38% in 2004/05 to 36.6% in 2005/06 and then to 34.4% in 2006/07 (MoFED, 2007, p. 131). Similarly, with regard to goal two (achieving Universal Primary Education) Gross primary enrolment grade 1-8) reached 91.6% in 2006/07. Further according, according to the same report education and related indicators have registered appreciable progress towards meeting the MDGs (Ibid, P. 131). In general, according to its recent review of the progress made towards achieving the MDGs (as detailed in Appendix 9), the government claims it has made advances in all the eight goals as well even though meeting all of them is unlikely. And it has to be noted that the debt acquired so far has, at lest partially, contributed to the progress made in this sphere.

§ Another salient feature of the Ethiopian economy worth emphasising is the economic performance that have been registered in the last few years are vulnerable since the economy dependent on agriculture and the latter on the vagaries of nature. And the huge debt that has flown to Ethiopia has not been used to help the country to transform the economy away from dependence on nature, such as via irrigation schemes to ensure food security.

4.0 Conclusions

This paper attempted to examine the challenges of debt sustainability in Ethiopia in general and in the post-HIPC era, in particular. After briefly reviewing the state of the Ethiopian economy as a background to assess the extent to which the economy could carry a debt burden, it investigated the challenges of debt sustainability using both the assessment of the multilateral institutions and based on the fiscal flow approach. That is, it examined the challenges of debt sustainability by assessing the sustainable primary balance that would prevail under different scenarios of donor behaviour in terms of allowing access to subsidized loans once the HIPC initiative is over.

The main findings could be summarized as follows.

- Due to the significant debt relief that has been extended to Ethiopia following the HIPC and MDRI initiatives, the Ethiopian debt has substantially declined relative to what it was until 2004.
- Due to the significant reduction in the absolute size of the external debt, the IMF and other donors believe that the current Ethiopian debt is sustainable coupled with the performance of the economy in the last few years.
- Examining debt sustainability even under the scenarios of an increase in unfavourable loans, a decline in growth of GDP, in exports or revenue (that is carrying out some debt distress tests), debt levels would still be deemed sustainable with reasonable changes in the above parameters.
- When the primary balance that is compatible with a sustainable debt is computed, it suggests that the fiscal policy effort required to achieve this sustainability is not as daunting as it used to be. This is because the computed required primary balance under different economic growth scenarios that are consistent with a sustainable debt are much higher than what is historically observed.
- Examining the evolution of the debt under the two scenarios considered suggest that the decline in the debt to GDP ratio is gradual in all the alternative growth rates considered, but in all cases the debt to GDP ratio indicates that it will declines to a manageable size.
- And, finally, this exercise helps us gauge the extent to which fiscal effort is required to achieve a primary balance that is compatible with a sustainable debt given the existing fiscal structure.

In summary, the most important conclusion that comes out of this study is that even under the more pessimistic scenarios that the donor community will not continue to offer concessional or subsidized loans after the end of the HIPC initiative, the public sector primary balance required to maintain a sustainable debt is not going to be that huge even under the more pessimistic scenario of low GDP growth, exports or revenue.

The above observations suggest that both in terms of the fiscal aspect of the size of the debt and hence in terms of its implications for development goals, the Ethiopian debt is less of a concern than what it was prior to 2004. And therefore, if the assumptions regarding the flow of new loans in the post-HIPC era did not dramatically change, the performance of the economy maintains its historical average and better yet its more recent average, the flow of concessional loans or aid continues and no new excessive private loans are contracted, Ethiopia is in good shape to keep its debt sustainable. And, if this holds, it implies that it is in historical terms, in a better position to address poverty reduction issues, in general, and achieving at least some of the MDGs (such as health and education), in particular.

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Appendix 1 Ethiopian: Some Basic Statistics

	External Debt	GDP	Exchange rate	Export	Revenue	Debt	Debt	Debt
	mill USD	Mil USD	Bir/US	Mil USD	Mil USD	%GDP	%Exports	%Revenue
2001/02	6218	7429	8.54	939.9297	1502.576	83.7	661.5	413.8
2002/03	6738	8029.2	8.58	1139.627	1830.186	83.9	591.2	368.2
2003/04	7371	9484.7	8.62	1499.884	2078.654	77.7	491.4	354.6
2004/05	6021	11373.1	8.65	1829.249	2329.133	52.9	329.2	258.5
2005/06	5973	13315.2	8.68	2097.35	2679.839	44.9	284.8	222.9
2006/07	2306.7	17284	8.7	2999.6	3083.5	13.3	76.9	74.8
Average/6yrs	5771.3	11152.5	8.6	1750.9	2250.6	59.4	405.8	282.1
average/3yrs	4766.9	13990.8	8.7	2308.7	2697.5	37.0	230.3	185.4

Appendix 2 Selected MDGs Indicators Synchronized with PASDEP Targets (2006/07)

MDGs	Component	Target	Baseline (2004/05)	2005/06	2006/07	PASDEP (end of 2009/10)
Goal 1	Eradicating Extreme Poverty and hunger	GDP growth rate	10.6	11.6	11.4	7.3 (period average)
		% of people who are below poverty line	39	36.6	34.6	29.2
		% of stunted children	38	35.6	33.5	27.6
		% of wasted children	47	40.5	---	22.6
Goal 2	Active Universal Primary education	Gross Primary enrolment (1 to 8) %	79.8	91.3	91.6	109.7
		Grade 5 completion rate (%)	57	63	65.2	136.6
		Grade 8 completion rate (%)	34	42	42.9	62.7
		Pupil: text book ratio	2:1	1.5:1	1.25:1	1:1
		Primary 1-4 student Section ratio	71	70	64	50
		Primary 5-8 student section ratio	55	68	63	50
		Pupil: teacher ratio				
		• Primary 1-4	71	64	65	54
		• Primary 5-8	55	55	54	45
Goal 3	Promote gender equality and empower women	Girls: Boys ratio				
		• Primary 1-4	0.87	0.90	0.93	0.97
		• Primary 5-8	0.69	0.74	0.78	1
Goal 4	Reduce Child Mortality	Child mortality	140/1000 (2003/04)	123/1000	---	85/1000
		DPT3 coverage	70	75.6	73	80
Goal 5	Improve Maternal Health	Maternal mortality	871/100000 (2003/04)	673/100,000	---	600/100,000
		Proportion of birth attended by trained health personnel	9	15.1	16	32
		CPR	15	35.6	33	60
		% of HIV positive pregnant women receiving complete course of ARV	42	---	36	50
Goal 6	Combat HIV/AIDS, Malaria and	% of people with advanced HIV receiving ART	10	---	37.1	70
		Proportion of households in malaria	1	43	91	100

Goal 6	Combat HIV/AIDS, Malaria and other diseases	% of people with advanced HIV receiving ART	10	---	37.1	70
		Proportion of households in malaria exposed areas with 2 bed nets, properly utilized (%)	1	43	91	100
		TB treatment success rate (%)	76	78	85	85
Goal 7	Ensure Environ-ment sustainability	Access to safe drinking water	42	47.3	52.4	84.5
		% of land covered by forest	3.6	---	---	9.0
		Provision of housing and basic services (%)	30	---	---	65
		Reducing stunt areas (%)	70	---	---	35
Goal 8	Develop a Global Partnership for Development	Net ODA to LDC, as a % of OECD/DAC donors' gross national income	0.2	---	---	---

Source: *MoFED (2007) " Ethiopia: Building on Progress: A Plan for Accelerated and Sustained Development to End Poverty (PASDEP)" Annual Progress Report 2006/07.*