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Policy Brief

Policy Brief 1: Profile of Ethiopian Debt and Its Institutional Challenges: An Exploratory Analysis

Policy Brief I

Profile of Ethiopian Debt and Its Institutional Challenges: An Exploratory Analysis

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Ethiopian debt has significantly increased in the past two decades, partly because it was financing the excellent growth it has attained in the last two decades. As a result, the country's outstanding debt has reached about USD 60 billion, equally divided between domestic and external debt, which is about 53 percent of GDP in 2022, a significant improvement from the 60 percent (of the GDP) rate registered in 2018. Multilateral lenders (especially the IDA wing of the World Bank), followed by China and private creditors, are its main creditors. Given the low and precarious growth of exports and exceedingly high growth in imports, servicing this debt, especially the external one that needs foreign exchange, is becoming a significant challenge for the government as it claims about two-thirds of its merchandise export earnings. Spending on servicing debt has also become the highest spending item (overtaking the combined share of the expenditure on education and roads) in the country's budget last year. The government, thus, has reached a point where it is heading towards suspending servicing its debt, waiting for creditors' goodwill to restructure it.

The Ethiopian debt problem is primarily a liquidity rather than a solvency problem, chiefly due to its underdeveloped export sector covering less than half of its imports. The economic growth that was brought about by the debt was and still is unable to provide the foreign exchange needed to service the external debt – revealing a growth strategy problem of financing its growth in the past two decades. The problem is akin to the 'transfer problem' that Keynes analyzed as Germany's problem after WWII, where it has to compensate (in foreign currency) for the damages it inflicted on the eventual winners of the war -the 'Allied Forces'.

The analysis in this study shows the existence of a significant debt burden and several institutional challenges of the debt problem, including its management. The country, in its Ministry of Finance (MOF), has a commendable organizational structure (including a department dedicated to handling Chinese finance and debt) to manage its debt, though with limited capacity or experts and challenges of proper implementation of rules and regulations by the government. This calls for capacity building, transparency, and accountability to manage the debt burden adequately.

In this study, we also argue that the institutions in charge of debt management and concerned about debt must go beyond debt management to develop an exit strategy from persistent aid dependency, which is the major source of the debt-creating flows, for financing development. This can be done by prudently managing its resources in the short run and adequately covering its spending (including external debt servicing in foreign currency) with its own resources in the medium to long term. Towards that end, from our analysis of the country's institutional aspect of debt management, we have outlined some policy directions to improve the institutional aspects of managing debt. Generally, addressing the debt problem requires improving or building government institutions and skilled human capital to manage the macro economy, which includes debt management.

With these general findings of the study, we have expounded these major findings and their policy implications in this "Policy Brief."

In this study, an attempt to provide the profile of Ethiopian debt and its institutional-related challenges is made in detail. The analysis reveals the Ethiopian debt to be significant, especially concerning the country's capacity to service its debt. The study also found that the Ethiopian current debt problem is primarily a liquidity problem, not a solvency one. The latter, in turn, is related to the underdevelopment of its export sector, which covers less than half of its imports, which sets the demand for continuous external indebtedness to cover the import-export gap and the resulting foreign exchange shortage.

The analysis also shows the country has quite a sophisticated institutional set-up to manage its public debt from an organizational perspective, including the timely release of well-organized public debt data. However, several institutional challenges in managing debt, including a lack of skilled experts and challenges in properly implementing rules and laws (i.e., political challenges), are identified as one of Ethiopia's major debt problems. This calls for the government's capacity building, transparency, and accountability to address the country's public debt challenges.

In addition to these general policy implications, the study points out the following specific policy directions that policymakers need to consider to adequately address the debt challenges related to the institutional aspect of debt and its management in Ethiopia.

First, though the MoF has an impressive organizational (institutional) structure concerning debt management and handling external debt-creating flows, these departments are poorly staffed and often need external expert assistance to carry out their task adequately. Thus, continuous capacity building and institutionalizing attractive incentive structures for staff (carrier and reward systems including decent salary) is essential to attract talent and maintain the existing experts. This also helps minimize the dependency on external experts, such as the IMF, for technical debt and macroeconomy-related work.

Second, the analysis reveals that there are no adequate institutional constraints to the government accumulation of both external and domestic debt in practice. This is particularly true concerning monetizing the fiscal deficit through government borrowing from the National Bank of Ethiopia (NBE) – the central bank, especially when external loans are unavailable for geopolitical or other reasons. Re-introducing the limit to government domestic borrowing from the NBE (as well as from banks and non-banking institutions) along with the 1994 NBE establishment proclamation is worth considering now, given the alarming growth of domestic public debt – direct advance, for instance, has grown by about 96.6% last year (2021/22) and 56.3% a year before. For instance, that law set a limit to government borrowing based on government revenue mobilization capacity in the past three years.

This policy needs to be augmented by monitoring other macro indicators, such as export and import growth, which are crucial for external debt servicing from a liquidity perspective (the 'transfer problems'). However, given that a government in a developing country such as Ethiopia will always be a developmental state, the limit on the level of monetization should be judged based on where the money is spent and its expected impact, including on debt repayment and inflation – using past data as indicators. Hence, it needs to be open for discussion during the parliament session or in the Council of Ministers meeting by calling expert witnesses (testimony) if needed.. In addition, setting up a legally binding debt service and debt-to-GDP ratio ceiling that serves as an "alarming bell" when additional borrowing is done is also worth considering to limit the extent of indebtedness, given the ever-growing government demand for debt.

Third, the study reveals that, though the MoF has a robust organizational structure to manage public debt, lawmakers (parliament) are unaware of the broader macroeconomic consequence of indebtedness (especially its implications on growth, repayment challenges, inflation etc., in the medium run). Such knowledge is also limited at the MoF debt management directorate and related departments/directorate because of the lack of tools such as a macro model and experts handling such analysis. Successive governments are not usually keen to show the broader macroeconomic implications of debt and its sustainability to the public or lawmakers. They are not strictly following the technical requirements outlined in the intuitional set-up of the MoF either. Parliamentarians hardly raise such issues when asked to approve government loans. Thus, parliament must call independent experts (from universities or other independent research institutions) as well as MoF experts as witnesses to hear their testimony and learn the overall consequence of a new loan on the profile of the public debt and its macroeconomic implications before deciding on approval.

This idea of calling experts for testimony needs to be extended to the decision about monetization of the deficit through government borrowing as that is also central for domestic debt accumulation and its macroeconomic implications, such as inflation and future debt servicing burden. Thus, establishing such a system of calling experts for testimony by parliament when loans (both domestic and external) and budgets are approved is a policy direction worth pursuing. The session also needs to be open to the media. This also contributes to the political accountability and transparency of the executive when such events at parliament are televised.

Fourth, a significant institutional challenge of handling debt relates to incorporating the future challenge of debt in the planning and budgeting process. This is central to address the root cause of the debt management problem from an institutional perspective. This issue, for instance, relates to how institutionally to include debt sustainability issues and potential macroeconomic implications of debt in the MEFF/Budget formulation process. By indicating the country's debt-carrying capacity, growth forecasting is critical in this respect (a rosy growth forecast in the past few years is recently being blamed as one of the factors for the current African debt problem. This is because it wrongly signalled a high debt-carrying and debt-servicing capacity and led many African countries to build up high debt). In addition, forecasting the growth of imports and exports is also crucial to gauge the economy's external debt-servicing capacity (liquidity challenges). Thus, capacity building in forecasting and using analytical tools such as macro modelling for forecasting and studying the economic-wide implications of debt and its servicing in the budget and plan preparation process is crucial.

Fifth, in addition, developing technical tools for prioritization of spending categories and the spending items at various budgeting units at the MoF and Ministry of Planning and Development (MoPD); capacity building on the project appraisal and monitoring at MoPD; capacity building on the setting up of the deficit ceiling and its economy-wide implications, which is currently done arbitrarily, are important areas for technical capacity building which are crucial for debt management from the perspective of institutional challenges. The monitoring of debt-financed projects also needs to be done from a governance, including a corruption and wastage perspective.

Finally, the study also argues that institutions in charge of debt management at the Ministry of Finance, as well as the MoPD, also need to go beyond the management of debt to developing an exit strategy from persistent demand for debt-creating flows (external aid dependency) for financing development and the day to day running of the economy. This could be done if the government plans to adequately cover its spending in local and foreign currency with its resources in the medium (say, five years) to long term (say, ten years).

By examining in detail each of the institutional challenges of debt management in the country, this study offers pointers for improvement.