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**Ethiopian Debt Policy: The Long Road from Paris Club to the MDGs**
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**Debt Restructuring and Sovereign Bankruptcy**

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# ETHIOPIAN DEBT POLICY: THE LONG ROAD FROM PARIS CLUB TO THE MDGS

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## Introduction

This case study looks at how Ethiopia has fundamentally changed the basis of its debt relief and new official development financing in recent years. It has done so by developing the national capacity to analyze debt issues and to design a national debt strategy, and by using this capacity to negotiate the best possible debt relief and new financing terms from its creditors. In addition, it has moved from being a passive recipient of whatever terms creditors were prepared to offer, to an active participant, setting its own agenda based on its needs for financing poverty reduction and reaching the Millennium Development Goals (MDGs).

As discussed elsewhere in this volume, developing country debt renegotiations and debt relief for the poorest countries had to be conducted within the framework of a cumbersome and time-consuming process of international negotiating fora and gradual progress in designing new debt relief initiatives. As a result, Ethiopia's achievements took around 5 years to materialize. In addition, the sudden (though temporary) cuts in external aid in 2005 showed that its achievements in debt relief were vulnerable to its continuing dependence on donor aid flows.

This chapter covers the period from 1992 to 2006. In 1992, the new government in

Ethiopia faced a heavy debt overhang of almost US$9 billion, resulting from accumulation of large debts to fight regional or national wars, and mismanagement or destruction of other investments funded by loans. As shown in Figure 1, the bulk of the debts owed (68%) were to former Eastern bloc creditors, notably Russia (60%), largely for military goods. Debts to multilateral institutions represented only 17% of the total, debts to member countries of the Paris Club only 9%, and commercial debts only 7%.

By the end of June 2006, there had been a fundamental reduction in the amount and a transformation in the structure of Ethiopia's debt. The amount had fallen to US$6 billion, and would later fall to an estimated US$3 billion after relief under the Multilateral Debt Relief Initiative (MDRI, see below). Russian debt was virtually eliminated at only 2% of the total (and agreement was reached to write off the remainder in 2007), and debt to non-Paris Club creditors had been reduced by one third. On the other hand, multilateral debt had grown by 231% and risen to 81% of the total (though it has fallen to only 60% after MDRI). Debt to the Paris Club had been reduced by 77% and fallen to only 7% of the total. Commercial debts had been reduced by 42%.

<Figure 1>

In attempting to reduce this debt burden, the main elements of the negotiating framework for Ethiopia have been:

- The *Paris Club.* This is a forum of the major developed creditor nations founded in 1956, to provide relief on "official bilateral" debt (owed to creditor governments).

This was initially created to provide debt relief to debtor countries with temporary liquidity problems, through debt rescheduling (postponement of debt service payment dates). However, with continued debt rescheduling, many countries faced a worsening debt burden as the rescheduled interest payments were added to the existing debt and had additional interest charged on them. As a result, in 1987, the Paris Club agreed, for the first time, to provide an element (33%) of debt cancellation to the poorest countries. Over the years, the ratio of debt cancellation to debt rescheduling has grown to 9:1for the poorest and most heavily indebted countries. {2}

- The *IDA Debt Reduction Facility*. This is a facility established in 1989 for member countries of the World Bank with low incomes that qualify only to borrow from the Bank's concessional arm, the International Development Association (IDA). IDA, co-financing with bilateral donors, provides through the facility grant funding for debtor countries to buy back their outstanding "commercial" debt (owed to commercial institutions such as banks and export suppliers). This is done at a deep discount on its original face value, which amounts to around 90% cancellation of the debt. {3}
- The *Heavily Indebted Poor Countries (HIPC) Initiative* was launched in 1996 to extend debt relief for IDA-only countries beyond their bilateral and commercial debt to "multilateral" debt (owed to multilateral lending institutions such as the World Bank, International Monetary Fund (IMF), African Development Bank (ADB) and its concessional lending arm, the African Development Fund (ADF), and other international and regional organizations). As the first version of this initiative provided only small amounts of debt relief, very slowly, and to only a small number

of the poorest countries, it was significantly improved in 1999 by the launching of the *Enhanced HIPC Initiative*, designed to provide faster, deeper and broader relief to a larger number of countries. {4} This was further improved upon by the *Multilateral Debt Relief Initiative*, which went into effect in 2006 and provides almost 100% relief from obligations to the IMF, the World Bank and the ADB for some of the HIPCs.

Ethiopia's debt restructuring and debt relief negotiations since 1992 are summarized in Table 1 below. As can be seen, Ethiopia has been involved almost constantly in debt relief negotiations between 1992 and 2005. It has been to the Paris Club five times, received assistance from the IDA Debt Reduction Facility, and received two treatments of its debt under the HIPC Initiative.

<Table 1>

Ethiopia's debt renegotiations are best analyzed by dividing them into two periods: before Ethiopia accessed the HIPC Initiative, when debt relief was determined largely by standard terms which were designed by creditors; and after Ethiopia accessed the HIPC Initiative, when debt relief was determined by analysis of the "sustainability" of Ethiopia's debt, in which Ethiopia played an active part.

## Ethiopia's Pre-HIPC Debt Relief Negotiations

### *Bilateral Debt*

In common with most developing countries, Ethiopia's earliest experiences of debt renegotiations were with the Paris Club. The Paris Club is a strange forum, in that the debtor country meets all its major developed country bilateral creditors in Paris, but there are no direct negotiations. Instead the debtor country presents its case for debt restructuring, including debt relief, in an opening plenary, and answers questions from creditors. Thereafter the debtor country delegates retire to a side room and the negotiations are carried out via a French Treasury official who acts as a mediator, shuttling between the debtor and its creditors. The process concludes with all parties signing a Paris Club Agreed Minute, setting out the eligible debt, debt restructuring and relief terms and timetable.

Before the HIPC Initiative, the main terms of the multilateral negotiations were already prescribed by Paris Club standard practice, and only a few details (such as the types of debt to be covered, or deferral of payments falling due after the rescheduling) could be negotiated in practice. The terms provided bore no relation to the "sustainability" of a debtor country's debt. Instead, they were based on a somewhat arbitrary classification of debtor countries into groups according to their income level, their type of borrowing from the World Bank group, and the level of their debt burden. Ethiopia qualified for "London" terms (50% cancellation) in 1992, because it was among the poorest highly-indebted countries, and for "Naples" terms (67% cancellation) in 1997, because it borrowed only from the IDA arm of the World Bank, had a per capita income below US$755, and had a high level of debt. No analysis was made of whether these terms

would bring Ethiopia's debt down to sustainable levels – rather all eligible countries received the same terms. Moreover, the consolidation of interest arrears in agreements (such as for Ethiopia in 1997 and 2001) meant that these increased the debt stock, offsetting a considerable part of the cancellation provided.

Concluding a Paris Club multilateral Agreed Minute is only the start of the process. Thereafter, the debtor country must negotiate a formal bilateral agreement with each creditor individually, under the umbrella of the Agreed Minute. During these bilateral negotiations, a debtor country may slightly improve the overall terms – mainly by reducing interest rates or administrative fees. These bilateral negotiations can be a very time consuming and long drawn-out process. For example, the bilateral agreements arising from Ethiopia's first Paris Club meeting in 1992 took 28 months to conclude. A major cause of these delays is the slow response time of creditors, notably Italy and Japan, to Ethiopia's requests to negotiate. During these delays, Ethiopia accumulated arrears which had additional interest charged on them.

So, effectively, Paris Club terms were largely non-negotiable from a debtor's point of view, and the nature of the treatment provided meant that little debt reduction was available.

As a result, as can be seen from Figure 1, Ethiopia's first two Paris Club agreements had very little impact on the overall debt stock. This also reflected three other factors:

- The percentage of actual debt stock cancellation was relatively low, as many creditors

decided to deliver their relief by reducing future interest payments rather than cancelling stock. As a result, US$370 million of Ethiopia's debt was rescheduled and only US$139 million was cancelled.

- The Russian Federation was not then a member of the Paris Club, so that Paris Club debt accounted for just 9% of Ethiopia's total stock at the end of 1991/92. {5}
- The Paris Club agreements cancelled only debt service due, not debt stock. Therefore the effect on the debt service to exports ratio was much more significant: it fell from nearly 30% in the late 1980s to below 15% in 1992/93 and thereafter.

The big debt stock reduction came in 1999/2000 when the Government concluded an agreement (arising from its 1997 Paris Club meeting) with the Russian Federation for the US$ 6.0 billion it owed to the former Soviet Union. In 1997 the Russian Federation joined the Paris Club as a creditor member and in doing so it agreed to provide an upfront cancellation of 80% of Ethiopia's debts to the former Soviet Union, followed by the application of the 67% reduction under Naples Terms to the remaining 20%, thereby providing 93.3% debt reduction. This more than compensated for the fact that these debts were still being valued at the original ruble exchange rate of 0.65/US $ (because the contractual documents insisted on this), even though the ruble had devalued more than 12-fold. Had they been revalued, this would have provided a 91.7% reduction.

As part of a Paris Club agreement, developing countries commit to negotiate Paris Club comparable treatment from all of their non-Paris Club bilateral creditors. In Ethiopia's case, its main non-Paris Club creditors included Algeria, Bulgaria, China, Hungary,

India, Kuwait, Libya, North Korea, Poland and Yugoslavia, which accounted for 8% of total debt in 1991/92. In common with most other developed countries, negotiating debt relief from many of these creditors was extremely difficult before the HIPC Initiative, because many of these creditor countries were not willing to provide any debt relief, let alone on Paris Club comparable terms. The only creditors that provided debt reduction before the advent of the HIPC Initiative were the Czech and Slovak Republics.

***Commercial Debt***

To reduce its commercial debt, the Ethiopian Government made use of the IDA Buyback Facility and some additional bilateral donor grants. These were used to buy back US$ 266m worth of debt owed to 15 creditors (about 80% of its total commercial debt) at a price of 8 cents/US dollar (8% of the original face value of the debt). In addition, the Government succeeded in getting US$ 30 million of interest payments cancelled. Ethiopia, along with Nicaragua, was the only country to achieve such a deep 92% discount, compared with an average of 87% for other heavily indebted poor countries. The effects of this buyback contributed to the modest decline in the debt stock in 1995/96 as shown in Figure 1, but did not have a major impact on total debt stock because commercial debt represented only 3% of the total.

***Multilateral Debt***

Prior to the advent of the HIPC Initiative in 1996, there were no formal mechanisms for

multilateral debt relief and Ethiopia was therefore servicing these debts. Multilateral debt continued to grow as multilateral lenders disbursed new loans (while bilateral creditors largely switched to grants). As a result, multilateral debt rose sharply as a proportion of the total, reaching more than 60% in the 1990s, and the multilateral debt service burden also rose, eating into resources available for development programs.

## Ethiopia's Debt Relief under the HIPC Initiative

In 2001, Ethiopia became eligible for relief under the HIPC Initiative. The HIPC Initiative marked an important step forward for HIPCs, in that their debt relief was provided for the first time on the basis of an assessment of its effects on the sustainability of their debt (albeit a very restrictive one linked to a few macroeconomic ratios). {6} Most importantly, as part of the HIPC Initiative process, the country conducted a tripartite debt sustainability analysis before the decision point and again before the completion point, together with the IMF and World Bank staff. This in principle allowed all HIPC debtor countries to have a say in the overall amount of debt relief received, as well as to negotiate "front-loading" of debt relief (i.e., its provision during the early years after the decision point), so that more money could be channeled into higher poverty reduction spending. By building its own debt analysis and negotiation capacity, Ethiopia took full advantage of this possibility.

### *HIPC Decision Point*

In preparation for their HIPC decision point, Ethiopian officials conducted their own debt sustainability analysis to assess HIPC eligibility and the amount of anticipated debt relief in March 1999 and again in April-May 2001. These two analyses identified 2 important features that, due to successful negotiations by the Government of Ethiopia (supported by its key donors) and flexibility by IMF and World Bank staff, were taken into account in the final HIPC "decision point" document, containing the commitment of relief:

- The 2001 analysis showed that to achieve significant poverty reduction by 2015, Ethiopia's creditors would need to provide maximum front-loading of relief. The Government's analysis enabled it to negotiate some front-loading of debt service relief (IDA relief was concentrated in the first 18 years rather than the 21 years originally planned, and ADF relief was provided over only 11 years), albeit not as much as it would have liked.
- More importantly, the 2001 analysis also helped Ethiopia argue successfully for a brief delay of the decision point, which thereby increased debt relief significantly. The analysis showed that a September 2001 decision point would warrant more debt relief than an earlier date which had been considered previously in 2001. It was able to establish that the lower exports than initially expected for 2000/01 would raise the debt/export ratio above the target level, requiring that relief be increased from US$1 billion to US$1.3 billion.

Thus, in 2001, Ethiopia was assessed as being eligible for US$1.93 billion of nominal debt relief (US$ 1.28 billion in present value terms) so as to reduce its ratio of the present value of debt to exports (henceforth denoted "PV/exports") from 284% to the HIPC

sustainability threshold of 150%. As a result of reaching its HIPC decision point and receiving frontloaded interim debt service relief from the African Development Fund, IDA and the IMF, Ethiopia's debt service payments declined from US$146 million in 2000/01 prior to HIPC to US$68 million in 2002/03. Its debt service ratios to exports and revenue came down to below 10%.

However, even with the US$1.9 billion in debt relief projected to be provided at its HIPC decision point, Ethiopia's debt was projected to become unsustainable (exceed the threshold) almost immediately again, due to high essential borrowing largely from IDA and ADB for programs of reconstruction and recovery after the war with Eritrea (IMF 2001b).

Ethiopian analysis also identified three risks which were not taken into account at decision point:

- The non-participation of certain creditors in the 1996 IDA commercial debt buyback and the non-provision of relief by many non-Paris Club bilateral creditors; this indicated a risk that debt sustainability would not be achieved by HIPC relief, which had assumed full participation in calculating the necessary relief.
- A major risk that the export projections in IMF documents (especially for coffee) would prove too optimistic based on historical experience and prospects for main exports, and therefore that the short "hump" of unsustainable debt/export ratio through 2007/08 might last much longer.
- The high level of domestic debt stock (though service was low because of low interest

rates). Domestic debt stood at 40% of GDP by 2001/02, though its fiscal burden was relatively low at 1% of GDP because of negative real interest rates reflecting excess liquidity in the banking system. A move to positive real interest rates would thus impose a heavy fiscal burden.

***After HIPC Decision Point***

Having reached its HIPC decision point in October 2001, Ethiopia was then required to go back to the Paris Club to negotiate Cologne terms flow relief (90% cancellation of debt service), which it did in April 2002, and thereafter commence the lengthy process of negotiating new bilateral agreements with each of its Paris Club creditors. As a result of their considerable experience in earlier bilateral negotiations, Ethiopian policymakers and officials reduced the costs by conducting them by facsimile or email. However, some creditors, notably the Russians, insisted on face-to-face negotiations, involving the Government in expensive trips abroad.

In addition to the Cologne terms, most Paris Club bilateral creditors have agreed to go further and cancel all so-called “ODA debt”. {7} In some cases, they also agreed to cancel some, or all, export credit or non-ODA debt. The total amount of such additional debt relief was US$ 284 million in present value terms. Given that Ethiopia’s debt was projected to become unsustainable soon after the decision point due to new borrowing, and in the light of the additional risks to sustainability Ethiopia had itself identified, the Government argued strongly, together with other HIPCs and some donor governments,

that this additional relief should be considered additional to the warranted HIPC relief, so as to bring its debt ratios even further down below the HIPC thresholds and give Ethiopia more of a cushion to keep debt sustainable. However, after much debate among creditors, it was decided that these cancellations should be treated as part of HIPC relief, thereby depriving Ethiopia of additional relief (while reducing the relief that had to be accorded by the other creditors to reach the targeted amount of debt reduction) and removing the cushion to keep Ethiopia's debt "sustainable".

Regarding its non-Paris Club bilateral creditors, the Ethiopian Government formally contacted all these creditors, requesting them to negotiate on Paris Club comparable terms (see Table 3 below). However, as expected given past experience, negotiating such relief proved extremely difficult. Between the decision and completion points, only Bulgaria, China and Hungary agreed to participate.

A technical problem arose as well, which complicated Ethiopia's ability to monitor how much multilateral relief was being received from the ADF, IDA and IMF. They were the main providers of interim relief, on terms set out in the decision point document. However, since IDA and the ADF provide some relief by cancelling specific loans, Ethiopian officials needed to validate the creditor statements to ensure the correct amount of relief was applied to the relevant loans in the national debt database. The ADF, however, simply provided a statement of the relief being given, without indicating to which loans it was applicable, making it very difficult for Ethiopia to track the process in its debt database.

Throughout this process, Ethiopia also increasingly benefited from exchanging information with other HIPCs on the terms they had achieved, via the HIPC Debt Strategy and Analysis Capacity Building Program's networks of Finance Ministers and officials. {8}

***Negotiating the HIPC Completion Point***

In the second half of 2003, Ethiopia started to prepare for its HIPC completion point (due in the first quarter of 2004) by conducting its own analysis to ascertain whether its debt would be sustainable at completion point, after the full delivery of HIPC relief pledged at the decision point. If it found that its debt was not sustainable, then it might obtain additional relief known as "topping up", which was in principle available under HIPC "if the deterioration in debt sustainability is primarily attributable to a fundamental change in a country's economic circumstances due to exogenous factors" (IMF 2001a). The additional relief to be provided would be the amount needed to bring its relevant debt ratio down to the threshold level at completion point.

In practice, the factors that affect the sustainability ratio at completion point are:

- New borrowings: if the level of new borrowing between a country's decision and completion point is higher than had been projected at the time of its decision point, then the present value of debt numerator will be higher than initially forecast. For example, Niger had higher than anticipated new borrowings because it had to borrow

more to compensate for significant shortfalls in EU grant aid disbursements

- Exchange rates: exchange rate changes, such as the devaluation of the US dollar against the SDR and Euro in 2002-03, can mean a higher debt stock and debt service in US dollar terms, the latter frequently having to be financed from exports priced in US dollars.
- Interest rates: the decline in world interest rates, which are used as discount rates for calculating the present value of debt, have resulted in a smaller discounting of debt service and thus a rise in present value of debt.
- Export earnings: if the level of export growth between the decision and completion points is lower than had been projected at the time of the decision point, then this can result in a higher PV/exports ratio. Lower than anticipated export growth can arise because of exogenous factors, such as lower commodity prices, weather-related crop failures or changing international market factors.

The impact of each of these factors on the country's present value of debt/exports ratio at its completion point is assessed, and if these impacts are judged to be caused exogenously, then topping up will be provided.

As a result of its analysis, the Ethiopian Government concluded that its debt burden would be unsustainable at completion point and Ethiopia should thus be eligible for an additional US$ 707 million of "topping up". The impact of each key factor on Ethiopia's debt indicators (as subsequently replicated in analysis by the IMF and IDA), is set out in Table 2.

<Table 2>

The Bretton Woods institutions had already estimated internally that Ethiopia's debt was unsustainable due to higher debt and lower exports, but they were being cagey about whether or not these factors were exogenous or not, and therefore whether Ethiopia would qualify for "topping up". This was because there was considerable disagreement among the major IMF and World Bank Board members as to whether lower world interest rates and the devaluation of the US dollar counted as exogenous factors in Ethiopia's case. Those opposed to "topping up" were above all worried about the large extra cost of relief for Ethiopia - an additional US$ 700 million in debt relief. As a result of a debate among countries in the Group of Eight (G8), the discussion of Ethiopia's completion point by the IMF and World Bank Boards was delayed for several weeks. In particular, the Russians opposed Ethiopia receiving topping up because as one of the few Paris Club creditors which had not provided 100% cancellation, they were going to be required to provide almost the entire share of the Paris Club creditors' topping up.

The Ethiopian Government felt strongly that these factors were exogenous and argued their case assiduously within the international donor community and via non-governmental organizations. They were joined in this campaign by other countries which were expecting to get topping up – notably Niger and Rwanda. Eventually, the Fund and Bank Boards agreed to topping up of US$ 707 million (in present value terms), of which multilateral creditors provided 78% and bilateral and commercial creditors 22%. This

made Ethiopia's debt burden "sustainable" at completion point, and also resulted in further debt service reduction of US$ 35 million per annum over ten-years, with this extra relief being available to fund additional poverty reduction expenditures. This marked another step forward in Ethiopia's ability to argue its own case and free additional funds to assist it in reaching the MDGs.

However, even with topping up at its HIPC completion point, Ethiopia's debt burden was projected to be above the HIPC sustainability threshold for the PV/exports ratio of 150% until 2021, as shown in Figure 2, on the baseline assumption that Ethiopia will receive on average 50% of its new external financing from all donors in the form of grants. This assumption about new grant inflows reflected a reduction of 8 percentage points on what had been projected at the time of Ethiopia's HIPC decision point because of higher performance-based IDA lending. However, if Ethiopia were to receive 10% more of its new external financing requirements in grants, rather than concessional loans, this would make its debt sustainable in 2019, two years earlier than in the base case, as shown in Figure 2.

<Figure 2>

The fact that Ethiopia was allowed to project borrowing considerable amounts of concessional funds after the completion point, in order to support the attainment of the MDGs, was another striking step forward for an MDG-based concept of debt sustainability, based on the acknowledgement that it was at that time impossible to

foresee mobilizing enough grants to fund more than 50% of the spending needed for the MDGs. While Burkina Faso had been allowed the same leeway two years earlier, its debt ratios had not been projected to exceed 200% at any stage, and they were to fall to sustainable levels much more rapidly. Many other countries (like Ethiopia in earlier years) faced major pressure from the IMF to cut back their borrowing regardless of the negative impact on MDG spending prospects, but with strong support from IDA (which had a huge lending program) this new precedent was set.

***After HIPC Completion Point***

Having achieved its HIPC completion point, Ethiopia had again to return to the Paris Club to negotiate its Cologne terms stock reduction and then negotiate with each creditor bilaterally for the fifth time. Given its depth of experience, this was less difficult than in the past. To negotiate the best terms, Ethiopian officials were in contact with other post-completion point HIPCs. With the Russians, negotiations were time-consuming and at times a bit difficult, but finally concluded in April 2005.

Throughout this period, the Ethiopians continued trying to negotiate with their non-Paris Club creditors and the results as of end-2006 are summarized in Table 3. As of that date, three creditors (Algeria, Libya and Serbia) had not yet agreed to negotiate relief. There was still a small amount of commercial credit outstanding (US$30 million), on which the Government was trying to negotiate relief – though it had already lost and paid a lawsuit to a Bulgarian commercial creditor.

<Table 3>

The Government also continued to conduct regular debt and new financing strategy analyses to assess its debt sustainability under alternative scenarios. This included comparing the impact of obtaining maximum possible HIPC relief, with what would happen if Ethiopia did not obtain the maximum, particularly from its non-Paris Club bilateral and commercial creditors. A first finding was that the debt sustainability indicators improved after the completion point analysis had been undertaken owing to a much stronger than anticipated recovery from the 2002/03 drought and hence faster GDP and export growth. A second finding, however, was that not all the relief programmed into the HIPC analysis was being delivered. Thus, as shown in Figure 3, the non-delivery of debt relief from non-Paris Club bilateral and commercial creditors pushed its present value of debt to exports ratio up by an average of 20 percentage points keeping it over the HIPC threshold of 150% in 2005/6 and 2006/7. Thereafter non-delivery of relief still added on average 12 percentage points to Ethiopia's debt ratio until 2015, even though the country's debt would become sustainable in HIPC terms.

<Figure 3>

## Managing Debt for Sustainability Post-HIPC

### *The New Debt Sustainability Framework for Low-Income Countries*

In April 2005, the Bretton Woods institutions agreed a new debt sustainability framework (DSF) for low income countries, which includes post-completion point HIPC countries. A central part of the new framework is that it associates a country's risk of debt distress (and hence "unsustainability") with the quality of its policies and institutions, as measured by the World Bank's Country Policy and Institutional Assessment (CPIA) scores, on the basis that better performing countries would be able to bear a higher debt burden. Table 4 sets out the debt indicators and sustainability thresholds under this framework.

<Table 4>

On the basis of its policies and institutions, Ethiopia's CPIA score classifies it as a medium country, so its debt sustainability was to be assessed on thresholds which were not all that different from HIPC. However the methodology of the debt strategy analysis underpinning this framework is different from the HIPC methodology: notably in that the export denominator to be used is for the same year as the debt indicator, rather than the average of the 3 preceding years which was used under HIPC. In addition, the new methodology replaces the currency-specific discount rates of the HIPC Initiative with one US dollar discount rate.

As a result, Ethiopia's debt indicators were much lower under the new methodology than those calculated under HIPC, as shown in Figure 4, albeit still above the indicated

threshold. In large part this reflects its continued export growth (accentuated in the calculation by the use of current year exports), but it is also slightly due to a US dollar discount rate which is higher than the previous multi-currency rates), and to slightly less borrowing than earlier projected.

<Figure 4>

Ethiopia benefited, nevertheless, from the new calculation in that it is used to assess each country's eligibility for ADF and IDA funds in the form of grants instead of loans. Under the framework, Ethiopia was classified as being a "red light" country, as its debt ratios were in excess of the thresholds for a "medium" policy country. As a result, it was agreed that Ethiopia should receive all its IDA and ADF funds as grants during 2005-08. {9}

The new framework also caught up with the methods Ethiopia has been using to assess its own debt sustainability for the last seven years, in four respects:

- It is forward-looking, and assesses the types of financing Ethiopia should receive for its future development on the basis of 20-year projections of debt sustainability rather than a snapshot of debt ratios at the current date.
- It is based on analyzing multiple economic and financing scenarios. As a result, the vulnerability of Ethiopia's debt sustainability to export shocks and alternative new borrowing plans will be evaluated, as the Government has been doing.
- It takes account of a wider range of indicators than the HIPC framework, notably giving some weight to those related to budget revenue and GDP, which Ethiopia has

been systematically monitoring since 1999.

- It includes some analysis of domestic debt. Ethiopia has been conducting analysis of the fiscal burden of domestic debt since 2001, concluding that even though the stock of domestic debt is relatively large at 35% of GDP in 2005 (down from 40% in 2001/03), its service burden is low (less than 1% of GDP) because interest rates are negative in real terms due to excess commercial bank liquidity. However, the DSF does not set any guidelines or thresholds for domestic or total (external plus domestic) public and publicly guaranteed debt, so Ethiopia will continue determining the fiscal sustainability of its debt on the basis of the thresholds that Ethiopia and other HIPCs have calculated for themselves, as well as assessing its potential contribution to long-term financial market development.

These changes in the ways of looking at debt sustainability will help Ethiopia to keep its debt more sustainable in macro-economic terms, but the new framework still fails to be MDG-based insofar as the financing needs do not have to be based around realizing the MDGs.

***Post-HIPC Debt Relief Initiatives***

Due to continuing concern that HIPC provided insufficient debt relief, the international community once again discussed new debt relief initiatives in 2004-05. These began with the UK Debt Relief Initiative, which offered to pay a share of the debt service to the ADF, IDA and IMF on behalf of the debtor countries on an annual basis, and then

proceeded to the Multilateral Debt Relief Initiative (MDRI), which involved cancelling most of the stock of debts owed to these institutions). Ethiopia played an important role in the advocacy of such further relief through the participation of Prime Minister Meles Zenawi in the UK Commission for Africa which was established in mid-2004 to help inform the debate leading up to the G8 Summit at Gleneagles. {10} This advocacy was based on its own assessment that even the additional HIPC relief it had received was inadequate to fund the MDGs. The Commission report went further than subsequent initiatives by advocating 100% debt cancellation to spend on the MDGs, but set as its immediate goal "100% multilateral debt service cancellation, where this is necessary to achieve the MDGs".

As implied by this quotation, both of these Initiatives also differed from their predecessors in that they explicitly aimed to ensure that debt relief provided additional financing for the MDGs. In other words, the level of debt cancellation was not based on economic thresholds but on an assumption that all eligible countries needed additional liquidity relief and removal of the debt overhang if they were to be assisted to attain the MDGs. However, while in the case of the UK Initiative 100% of the funding was additional for the MDGs, under the MDRI the degree to which ADF and IDA debt relief provided additional MDG funding depended on each country's performance-based allocations of funding. {11}

Ethiopia is benefiting substantially from the MDRI, in having its PV/export ratio reduced from 108.8% to only around 51.9% by end-2006, and its debt service/export and debt

service/revenue ratios reduced by around 1.3%. In addition, in Ethiopia's case, the MDRI relief is (at least initially) translating into significant net savings to spend on the MDGs, because its high levels of performance-based allocations under ADF and IDA will mean that it receives a substantial share of the funding allocated to the MDRI. {12}

***Mobilizing Sustainable MDG Financing***

Debt relief on its own (even if extended to 100% cancellation of all Ethiopia's external debt) would be woefully insufficient to finance its attainment of the MDGs. As a result, Ethiopia has realized for some years that the key factor in financing the MDGs will be its future new financing strategy. The central determinant underpinning this strategy has been its desire to attain the MDGs by 2015 and the national goals expressed in its Sustainable Development and Poverty Reduction Program (SDPRP- 2002) and its Plan for Accelerated and Sustained Development to End Poverty (PASDEP- 2006).

Since 2002 the Government has engaged in a concerted effort to convince all development partners to use these goals as the basis for their programming. As a result, 2002-05 budget spending and financing plans were based on the SDPRP, and recent 2006-15 PASDEP spending and financing plans have been produced in collaboration with the Millennium Project and the World Bank through revising poverty reduction costings and expenditure plans on a sector-by-sector basis, including large amounts of infrastructure investment. Extensive joint work with the IMF and World Bank has also resulted in the adoption of the lower scenario of PASDEP spending and financing plans

as the basis for the 2005-08 IMF macroeconomic framework, and continuing intensive discussions over possible adoption of PASDEP's higher scenario for accelerated growth.

Both these scenarios imply major increases in external aid flows – at least doubling as a percentage of GDP during the next 5 years. As a result, the Government has also been designing a new financing strategy for funding the PASDEP while keeping debt sustainable. One important aspect involves examining the proportions of new loans and grants it will receive, such as the implications of receiving 100% grants from IDA and the African Development Bank during 2005-08. As a result of the anticipated new grant commitments from IDA, the African Development Bank and other major donors, the composition of Ethiopia's new external resources is expected to shift from the average of 62% grants to 38% loans in the last four years to closer to 80%:20% by 2008/09. This higher proportion of grants (together with faster economic growth) could have a dramatic positive effect on Ethiopia's debt sustainability, keeping its debt at clearly sustainable levels after MDRI, whereas one-third concessional loans would put debt sustainability at risk even after MDRI.

For this more desirable outcome to be feasible, it will be vital that donor governments in particular follow the signal provided by the World Bank and provide only grants rather than loans. In this context, two developments have been worrying in 2005-06: the suspension of considerable amounts of grant aid by some donors in response to concerns over governance (though aid flows have now been resumed with earmarking for antipoverty expenditures); and the offering of substantial (albeit concessional) new loans

to Ethiopia by some traditional and new donor governments.

In this context, Ethiopia's own debt management becomes even more important. The government has been keeping a tight rein on debt contracted, making sure that it refuses the vast bulk of such loans – as well as all non-concessional loans, and intends to formalize this process by introducing multi-year debt ceilings into its budget to avoid debt becoming unsustainable. It also intends to enhance transparency in debt management by publishing a quarterly bulletin and annual report on debt management.

However, it was not the degree of concessionality of Ethiopia's borrowing that made its debt unsustainable in the first place, but the poor quality of money that was mobilized (i.e., fragmented project-style financing) and the uses to which they were put. It will therefore also be vital that Ethiopia mobilizes the highest-quality financing in order to ensure maximum effectiveness of the aid flows on poverty reduction and on meeting the MDGs. Ethiopia therefore in June 2002 launched a program for donors to harmonize their procedures and policies and to align them more closely with those of government. As a result, it agreed a comprehensive framework for dialogue with donors, a common performance assessment framework for budget support which has led to greater alignment with the SDPRP reviews and the budget cycle, and increased predictability and volume of donor budget support through multi-year commitments; and donor commitments on harmonization and mutual accountability.

The global-level undertakings to improve aid effectiveness that donor governments made

in Paris in February 2005 are also expected to assist Ethiopia in improving the quality of its aid flows, by allowing it to design its own detailed strategy for improving aid quality and for holding donors accountable for those commitments. In addition, to ensure that donors continue to make progress in improving the quality of their aid, the Government has been monitoring the quality of its external financing using a range of 23 criteria relating to policies and procedures. It has identified the areas in which donors can improve their performance and designed a matrix of targets for itself and its donors to continue improving aid quality. {13} Now that relations with donors are beginning to improve again, it is also accelerating its efforts to mobilize higher quality aid flows by designing its own national aid strategy to discuss with donors.

**Conclusion**

The last decade has seen a major change in the way the international community looks at debt sustainability for Ethiopia and other HIPCs. Before 1997, the Paris Club agreed standard terms with Ethiopia, regardless of the effects on its debt sustainability or poverty reduction. Thereafter, Ethiopia progressed through the HIPC Initiative, where debt relief was determined by relatively narrow economic considerations of debt sustainability, to the slightly wider macroeconomic view of where financing prospects and borrowing limits should be set under the Debt Sustainability Framework for low-income countries of the Bretton Woods institutions.

From 1999, the government acquired a high level of capacity to analyze its own debt

sustainability and negotiate debt relief using the HIPC framework, and thereby substantially increased its relief at both decision and completion points. In 2003, the government began using its own calculations of financing amounts and quality needed to reach the MDGs, to conduct a more MDG-based analysis of debt sustainability. It used this to advocate debt relief going way beyond HIPC through the MDRI, and a major increase in grant aid flows, which have respectively made its debt sustainable and provided it with strong prospects of keeping the debt sustainable. It is now using updated MDG need calculations and reconciling them with the Bretton Woods Debt Sustainability Framework in order to determine how much debt (and of what type) it should contract.

Indeed, as a result of the debt relief received and the increase in aid flows between 2000 and 2005, combined with a determination to reallocate spending to anti-poverty purposes, poverty-reducing government expenditure in Ethiopia has risen from 6.8% of GDP in 2000 to 17% in 2004/05. Partly as a result of this extra fiscal spending, combined with effective public expenditure management, Ethiopia has seen important progress towards the MDGs, with the nutrition, water, universal primary education and gender equality in education goals likely to be met.

Nevertheless, the process has been complex and laborious. It has taken huge efforts by the Ethiopian government, sustained over 14 years, to navigate its way through the succession of debt relief and aid initiatives. Even now both the attainment of the MDGs and continued debt sustainability could be at risk unless the ambitious scenario of the PASDEP is adopted by the donor community, and donors provide the much higher levels

of grants needed for its attainment. The lesson of Ethiopia's experience for other low-income countries is therefore that much can be achieved by negotiating within the current framework, but more fundamental reform of the framework is essential to ensure that IMF programs are MDG-based and donors deliver on their aid commitments.

**Endnotes**

1. Director, Debt Relief International (DRI), a non-profit organization based in London, which assists heavily indebted poor countries (HIPCs) to build their debt strategy capacity. The views expressed here are those of the author and not of the Government of Ethiopia or DRI's donors. The paper draws heavily on the excellent work by many Ethiopian government officials with whom we were happy to have cooperated since 1997.

2. For more on the history and gradual development of Paris Club debt relief terms, see Vilanova and Martin (2001).

3. For more details of the IDA Debt Reduction Facility, see IDA (2004).

4. For more detailed analysis of the original and enhanced HIPC Initiatives, see Martin and Johnson (2001).

5. All figures in this paper are presented in Ethiopian fiscal years, which are July-June, in line with Ethiopian government practice.

6. See Martin (2007) for a critique of this approach.

7. That is, debt that resulted from official development assistance that had been provided

as concessional loans.

8. For more on these, see http://www.hipc-cbp.org.

9. Subsequent to this assessment, however, Ethiopia received MDRI relief, which brought its debt indicators below the thresholds, as noted earlier.

10. For the text of the report, see http://www.commissionforafrica.org.

11. For more details of how this process works, see Debt Relief International (2007).

12. This is because IDA and ADF first reduce each country's new assistance by the amount of their MDRI relief (so their net cash flow relief at this point is zero) and then take all the donor grants provided to compensate the institutions for debt repayments foregone and allocate them to all countries according to the same performance-based allocation system initially used for the annual distribution of loanable funds to eligible countries. Because of its high performance-based IDA and ADF allocations, Ethiopia expected to receive significant net funding under the MDRI.

13. See Government of Ethiopia 2003/2004/2005. For more details of the methodology, see Johnson, Martin and Bargawi 2004.

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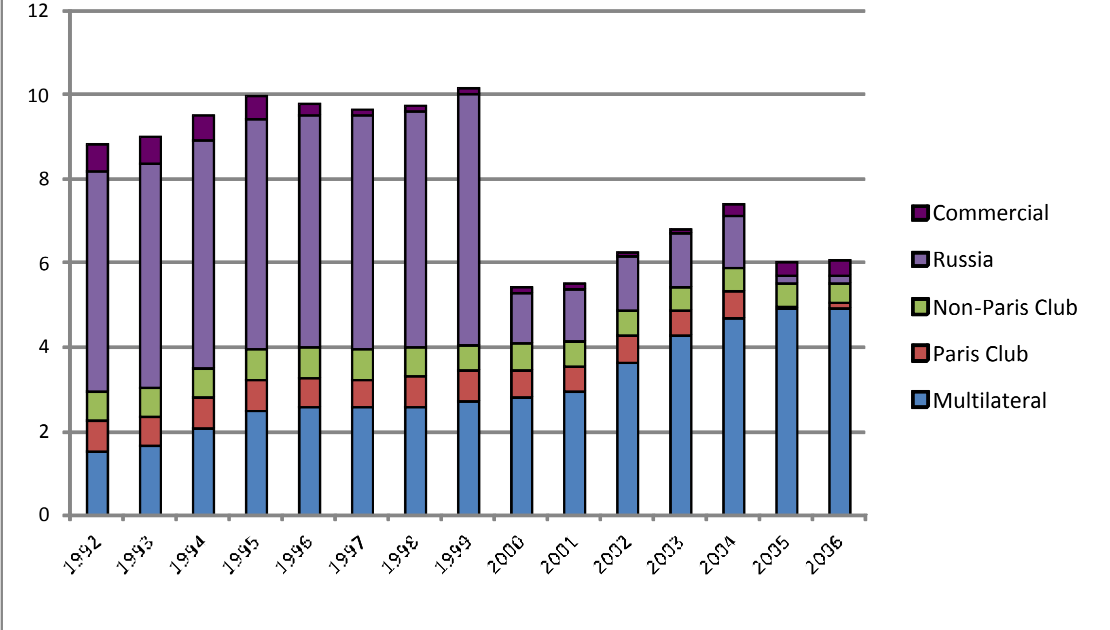
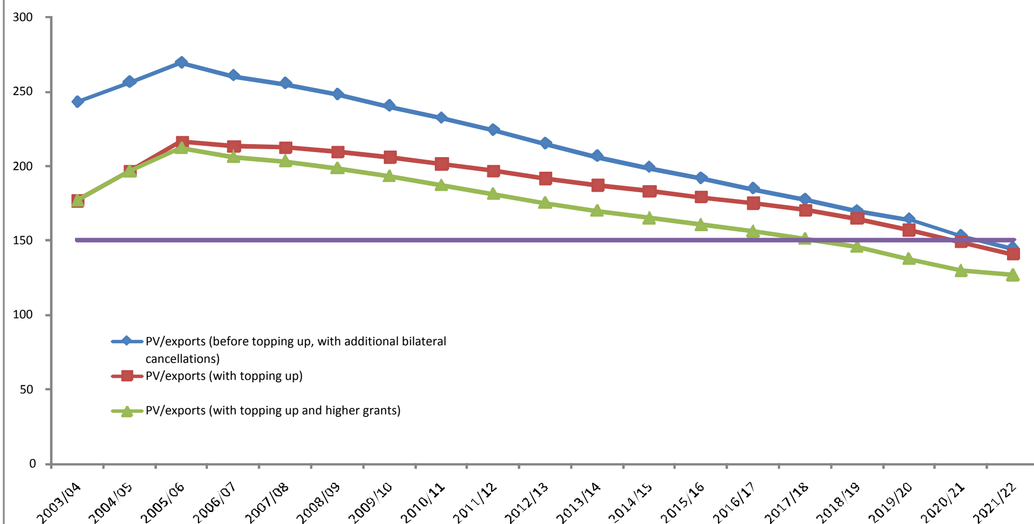



Source: Government of Ethiopia (data as of end of fiscal year, June 30, of year indicated)



Source: IMF, Ethiopia HIPC Completion Point Document (April 2004).

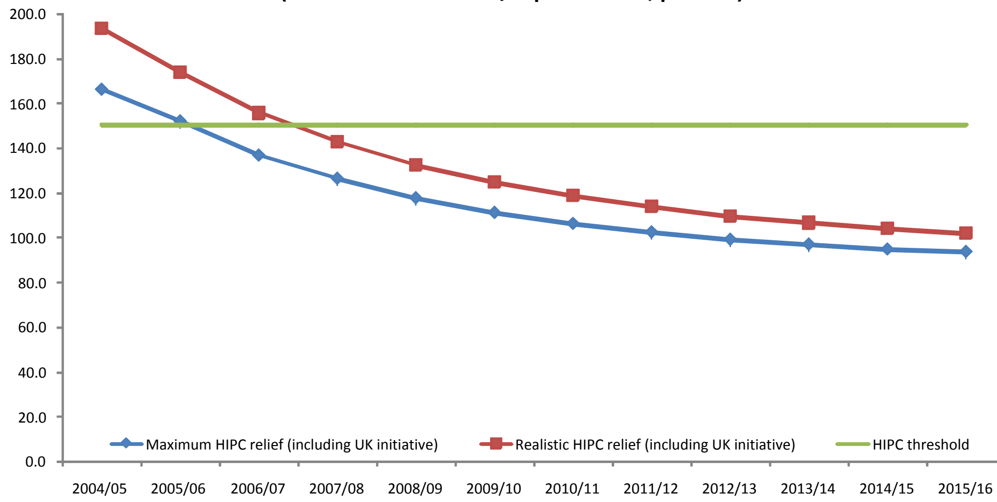
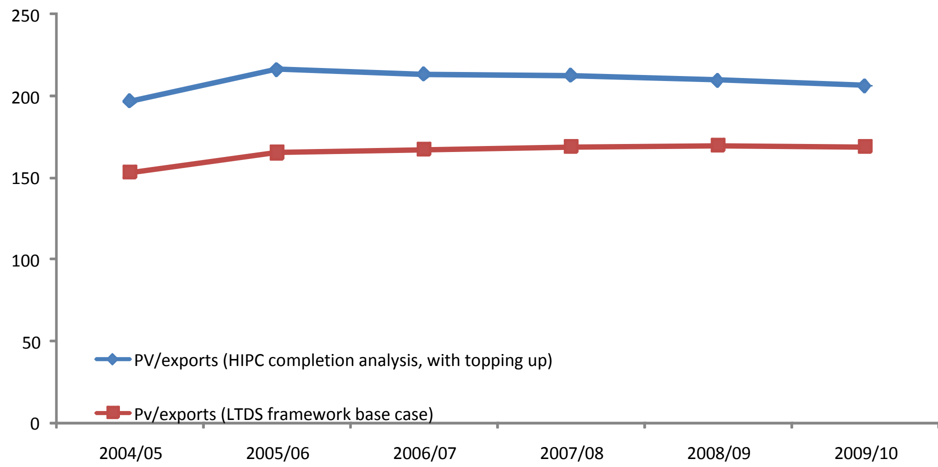


Figure 3. Ethiopia's Debt Ratios: Projections to 2016 as at April 2005
(Present value of debt/exports ratios, percent)
200.0
180.0
160.0
140.0
120.0
100.0
80.0
60.0
40.0
20.0
0.0
Maximum HIPC relief (including UK initiative)
Realistic HIPC relief (including UK initiative)
HIPC threshold
2004/05
2005/06
2006/07
2007/08
2008/09
2009/10
2010/11
2011/12
2012/13
2013/14
2014/15
2015/16
Source: Government of Ethiopia, April 2005.

**Figure 4. Ethiopia's Debt Projections as Seen in 2004 under HIPC Completion Point and Long-Term Debt Sustainability Methodology**

**(Debt/Export ratios; Percent)**




Source: IMF, January 2005 and April 2004.

## Table 1. Ethiopia's Debt Renegotiations, 1992-2004

| Date | Official Forum/ Facility | Applicable debt | Terms negotiated* | Debt reduction achieved |
|---|---|---|---|---|
| **Pre-HIPC** | | | | |
| Dec 1992 | Paris Club | Official bilateral debt | London flow treatment | 50% cancellation, 50% rescheduling |
| Jan 1996 | IDA Facility | Commercial debt | Buyback using grants | Buyback price of 8 cents/US $ |
| Jan 1997 | Paris Club** | Official bilateral debt | Naples flow treatment | 67% cancellation, 33% rescheduling |
| April 2001 | Paris Club | Official bilateral debt | Naples flow treatment | 67% cancellation, 33% rescheduling |
| **HIPC Initiative** | | | | |
| Oct 2001 | HIPC decision point | Multilateral debt, official bilateral and commercial debt | HIPC interim relief | 47.2% reduction – 50% of IDA service, 80% ADF, 40% IMF |
| April 2002 | Paris Club | Official bilateral debt*** | Cologne flow treatment | 90% cancellation, 10% rescheduling |
| April 2004 | HIPC completion point | Multilateral debt, official bilateral and commercial debt | HIPC debt stock and debt service relief | 31% additional reduction – 90% of IDA and 71% of IMF service |
| May 2004 | Paris Club | Official bilateral debt*** | Cologne stock treatment | 90% cancellation (additional 10% cancellation by most Club members) |

* - Flow treatment applies to debt service payments of principal and interest falling due. Stock treatment applies to the debt outstanding. See Cosío-Pascal, this volume, for details on named terms.
** - Includes treatment of Russian debt for the first time (see text)
*** - These Paris Club agreements were part of (i.e., not additional to) the HIPC relief.

Source: Government of Ethiopia National Debt Strategies, 1999-2005

## Table 2. Ethiopia: topping up to of HIPC debt relief

| Factors underlying topping up of relief | Debt/export ratio | Percentage points impact |
|---|---|---|
| **Debt/exports target ratio after full relief at decision point** | **150%** | |
| Factors anticipated at the time of the decision point: | | |
| New borrowings | | 36.3 |
| Changes in exports | | - 8.9 |
| Difference anticipated and actual interim relief | | -3.9 |
| Unanticipated factors at the time of the decision point: | | |
| Changes in discount rates used to calculate PV of debt | | 43.9 |
| Changes in exchange rates | | 19.1 |
| New borrowings | | 4.3 |
| Change in exports | | -3.5 |
| Additional bilateral cancellations and other factors | | -18.7 |
| **PV/exports after full delivery of relief at completion point** | **218.4%** | |
| **Debt relief to reduce PV/exports ratio to 150%** | **US$ 707 m** | |

Source: IMF, HIPC Completion Point Document (April 2004)
Note: Numbers do not add up due to rounding.

## Table 3. Outcomes of Ethiopia's Non-Paris Club Negotiations, December 2006

| Creditors | Debt relief terms negotiated |
| --- | --- |
| Algeria | Not willing to negotiate to date, despite Government repeated requests |
| Bulgaria | Debt buyback of bilateral debt at 95% discount. Commercial creditor sued Government for repayment and won. Government paid. |
| China | Write-off of pre cutoff date debt. Postponement of post cutoff date loans by 1-2 years when they mature. |
| Czech and Slovak Republics | Pre-HIPC buyback at 8 cents per US dollar |
| Hungary | Buyback at 10 cents per US dollar |
| Kuwait | Excluded, as post cutoff date debt |
| Libya | Not willing to negotiate to date, despite Government repeated requests |
| Korea, DPR | 80% reduction |
| Poland | Buyback at 20 cents per US dollar |
| Serbia (former Yugoslavia) | Not willing to negotiate to date, despite Government repeated requests |

Source: Government of Ethiopia

## Table 4. IMF/World Bank Framework for Debt Sustainability Thresholds, 2005

| Debt sustainability indicators | Country Policy and Institutional Assessment score | | |
|---|---|---|---|
| | **Strong (CPIA ≥ 3.75)** | **Medium (3.25 < CPIA < 3.75)** | **Weak (CPIA ≤ 3.25)** |
| PV of debt/GDP | 50% | 40% | 30% |
| PV of debt/exports | 200% | 150% | 100% |
| PV of debt/budget revenue | 300% | 25% | 200% |
| Debt service/exports | 25% | 20% | 15% |
| Debt service/budget revenue | 35% | 30% | 25% |

Source: IMF