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Policy Brief

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A Two-Edged Sword: The Impact of Public Debt on Economic Growth—The Case of Ethiopia

August 2023

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Acknowledgement: This paper is the outcome of a project on "Promoting a Pandemic Recovery: Evidence to Support Managing the Growing Debt Crisis," supported by the International Development Research Center (IDRC) in Ottawa, Canada, under grant number 109742-001. It is carried out by researchers at the Institute of Development Policy Research (IDPR) and the Department of Economics of Addis Ababa University (AAU). We are grateful to the IDRC for its generous financial support of this study. We are also thankful to Arjan de Haan (IDRC) and Carolina Quintana (Red Sudamericana de Economía Aplicada/Red Sur, Montevideo, Uruguay) for their assistance with the administrative aspects of the project. However, any errors are our own. The views expressed in this study are solely ours and do not represent the views of IDRC, Red Sur, or the institutions with which we are affiliated.

Understanding the pathways and nature of the relationship between public debt and economic growth in Ethiopia is more crucial than ever. This is particularly true as the government intensifies its efforts to transform the country into a middle-income nation by 2030 and confronted with multiple shocks to handel (both internal and external). This transformation and handling shocks requires a sustainable method of financing its ambitions. This is because the causal relationship between sovereign debt variables and economic growth has direct policy implications, particularly on tax, development financing and investment choices—and consequently on economic growth.

Therefore, it is essential for policymakers in Ethiopia to carefully analyze the relationship between debt and economic growth and take measures to make informed choices for financing growth and managing the debt sustainably. This may include implementing fiscal reforms, increasing revenue generation, and improving debt management practices. By doing so, Ethiopia can ensure that public debt is effectively utilized to promote long-term economic growth and development.

This study investigated the dynamic effects of public debt on economic growth in Ethiopia, both in the short and long run, using annual data from 1980 to 2021 and an econometric model. In addition, it also examined the principal channel through which the impact of public debt is transmitted to economic growth, which is the investment channel.

The empirical results obtained showed that public debt hinders long-term growth in Ethiopia. However, it (especially domestic debt) has a growth-enhancing effect in the short term, *inter alia*, by boosting investment.

As part of the debt issue, debt servicing has been proven to have a detrimental impact on growth and investment, both in the short and long term, as it requires a significant reduction in vital resources that could have otherwise

been allocated to investment. *In addition, while debt positively affects investment in the short run, its long-term impact is negative and significant.*

Thus, debt is a two-edged sword for economic growth in Ethiopia. On the one hand, it can provide financing for investments in infrastructure and other projects that can stimulate economic growth. On the other hand, high debt levels can hinder economic growth, especially in the long run. *Our results have some interesting policy implications.*

Firstly, it is necessary to examine why increases in the public debt-to-GDP ratio negatively affect long-term growth in Ethiopia. Is it because public debt is used to finance projects of little value to future economic growth and is also inefficiently used? Or is it because the rise in public debt has benefited a few elites and corrupt officials at the expense of burdening the rest of the population with more debt and its servicing? The answer may be that a combination of all the elements comes into play.

Secondly, given the negative growth effect of debt from this study, the country should consider implementing institutional improvements in the effective and efficient use of debt-creating flows. This could be in areas of project analysis, selection and monitoring, and control mechanisms that ensure fiscal and ethical (non-corrupt) discipline by the government and its agencies. A detailed direction of such policy related to institutional challenges is provided in a companion study about Ethiopia's "institutional aspect of the debt problem" (Alemayehu and Getnet, 2023).

This means it needs to enhance its institutional capacity to manage debt and debt-financed projects at large. The latter includes prudent fiscal discipline, domestic revenue mobilization to address the growing financing needs in the country, efficient debt management strategies to prevent the misuse of debt and corruption, and improved prioritization of needs are some of the policy options to mitigate the adverse impact of public debt on economic growth.

In addition, to address the long-term negative growth effect of public debt, the country needs to implement prudent policy changes to ensure the best use of its spending (including public investment) and monitor private investment, as investment is the principal channel through which debt affects growth. One such policy direction, for instance, is using investment to address the structural trade deficit problem of the country, which is one of the crucial drivers of debt in the country.

Nonetheless, reducing budgetary and trade deficits and using such resources effectively may not be easy, nor will it be sufficient to address the debt problem. Thus, it is crucial to seriously consider implementing additional public policies and strategies to address the domestic and external debt problems effectively. One way of doing this is directing deb-creating flows to areas and sectors that led to the high indebtedness in the first place. That will be the first step to address the country's debt challenge in a lasting manner. A detailed direction of such a strategy is given in a companion study about "drivers of debt" in Ethiopia (Alemayehu and Addis, 2023).

However, achieving this could be challenging in the short term due to the country's current political and economic context. The economy is being negatively affected by significant macroeconomic imbalances (inflation, shortage of foreign exchange and inability to service debt being the major ones), which in turn are partly the result of past wrong financing policies that are impacting the social and economic conditions of the population today, leading to high unemployment and poverty. The latter conditions are aggravated by periodic conflict. These challenges, in turn, require significant social spending and increased public investment, which will inevitably exacerbate the budget deficit and the indebtedness problem. That is why a strategic approach to transit from debt/aid dependency in the medium term and debt restructuring in the short run needs to be pursued.