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Ethiopia
Working Paper Series

From Debt to Development: What are Ethiopia's Choices?

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April 2023

Note: This Working Paper series is designed to bring the analytic work of UNDP-Ethiopia and its partners to a broad audience, as a contribution to the policy agenda and debate in Ethiopia. They do not represent the official policy or views of UNDP.

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OUTLINE OF THE PAPER

Ethiopia is at a crossroads. Buffeted by major external and internal shocks compressed within the short space of two years (2020-22), it faces the daunting policy challenge of finding a feasible and effective pathway out of crisis in order to return to rapid and sustainable development.

The country faces multiple headwinds as it makes its policy choices and charts its future development direction. Six stand out, in particular:

> **Key macro parameters are in the danger zone:** Real GDP growth has reduced to an average rate of 6 percent in the past three years, which is lower compared to the average growth rate during 2017-2019 of 9 percent. The fiscal deficit as a ratio of GDP has widened to 4.2 percent in 2022 from 3.3 percent in 2021. Combined with imported inflation due to the conflict in Ukraine, financing of the fiscal deficit from the banking system through direct advances has created inflationary pressures, with year-on-year headline inflation standing at 33.9 percent in January 2023. There has also been significant pressure on the current account, which resulted from a combination of growing import demand, shrinking exports and increase in global commodity prices. The foreign exchange reserves have continued to dwindle significantly. In February 2023, the reserves lowered to less than a month of import coverage, creating pressure in the foreign exchange market and widening the gap between the official and parallel market rate. The official rate was Birr 53.5819/ USD but the black-market rate as of February 2023 was close to Birr 100/USD.

> **There is a debt liquidity rather than solvency problem that will peak precipitously in 2023-25:** Faced with persistent current account deficits, reflecting a small export base (volume and value) and huge demand for imports, the country's investment has been financed through significant borrowing. About 20 percent of the government budget is covered through domestic and external borrowing. As a result, the stock of Ethiopia's public debt at the end of September 2022 reached USD 57.15 billion equivalent or 50.1 percent of GDP. Although the current ratio of total debt stock to GDP does not pose a solvency risk for Ethiopia, on the external debt side there is a liquidity risk embedded in the existing indicators. External debt servicing to export ratio has reached 22 percent which is above the recommended IMF ceiling of 15 percent. Consequently, as Ethiopia's liquidity indicator breached the recommended threshold in the last IMF's DSA, it was classified as high risk of debt distress country. Additionally, a ten-year Eurobond of USD 1 billion will mature next year putting additional pressure on needed fiscal resources. According to Fitch, Ethiopia faces debt servicing of USD 2 billion in 2023.[1]

> **External financing, especially, ODA, has dropped off the cliff, contributing to a major squeeze in forex availability and reserves:** Forex availability has declined in the past three years, contributing to the significant decline in reserves. Official Development Assistance (ODA) dropped substantially between 2020 and 2022. Official statistics from the Ministry of Finance show that ODA has declined from USD 4.7 billion in 2020 to USD 3 billion in 2021 and further to USD 2.7 billion in 2022, a fall of more than 40%.

> **Ethiopia's fiscal effort falls short of that of peer countries:** Domestic resource mobilization, measured by tax revenue to GDP at 10 -12 percent of GDP, has been low and stagnant compared to other African countries and the rest of the world (Figure 1). Likewise, the country's gross national savings, although increasing during the 2000s, has remained below the investment needs of the country (Figure 2).

1 Fitch (2023). According to IDS principal payments on external public and publicly guaranteed (PPG) debt is USD 2 billion and USD 3 billion in 2023 and 2024.

Figure 1 Tax revenue (percent of GDP)

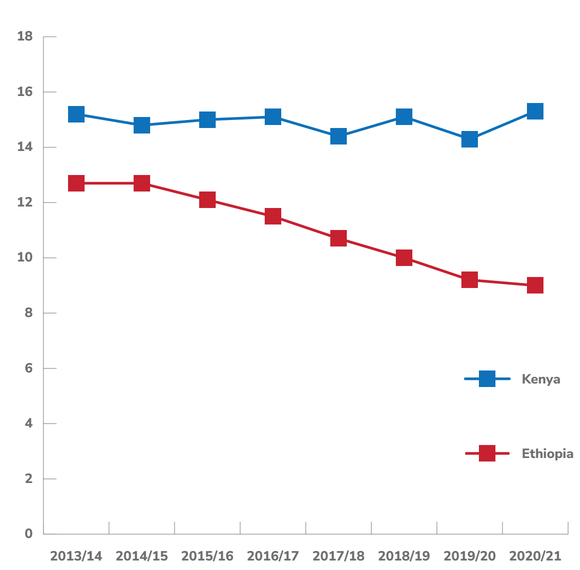
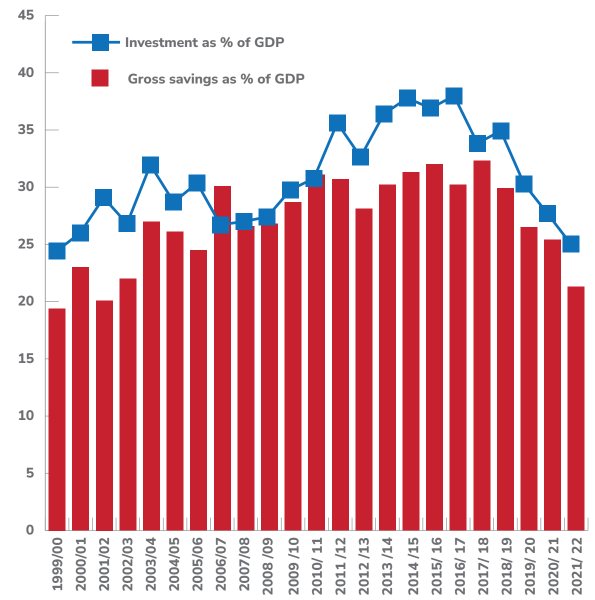


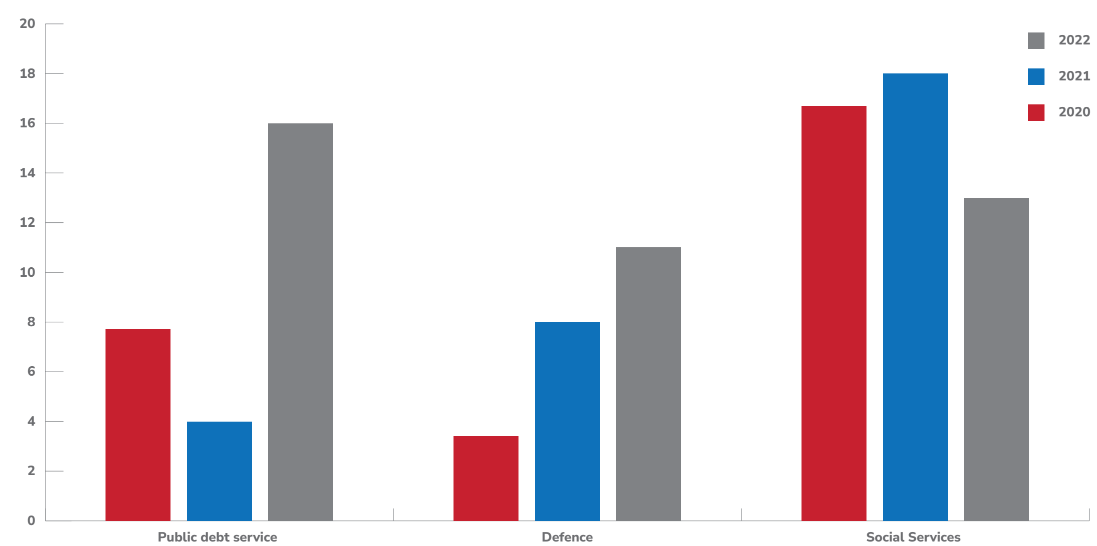
Figure 2: Saving and Investment(percent of GDP)



Source: IMF, MoF

> **Fiscal space has essentially disappeared, and the allocation of spending has become skewed to debt service and defence:** The government budget, particularly in the past three years have been affected by increasing defence and debt servicing expenditures. In 2023, the two expenditure items had taken more than a fourth of the total budget (Figure 3).

Figure 3: Expenditure in debt service, defence and social services (% total expenditure)



Source: Constructed based on data from MoF

> **Fiscal and forex needs have ballooned even as means of financing have shrivelled:** Ethiopia's Humanitarian Response Plan for 2023 calls for just under USD 4 billion of funding. Beyond this, a World Bank coordinated assessment suggests that USD 20 billion will be required over five years, with as much as USD 5 billion needed in the first year, to finance resilient recovery and reconstruction following the conflict in Northern Ethiopia. In addition, initial estimates indicate a requirement of USD 0.5 billion to pay for demobilisation and reintegration of up to 250,000 ex-combatants.

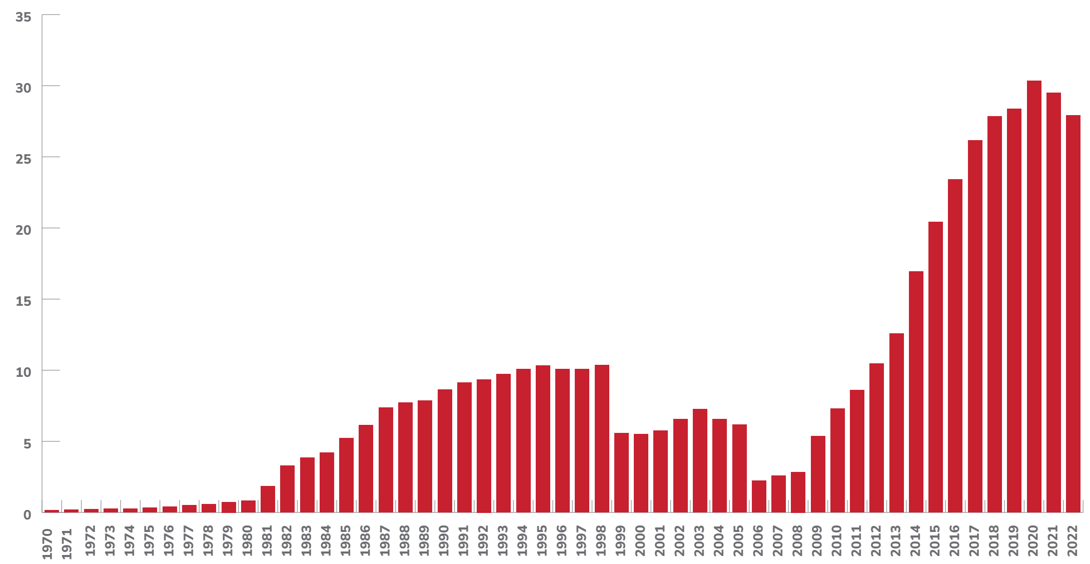
This Working Paper examines one aspect of the policy dilemmas facing Ethiopia: its debt relief options as it seeks to find the fiscal space to address post-conflict needs, accelerate essential economic and governance reforms, and restore sustained peace.[2] **It aligns, in this sense, with recent United Nations analytics on debt.** The UN Secretary General has called for a new debt architecture that supports debt relief for low-income countries. The UN's SDG Stimulus Plan, which calls for additional liquidity, effective debt restructuring and the expansion of development financing, has the potential to free up significant fiscal space in developing economies. According to the analysis, for 52 most debt-vulnerable economies, a 30 percent haircut of 2021 public external debt stock could lower debt service payments in 2022–2029 by between USD 44 billion and USD 148 billion, depending on the participation of various creditor classes.[3] From this perspective, it is important to consider a reduction on external debt stock to lower country debt service payments and provide fiscal space to address the SDGs.

2 This paper uses the nominal official exchange rate of the local currency Birr against the USD.

3 Molina and Jensen (2023)

Ethiopia has had a history of recurring debt distress in the past. Growth of debt has been higher than that of the GDP growth for most of the years in the past four decades. Ethiopia's external debt stock increased from US 1.8 billion to USD 10 billion in the two decades beginning in 1980 (Figure 4). For much of this period, the country had been undergoing internal conflict leading to significant spending on war. Furthermore, Ethiopia was also following a command economy system until reforms in the early 1990s led to initial progress towards a more market-based economy. Moreover, consecutive negotiations to secure debt relief were successful during the latter part of the 1990's and early 2000 period. Indeed, in the early 2000s, the country benefited from debt relief initiatives promoted by the IMF and the World Bank, such as the Highly Indebted Poor Countries and the Multilateral Debt Relief Initiative (MDRI), resulting in external debt stock reduction of about USD 2.2 billion by 2006. [4] [5]

Figure 4: Total Stock of External Debt 1973-2022 (USD billions)



Source: WB and MoF

During the second decade of the 2000s, a Growth and Transformation Plan was put in place by the Government that was implemented in two five-year phases. This was a period when the country envisioned to kick start industrialization and invested in basic infrastructure and on state-owned enterprises, such as the Ethiopian Sugar Corporation, Ethiopian Railways Corporation, and Ethiopian Electric Authority as well as building industrial parks.

The total public debt stock of the country increased significantly during this period. By 2022, total debt stock had reached USD 57.2 billion, of which 47 percent was from external sources.[6] On the external debt side, official creditors (multilateral and bilateral) represent about 81 percent while the remaining 19 percent is to private creditors. A quarter of the external debt stock is owed to non-Paris Club bilateral creditors, mainly Exim Bank of China. Furthermore, a 10-year USD 1 billion Eurobond issued back in 2014 is due to mature in December 2024.[7] Most of the debt owed to private creditors is due to commercial banks. It is important to note that while multilateral debt is higher than Chinese debt, the interest payments on Chinese loans are generally at a higher interest rate (between 5 and 6 percent) than those for multilateral loans (less than 2 percent), although some of the terms and conditions of Chinese loans are not fully transparent. These amounts and creditor types are very relevant for the restructuring scenarios that will be presented later in the document.

Total public debt to GDP ratio is currently 50.1 percent while the debt service to export ratio is about 22 percent. While Ethiopia's debt stock ratio is not high compared to many emerging economies, it still represents a challenge when we look at it in terms of its fiscal costs. In 2022, the country made a total of USD 2.1 billion in external debt service payments, while spending on poverty-focused social spending was about USD 1.9 billion. Figure 5 and Figure 6 below show the increasing trends in external debt servicing. In spite of external financing coming down in recent years and Government undertaking reform measures to better manage SOEs debt, domestic debt has been rising due to fiscal pressure to overcome the multiple macroeconomic shocks suffered by the country in the past three years.

A decomposition of public guaranteed external debt reveals several patterns. The stock of external debt from bilateral creditors, Paris Club and non-Paris club, reached USD 7.7 billion with a composition of 10 percent from the Paris Club and the rest from non-Paris Club (Figure 7 and Figure 8, Annex Figure 1). China is the major bilateral, non-Paris Club creditor for Ethiopia, accounting for 30 percent of total external debt.

The stock of debt owed to multilateral creditors at the end of September 2022 stood at USD 14.2 billion or 52 percent of the total external debt. IDA debt is 75 percent of the total multilateral debt, with smaller shares by AfDB (15 percent), IMF, and others. There is also significant private creditor debt with commercial banks owing USD 2.9 billion, suppliers due USD 1.1 billion and a Eurobond with a value of USD 1 billion (Annex Figure 2).

4 World Bank (2004)

5 IMF (2004) and IMF (2009)

6 Close to 62 percent of the total debt stock is accounted for central government debt while 38 percent is debt to State Owned Enterprises (SOEs). Debt to SOE's is mostly non concessional and on variable interest rates.

7 IMF, 2019.

ETHIOPIA'S PAST AND PRESENT DEBT STATUS

Figure 5: Debt Service to Exports (percent)

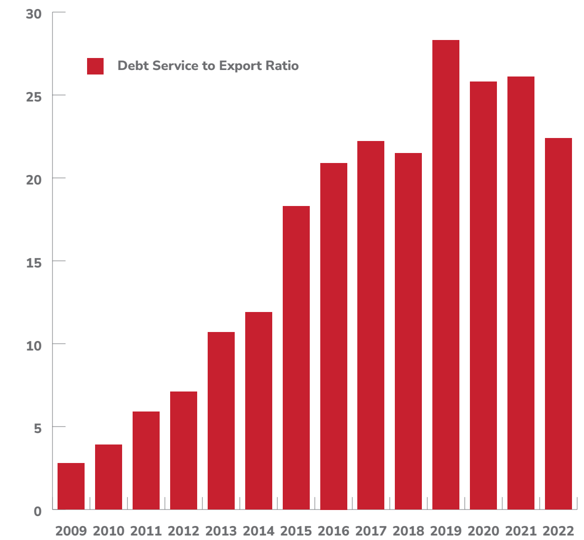


Figure 6: Debt Service Decomposition (USD million)

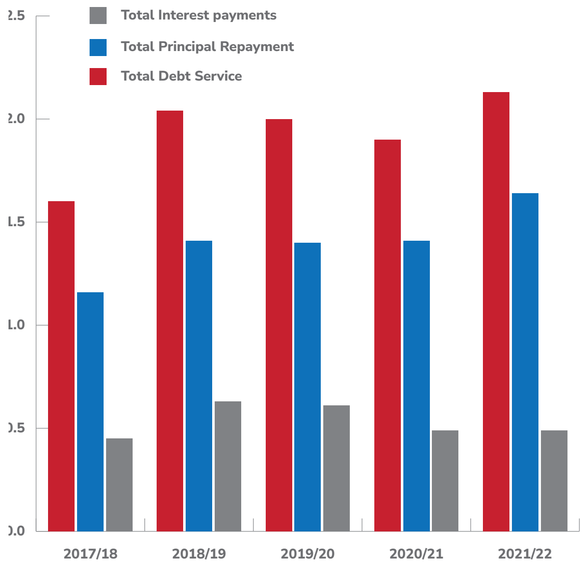


Figure 7: External Debt Decomposition (percent)

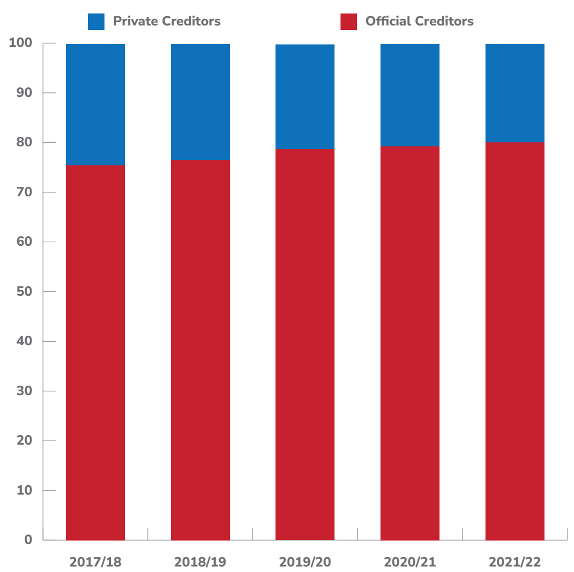
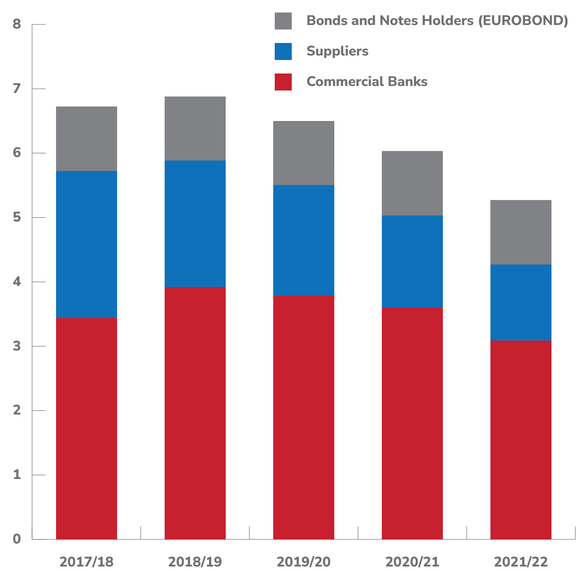


Figure 8: External Debt to Private Creditors (USD millions)



Source: MOF

Domestic and SOE Debt

The total stock of domestic debt was at Birr 1.6 trillion equivalent to USD 30.3 billion by the end of September 2022. Out of this, central Government debt represents 57 percent (USD 17.2 billion), while SOEs represents about 43 percent. Central government's domestic debt has been on the rise with most of the debt coming from issuing treasury bills and direct advances (Figure 9). More than half of the central government debt is sourced from NBE via direct advances and from sale of treasury bills during the fiscal year 2022.

The domestic SOE debt stock has been increasing. By the end of January 2023, SOE domestic debt stock had reached Birr 832.6 billion of which nearly 50 percent or Birr 436.4 billion represent transfers to the Liability Asset Management Corporation (LAMC). LAMC is designed to absorb 20 to 100 percent of SOE domestic debt.[8] So far, transfer of debts for Ethiopian Electric Authority, Ethiopian Railway Corporation, and Ethiopian Sugar Corporation has been affected since these companies have accumulated arears by the tune of Birr 123.2 billion. SOEs are expected to service their remaining balance of debt that has not been transferred to LAMC. As can be seen in Figure 10, there is also a significant proportion of arrears with other SOEs.

Figure 9: Central Government Debt Stock by Source (Billion birr)

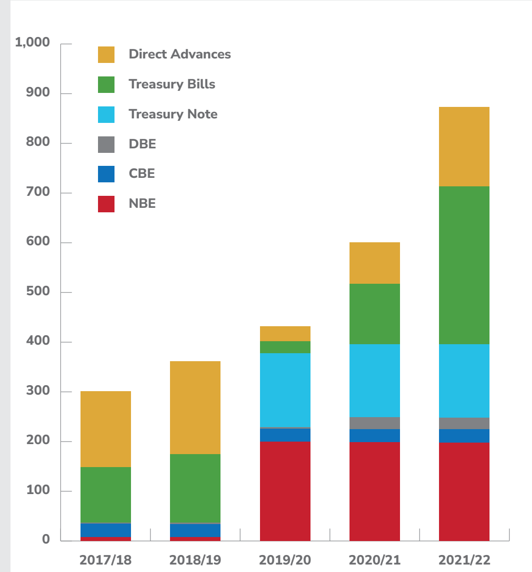
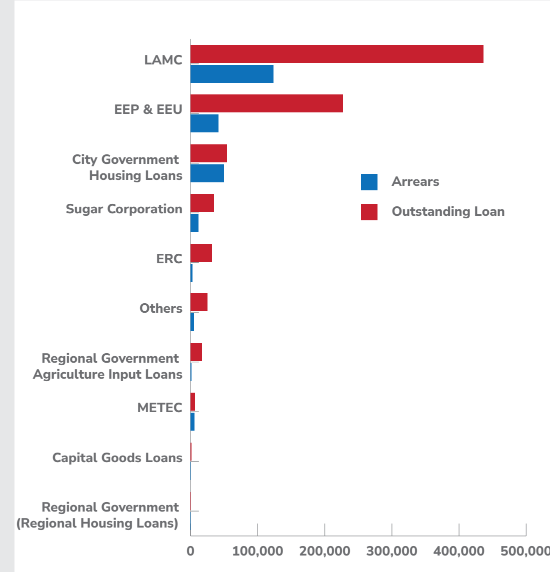


Figure 10: SOE Stock of Debt and Arrears (Billion Birr)



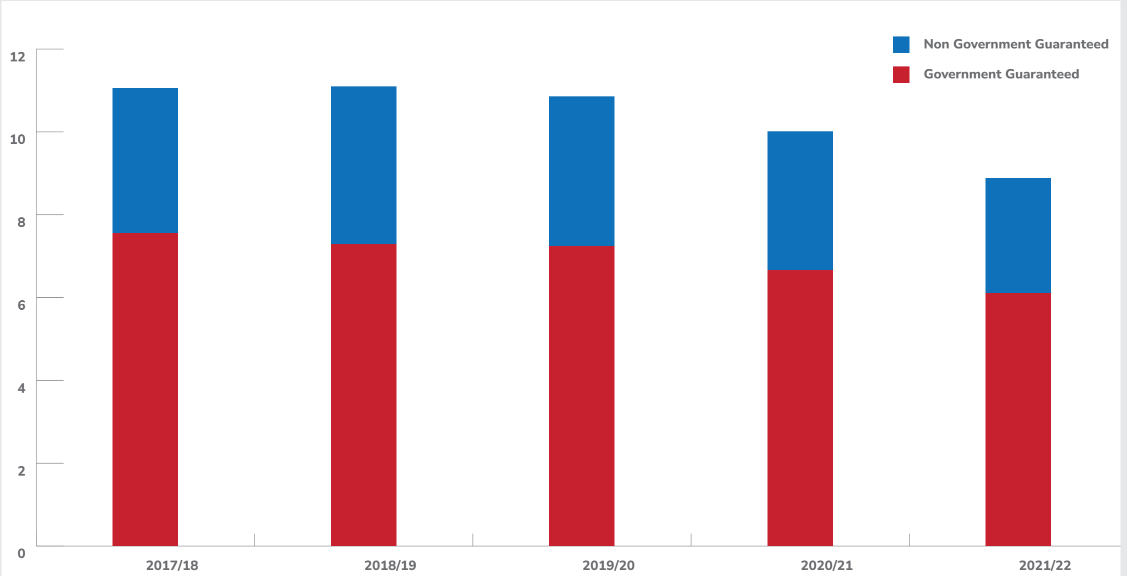
Source: MOF; based on Data from CBE (January 2023)

8 The newly established Liability Asset Management Corporation (LAMC) has been mandated to manage the accumulated debt and the servicing of some SOE debt.

Most of the country's 40 SOEs are undertaking management reforms due to existing ratios of debt distress and inefficiencies. Although they have had an important role in the economy, they have shown a high dependency on Government support throughout the years. SOEs are clustered by sector such as transport, communications, finance, manufacturing, construction, agriculture and trade and service sectors. Ongoing reforms are showing results, and a recent review by a consulting firm Cepheus[9], suggests that some SOEs are showing an increase in revenue as well as profits during the first half of 2022 compared to the previous year. SOEs in the transport sector; Ethiopian Airlines, Ethiopian Shipping Lines, as well as SOEs in the financial sector, mainly Commercial Bank of Ethiopia, have been the most profitable.

Total SOE debt stock as of September 30, 2022 reached USD 21.2 billion, out of which USD 8.5 billion is external debt while the balance is domestic debt. SOE external debt is comprised of government guaranteed and non-government guaranteed (Figure 11), where the latter is mainly channelled to Ethiopian Airlines and Ethio Telecom. Debt restructuring was part of the concluded Home-Grown Economic Reform plan (HGER). Under this plan, the government identified seven SOEs (*Ethiopian Electric Power*, *Ethiopian Electric Utility*, *Ethiopian Railway Corporation*, *Ethio-Engineering Group (formerly METEC)*, *Chemical Industry Corporation, Construction Works Corporation, and the Sugar Corporation)* facing severe financial distress and transferred their management to LAMC. Government intends to use the proceeds of privatization of selected SOEs to address about Birr 421 billion of debt transferred to LAMC.[10]

Figure 11: Government Guaranteed and non-Government Guaranteed External Debt of SOEs (percent)



Source: MOF

9 Cepheus (2022)

10 MoF (2022)

The Debt Sustainability Analysis (DSA) of the World Bank and IMF in 2019 assessed Ethiopia's external debt to be at 'high risk of debt distress'. Based on the analysis in the DSA, Ethiopia's solvency indicators (PV of external debt to GDP and to Exports) were below the corresponding sustainability thresholds, but not the liquidity ratios (external debt service to revenues and external debt service to exports) which were above their respective thresholds. In the Home-Grown Economic Reform (2019), the government recognizes misalignment of the exchange rate and debt distress of selected SOEs. With this the government recognizes the urgent need to reduce debt servicing through reprofiling some of the bilateral debts which was intended to eventually create some resilience to absorb shocks by providing more fiscal space to the authorities for social spending.

Ethiopia's credit rating has been downgraded by various rating companies in the past two years. In December 2022, Fitch, an international ratings agency, downgraded Ethiopia's ratings due to lack of external financing to meet financing gaps. Likewise, Standard and Poor's rating has downgraded Ethiopia's ratings to CCC in 2022 while Moody's rate was downgraded to Caa2, with a negative outlook. **These downgrades have added to the difficulty of finding financing for the country's development, despite some resilience on the economic front.** These downgrades are due to the rating agencies' assumptions that the lack of identified external financing necessary to meet substantial external financing gaps, along with a decline in Ethiopia's foreign exchange liquidity would make servicing its debt service commitments cumbersome.[11] Although in the past 3 years, the economy has been growing at an average rate of 6 percent, value of goods exports reached USD 4 billion in 2022 but imports amounted to USD 18 billion in the same year, due to higher costs in fuel and food.

As a result of recent macroeconomic shocks and pre-existing debt unsustainability ratios, Ethiopia[12] applied for debt relief treatment within the G20 Common Framework. According to the Common Framework (CF), all creditors should be 'comparably treated' under any potential CF restructuring agreement. This includes the eligibility and treatment of any bilateral and commercial debt (banks, suppliers, and bonds). Under the CF, participating official creditors would provide their share of debt relief while requiring the debtor country to secure private creditors' participation on comparable terms to overcome collective action challenges and ensure fair burden sharing. Ethiopia's application was filed in February 2021 and deliberations started in September 2021. On September 16, 2021, 12 countries formally formed a creditor committee, co-chaired by China and France, and a second meeting was held on July 19, 2022. The major creditors on the committee are China, Denmark, France, Italy, Korea, Japan, and the Saudi Fund. However, the process for securing debt relief under this framework has been slow.

The debt relief provided under the CF will be guided by the upcoming DSA that will be conducted by the World Bank and IMF. The DSA will contain the amount of relief required for debt sustainability.[13] For a variety of reasons, the DSA has not yet been concluded. This would be the first step in the debt restructuring process. Any debt relief to be provided will be calculated based on the DSA's solvency and liquidity indicators.

11 Fitch Ratings (2023)

12 Along with Chad, Ghana and Zambia.

13 It is likely that the DSA concludes that Ethiopia's debt is unsustainable.

Under the Common Framework, an agreement is prepared between creditors and the debtor country, stipulating that parameters of the debt treatment. The three key parameters are[14]: the reduction in debt service over the life of the IMF supported program; the reduction in the net present value of debt; and the extension in repayment periods (please see box below).

THE G20 COMMON FRAMEWORK

The G20 Common Framework for Debt treatment beyond the Debt Service Suspension Initiative (DSSI) was launched in November 2020. The main purpose of the CF was to facilitate the debt restructuring of both bilateral and private debt of the 73 highly indebted low-income countries, should any of them found itself in need of debt relief. The framework was designed to facilitate a timely, orderly, and durable debt treatment. For those countries whose ratios are deemed to be unsustainable, the IMF takes a case-by-case approach and assesses the need for a debt restructuring operation based on the corresponding Debt Sustainability Analysis (DSA). This analysis will determine the financing envelope required to restore sustainability. For countries with no debt solvency difficulties but need liquidity relief, the Common Framework eases the financial pressure by providing the necessary debt service payments relief. Under the Common Framework, a debtor country that applies for debt relief, is required to sign a Memorandum of Understanding (MoU) with participating creditor countries to seek debt treatment from other creditors that is at least as favourable as the one agreed in the MoU. The CF initiative is based on the following principles:

(a) Debt eligible to be treated will include only public and publicly guaranteed debts with an original maturity of more than one year.

(b) The debtor country requesting a debt treatment will provide to the IMF, the WBG as well as participating creditors the necessary information regarding all public sector debt commitments, while respecting commercially sensitive information.

(c) The key parameters will include at least (i) existing nominal debt service over the IMF program period (three years); (ii) where applicable, the required debt reduction in net present value terms; and (iii) the extension of the duration of the treated claims. It is important to highlight that, in principle, debt relief treatments will not be conducted in the form of debt write-off or cancellation. This option will only be available in the most difficult cases, and only after an IMF-WBG's DSA and the participating official creditors' collective assessment

(d) Comparability treatment with all creditors. Debtor countries will need to negotiate with all their non G20 creditors (except multilateral creditors) debt relief treatments comparable to the one provided under the CF.

While the Common Framework is aimed at providing liquidity relief and addressing solvency issues, it has experienced delays and implementation difficulties, which remain a serious challenge for its success. The main reason has been the lack of appetite and interest on the part of some bilateral and private creditors, including China, to take part in the Initiative. Bilateral creditors for instance, are more likely to agree on haircuts than private creditors. Weak coordination between Paris and non-Paris Club creditors has contributed to the delay in implementation. This had also been the case during the HIPC Initiative. Furthermore, lack of transparency in loan contracts remains a final challenge.

14 G20 meeting Final Communique (2020)

A. Required Debt Relief

Ethiopia's debt carrying capacity, a measurement of how much debt a country can safely contract and remain sustainable for the medium term, is considered to be medium. Ethiopia's Compositive Index (CI)[15] stood at 2.8 in 2019, within the 2.69 and 3.05 range used to assess country's debt carrying capacity. This assessment is based on its macroeconomic performance, policies, and ability to absorb shocks. The CI number indicates that Ethiopia has medium debt-carrying capacity, with a higher number meaning a higher debt-carrying capacity. Table 1 below shows the corresponding debt sustainability thresholds that need to be used for assessing Ethiopia's external debt sustainability.

Table 1: Ethiopia: Debt Sustainability Thresholds

INDICATOR	THRESHOLDS (IN PERCENT)
PRESENT VALUE OF PPG EXTERNAL DEBT TO GDP	40
PRESENT VALUE OF PPG EXTERNAL DEBT TO EXPORTS	180
EXTERNAL DEBT SERVICE TO EXPORTS	15
EXTERNAL DEBT SERVICE TO REVENUES	18

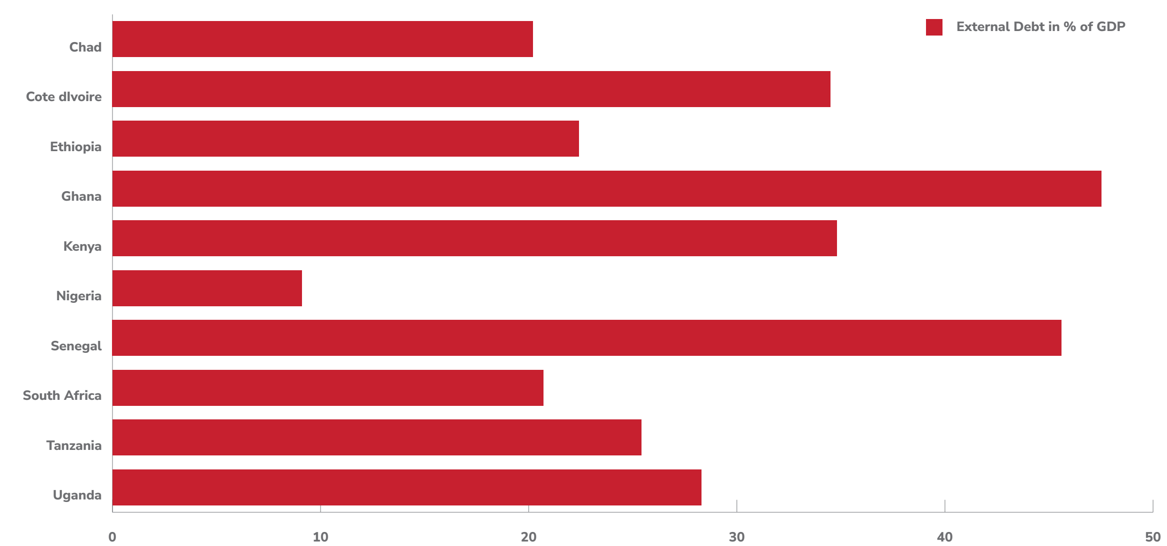
Source: IMF, Article IV 2019

B. Liquidity vs Solvency

According to the DSA conducted in 2019, Ethiopia is experiencing a liquidity and not a solvency problem.

Compared to other countries in SSA in 2022, Ethiopia does not have as serious a stock problem. Ethiopia's external debt in percentage terms is lower than countries like Ghana, Cote d'Ivoire, and Kenya, but it is higher than larger economies like Nigeria and South Africa (Figure 12).

Figure 12: External Debt (percent of GDP) in 2022



Source: IMF Africa Regional Economic Outlook, October 2022

15 The CI is an index calculated using the World Bank's Country Policy and Institutional Assessment (CPIA), real growth rate, import coverage of reserves, remittance and global economic growth. Based on the resulting index a country is considered with a low, medium or high carrying capacity.

Due to more than 50 percent concessional share in Ethiopia's total external debt portfolio (which is central government debt plus publicly guaranteed debt), its present value was 18 percent of GDP at the end of March 2022, well below the existing threshold of 40 percent. On the liquidity side, however, the latest estimate available shows a debt service to export ratio of 22.4 percent well above the 15 percent threshold. Table 2 below shows the latest estimates for some key debt sustainability indicators. It shows the existing ratios for the different indicators and then shows how much debt reduction in that year would be necessary to bring down each of the two liquidity indicators (external debt service to revenues and to exports) to the required thresholds. The last column on the right (total) shows the cumulative debt relief needed for the three-year period.[16]

Table 2: Ethiopia - Debt Relief Gross Estimates

	2022/23	2023/24	2024/25	TOTAL
TOTAL SCHEDULED EXTERNAL DEBT SERVICE (TEDS) (USD BILLION)	2.1	3.1	4.1	9.3
REVENUES (PERCENT OF GDP)	10.9	11.2	11.5	
TEDS/REV (PERCENT)	21	28	37	
DEBT RELIEF (USD BILLIONS)	0.34	1.55	1.03	2.92
EXPORTS (PERCENT OF GDP)	12.4	12.7	13.0	
TEDS/EXP (PERCENT)	17	25	32	
DEBT RELIEF (USD BILLIONS)	0.4	2.1	1.6	4.08

Source: IMF, Art IV 2019 and Ministry of Finance, Debt Management Bulletin 2022

Note: TEDS is total external debt service, REV is revenue, EXP is exports. The numbers on total debt service are based on Government estimates. The data is based on official estimates of Chinese debt. It also includes debt from Ethiopian Airlines and Ethio Telecom.

The numbers are significant in terms of potential debt relief. Initial estimates, based on the preliminary data available, would indicate that Ethiopia would need an estimated debt relief for 2023-2025 of **USD 2.9 billion** to bring down the TEDS to revenues ratio below the corresponding threshold. On the other hand, if we were to use the TEDS to export ratio, the required debt relief for the same period would reach an estimated **USD 4 billion**.

Given the potential higher amount of debt relief, the country should request to use the debt service to exports ratio (rather than the debt service to revenue ratio) to maximize debt relief. The exact required debt service relief needed for Ethiopia, however, would come from the DSA currently being conducted by the IMF and the World Bank which will be the basis of the evaluation by the G20 under the CF framework. This analysis is currently being conducted by the IMF/WBG.

16 The analysis shows the required amount of debt relief necessary on a yearly basis

This Working Paper identifies the following four debt management options for Ethiopia.

Option 1: Reduction in Stock of Debt: HIPC-Lite

DESCRIPTION

This option would entail a Highly Indebted Poor Countries (HIPC)-lite type of net present value (NPV) debt stock reduction through debt restructuring. The amount could be between USD 2.9 billion and USD 4 billion depending on the debt service ratios and the relief needed to bring them down to the appropriate thresholds. This would depend on government and creditor appetite. In 2004, under the HIPC Framework and the Multilateral Debt Relief Initiative (MDRI), considerable debt relief was provided to qualifying countries. For the 37 participating countries, the total debt relief provided was more than USD 100 billion.[17] Total debt relief to Ethiopia provided under the HIPC Initiative amounted USD 3.27 billion, in nominal terms, while debt relief obtained from the MDRI amounted to USD 3.13 billion, totalling USD 6.4 billion of debt relief.[18]

POTENTIAL PAYOFF

This is a more ambitious debt relief option, as was done in the early 2000s, and would be an ideal solution for improving the government's fiscal space. It would allow Ethiopia to achieve greater macroeconomic stability and reduce the debt obligations to bilateral and commercial creditors even if multilateral creditors would not take part in it.

ADVANTAGES AND DISADVANTAGES

First, this option leads to a decline in the stock of debt and debt servicing ratios and frees fiscal space for development spending. Second, it allows the country to address not only liquidity issues but potential solvency problems. This will make all debt ratios sustainable in the short and medium-term.

As explained earlier, however, Ethiopia's solvency indicators would not require such an aggressive treatment. It would, therefore, be difficult to argue for such treatment. There seems to be little creditor appetite for such a comprehensive debt relief treatment and little international political support for it, making this option unlikely. It is technically complex to execute and time-consuming, especially with China. In addition, there are technical limits to the amount of debt stock that could be forgiven. A recent study finds that the current approach increases the likelihood of 'light' restructurings (rescheduling of debt service with limited or no NPV reduction) as official creditors are not likely to commit to deep relief in the absence of similar assurances from private creditors.[19]

FEASIBILITY

This is not feasible under the existing Common Framework. Under the latter, it is only possible to negotiate a reduction in the NPV of debt in three ways: maturity extension, reduction in interest rates, and relaxation in grace periods. Under normal scenarios, a haircut is preferable to a reprofiling in lowering the NPV of debt. However, most creditors are interested in reprofiling, which means

17 https://www.worldbank.org/en/topic/debt/brief/hipc

18 World Bank (2019)

19 Rivetti (2022). The current approach has a lengthy negotiation phase as private creditors are not given any indication of the restructuring terms until the terms are confirmed by official creditors.

stretching out for a short period without haircutting principal or interest. Creditors appear to have little appetite for a stock reduction. This option is only reserved for extreme cases after a DSA has been conducted.

Option 2: G20 Framework

DESCRIPTION

This approach calls for working within the parameters of the G20 Common Framework (CF) and focus on securing vital fiscal relief during the next three-year period. Under this approach, Government would seek to reduce debt service payments without reducing the debt stock and interest rates. The CF would involve mainly debt reprofiling (maturity extensions) from all bilateral and private creditors to 2033, as the CF framework is designed to ensure broad participation of creditors with fair burden sharing. This would retain the same amount of debt, but with a smoothened payment schedule, and without changes in interest rates. Reprofiling is the dominant element in the CF, but the CF allows an interest rate reduction which countries can ask. The decision on the extent of maturity extension is expected to be decided based on bilateral discussions between creditors and the Ethiopian Government. The potential payoff estimated below tries to show the amount needed to free some fiscal space between 2023 and 2025 (Table 3). The CF is based on a discretionary methodology and not based on a common discount rate.

POTENTIAL PAYOFF

This CF debt reprofiling would address the Government's liquidity concerns. This measure could reduce Ethiopia's debt service payments by about 30 percent over the next three years (2023, 2024, and 2025). In relation to private creditors, based on the required debt relief needed from bond holders, Ethiopia could need to request coupon payments for 2023 and 2024 on Eurobonds to be reduced by USD 132.41 million for the two years. [20]

According to the G20 Common Framework's guidelines, any debt relief to be provided under the framework would need to be calculated based on burden sharing.[21] This principle means that the debt relief would need to be allocated to the different bilateral and commercial creditors (multilaterals are excluded from participating) based on their share of the combined bilateral and commercial debt as of the end of March 2020, the cut-off date established by the G20.[22] Based on estimates, using end of FY 20 available from authorities, the debt relief to be provided by these creditors[23] would be distributed, according to their share in the debt stock as of March 2020.

20 This amount is the sum of the 2023 and 2024 coupon payments owed to Eurobond holders by Government of Ethiopia given the coupon rate of 6.625 percent, a ten-year tenor, and a USD value.

21 G20 (2020).

22 G20, (2020)

23 Calculations are made assuming Ethiopia would request debt relief based on the external debt service to exports ratio and not on the external debt service to revenues ratio.

OPTIONS ON DEBT RESTRUCTURING

Table 3: Estimated distribution of debt relief by creditor type

	TOTAL DEBT RELIEF NEEDED *(USING THE TEDS OVER EXPORT THRESHOLD)*		
	DOD (USD MILLION)	**SHARE (PERCENT)**	**DEBT SERVICE RELIEF FOR THE 3-YEAR PERIOD BASED ON SHARES**
PARIS CLUB	812.70	5	215.22
NON-PC	7,794.00	52	2,063.99
COMMERCIAL BANKS	3,790.00	25	1,003.66
SUPPLIERS	1,708.00	11	452.31
EUROBOND	1,000.00	7	264.82
	15,104.70	100	4000.00

Source: Government data and author's calculations

Note: These estimates would need to be refined by using data as of end-March 2020 and a distribution of stocks by creditors.

ADVANTAGES AND DISADVANTAGES

The main advantage of this approach is that it addresses the key liquidity problems of Ethiopia in the short and medium-term. But the Common Framework approach is very difficult to implement given the lack of unified perspective among multilateral creditors, Paris Club and non-Paris Club (including China) bilateral creditors, and private creditors. It is uncertain whether key non-Paris Club creditors would participate and whether private creditors would be willing to go along.

FEASIBILITY

This approach has some feasibility as there may be some support from several creditors. Ethiopia has recently started discussions with creditors such as China and France. The talks are ongoing as of March 2023. The objective is to get debt reprofiling and financing assurances so Ethiopia can pursue discussions on an IMF programme.

A first challenge for Ethiopia in this process, however, will be to secure participation of its commercial creditors. The Common Framework requires comparability of debt relief treatment. The recent experience in Zambia, which is currently negotiating under the G20 Common Framework, has shown that negotiations will be very complex and lengthy, particularly with private creditors.

A second challenge would be to ensure China's participation. China is Ethiopia's largest bilateral creditor and has offered a multiplicity of loans to Ethiopia since 2000. Johns Hopkins University finds that Ethiopia has been an important country for the rollout of the Chinese Belt and Road Initiative. During the HIPC Initiative, China was more willing to provide debt relief for loans in yuan but more reluctant for USD denominated debt. Even in the case involving the Addis-Djibouti Railway, when the loan ran into trouble, China favoured a 30 - year loan repayment period rather than a 10 year, rather than any reduction in the size of the debt.[24] Instead of a haircut, China favoured extending the repayment period.[25] Given that more than 40 percent of the debt service will be to China between 2023-29, the role of China will be key to help Ethiopia's debt challenges.

24 IMF Art IV. Jan 2020. DSA section. Page 4

25 https://www.reuters.com/article/ethiopia-china-loan-idUSL5N1VS4IW

Under such an environment, reprofiling via parallel discussion with selected individual creditors may be the best approach. Getting China and other bilateral creditors, as well as private creditors on the same page might prove to be difficult, a factor explaining the very slow pace of progress of the Common Framework. In February 2023, the Ministry of Finance began bilateral discussions with Chinese authorities in Beijing on bilateral debt reprofiling.[26] Of the total bilateral debt as of September 2022, Chinese debt is 90 percent of bilateral debt of USD 7.7 billion, but there is also some private creditor debt that is also Chinese. In January 2023, China had agreed to cancel an unspecified amount of debt owed by Ethiopia, according to the Ministry of Foreign Affairs (MoFA). It is yet early to predict how the required debt relief would be provided by the different creditors.

Three different approaches can be considered under this option. The first approach would involve a reprofiling of existing debt service so that the resulting cash flow projections fall below the required thresholds. The second approach could involve consolidating the sum of all debt service falling due during the three-year period that is above the threshold (USD 4 billion calculated in Table 2). This means that Ethiopia could treat all debt service payments as a consolidated whole rather than on a creditor-by-creditor basis. Finally, in special cases, the Ethiopian Government could argue for selected interest rate reductions on bilateral debt, but that will be based on the DSA finding that Ethiopia's debt is unsustainable. It is also important to note that it will be key to speed up bilateral negotiations given the slow pace of the CF.

Option 3: Bond Restructuring

DESCRIPTION

Bond restructuring takes place when a debtor country faces distress on its bond payments. Ethiopia has a set of Eurobonds that were issued through commercial terms with the interest rates and coupon payments determined by the market rate. The holders of Ethiopia's sovereign bond are mostly US-based mutual funds and institutional investors, including some well-known emerging market investors. The largest holders were American Beacon Frontier Markets Fund (USD 125 million out of the USD 1 billion), Templeton Emerging Markets Bond Fund (USD 65 million), Pictet (USD 51 million), and JP Morgan's Emerging Markets Bond Fund (USD 32 million).

In a typical bond restructuring, lenders usually agree to reduce the coupon rate, extend the maturity, or both. Bond restructuring can involve the exchange of the old bond for a new one with a new tenor (longer maturity) and a new coupon rate (lower interest rate). Ethiopia has the option of negotiating a lower coupon rate than 6.25 percent or a longer tenor of more than ten years. The exchange can be done at par[27] or applying some agreed discount. In some cases, when a country has accumulated interest arrears, part of these arrears might be cancelled as part of the transaction. For example, in the cases of Ghana and Zambia, current discussions indicate that the exchange will imply a deep discount and that some interest arrears will be cancelled. The negotiations tend to be very complex and involve a very lengthy process.[28]

26 Jensen and Molina (2022) provide a UNDP perspective and discuss possible ways forward for the Common Framework focusing on country eligibility, debt sustainability analyses, official creditor coordination, private creditor participation, policy conditionalities and the use of debt clauses that target future economic and fiscal resilience.

27 One dollar of the old bond is exchanged for one dollar of the new bond.

28 Tran, Hung (2022)

Ethiopia began discussions with private bondholders in March 2023. According to MoF, a group of international bondholders has proposed to Ethiopia's government to extend the maturity of the country's USD 1 billion Eurobond issue coming due in 2024. One proposal is to spread out the interest payments until 2030. The discussions are ongoing, and it is unclear at this stage if all bondholders have agreed to a collective action clause (CAC).

Currently, there are three options open to Ethiopia to restructure its bonds:

- First, Ethiopia can buy-back the debt on the secondary market, where investors buy and sell existing debt. When this option is used, secondary market prices tend to increase after the debtor country makes its announcement that it plans to repurchase its bonds. In the case of Ethiopia, it has an outstanding 10-year USD 1 billion Eurobond with a coupon rate of 6.625 percent that will mature in December 2024. Its secondary market price has fluctuated since the issuance, due to the civil conflict and later to the announcement that the government was seeking debt restructuring under the G20 framework. It is hard to predict the secondary market price for Ethiopian bonds as it depends on market outlook and global interest rates. Yields have gone down since the peace agreement but remain vulnerable to a change in investor sentiment driven by progress on implementation as well as other factors such as the possibility of an IMF programme and accompanying debt restructuring.
- Second, it can refinance the bond through new borrowing. Given higher interest rates at present, this will not be the best option forward.
- Third, it can continue to engage with Bond holders to refinance the Bond, when it becomes due, at lower rates and longer maturity.

POTENTIAL PAYOFF

Bond restructuring would reduce the debt service paid to private creditors and address the liquidity concerns, especially the spike in Eurobond payment of USD 1 billion in December 2024. It would smoothen debt service over the repayment period.

ADVANTAGES AND DISADVANTAGES

The bond restructuring can help address liquidity challenges of the Government of Ethiopia. It would be difficult to negotiate if bondholders are not in agreement with the terms. There are some challenges. Bond restructuring can entail a higher coupon rate upon restructuring, and it can adversely impact future borrowing costs.

FEASIBILITY

There are concerns regarding the participation of all Eurobond holders. Negotiation with bondholders is impacted by the heterogeneous nature of investors and diverse tolerance of individual bondholders. Holdout creditors can complicate the process. It is unclear if the private creditors for the Eurobonds will accept a haircut or delay in repayment. If Ethiopia decides to refinance the bond, it will require that Ethiopia seeks new resources to finance the transaction, an option that is not currently available.

On top of this, there have been recent downgrades that have affected bond prices. In March 2021, Moody's downgraded Ethiopia to Caa1 from B2, furthermore, in August of the same year, S&P also downgraded Ethiopia's credit standing, citing political turbulence, civil war and susceptibility to failure in servicing its payments, including dues on the Eurobond. Lastly, on January 22, 2022, Fitch downgraded Ethiopia's credit rating to CCC[29], which means a very high level of default risk relative to other issuers. Nevertheless, Government has been making the USD 66.6 million yearly interest payments. Secondary market price for Ethiopia Eurobond has been trading at a discount of about 22 percent, as reported by Bloomberg.

Option 4: Debt Swaps

DESCRIPTION

Debt swaps are defined as any operation by which a debt is exchanged, in local currency, to finance development or climate change projects or acquire equity. Under the Paris Club framework, a debt swap option is available and under the CF the same option might be made available by Paris Club creditors.

POTENTIAL PAYOFF

Although there would be little fiscal relief, the debt swaps would be an innovative solution to manage public debt. Furthermore, no foreign exchange would be used as these funds would be spent in Ethiopia thus providing foreign exchange relief to the country. Debt swaps could be superior to conditional grants when they can be structured in a way that makes the commitment de facto senior to debt service; and they could be superior to comprehensive debt restructuring, when the latter is expected to produce large economic dislocations and the debt swap is expected to materially reduce debt risks (and achieve debt sustainability). [30]

Once the debt service relief has been received under the Common Framework following the described requirements included in the DSA, Ethiopia can explore, bilaterally and on a voluntary basis, securing further debt relief options. While there is not a formal rule whereby CF adherence is a prerequisite to debt swaps, in practice creditors do not want swaps to be substitutes for debt restructuring and prefer issuing swaps when the country's debt payment strategy has been solidified. The debt swap option might allow further reduction in debt stock (and its associated cash flows) of up to 100 percent of the Official Development Assistance loans and 20 percent of non-ODA. Countries such as France might be willing to engage in this type of operations, as they have done so in the past. Other countries, such as Japan and China have not participated in this type of operations and would be harder to engage them. Table 4 below, shows the potential amounts[31] that could be available for debt conversion using the criteria established by the Paris Club for ODA and non-ODA debt.

29 CCC National Ratings denote a very high level of default risk relative to other issuers or obligations in the same country or monetary union. 'CC' National Ratings denote the level of default risk is among the highest relative to other issuers or obligations in the same country or monetary union (quote from Fitch).

30 Chamon et al (2022)

31 These amounts might not be realistic given previous reluctancy by China and Japan to participate in this type of agreements.

Table 4: Central Government's bilateral outstanding debt as of Sept 30, 2022 USD million

	OUTSTANDING DEBT	PERCENT FOR SWAPS	POTENTIAL AMOUNT
BILATERALS	3,596.19		3,437.92
ODA	3,398.36	100.00	3,398.36
NON-ODA	197.84	20.00	39.57

Source: MoF

ADVANTAGES AND DISADVANTAGES

A total of USD 3.4 billion could potentially be available to be used for swap operations if the Common Framework maintains existing Paris Club processes regarding debt swaps. The amount available to conduct swaps will be greatly reduced once countries that traditionally have stayed away from this type of operations (mainly China and Japan) are taken away from the pool. The actual amount would be certainly below USD 500 million given the low share of bilateral non-China debt.

Nevertheless, there are challenges with debt swaps. First, one would have to carefully find the donors. Denmark, France, and Italy have done debt swaps in the past, mostly debt for development swaps. Japan could be potentially interested.[32] Second, implementation challenges would need to be overcome to ensure funds were ring-fenced and spent as agreed in a transparent and verifiable fashion. This matter, however, is not insurmountable in Ethiopia; the UN and World Bank could jointly support Government on these aspects to provide additional reassurance to creditors. Finally, local currency contributions should be budgeted for the scheme since creditors normally provide debt-relief to a developing country in exchange for the country's local financing of an agreed project.

FEASIBILITY

The debt swap is feasible provided one finds the willing bilateral creditor. One feasible innovative option for Ethiopia might be to showcase to creditors the opportunity available to them – without recourse to *additional ODA* – to support vital national priorities. These could well be peace support for 12-18 months to deliver a peace dividend in Northern Ethiopia and/or financing for DDR and, more broadly the five-year Resilient Recovery and Reconstruction Framework (3RF).

32 Traditionally, Japan has not forgiven debt. The scheme use by this creditor is that the debtor country contributes to pay for the debt service, and then Japan provides the same amount in the form of a grant.

Three general scenarios can be considered to map out possible choices: no debt restructuring, Common Framework, and HIPC-lite. The chart below shows the different debt service payments under each scenario (Figure 13).

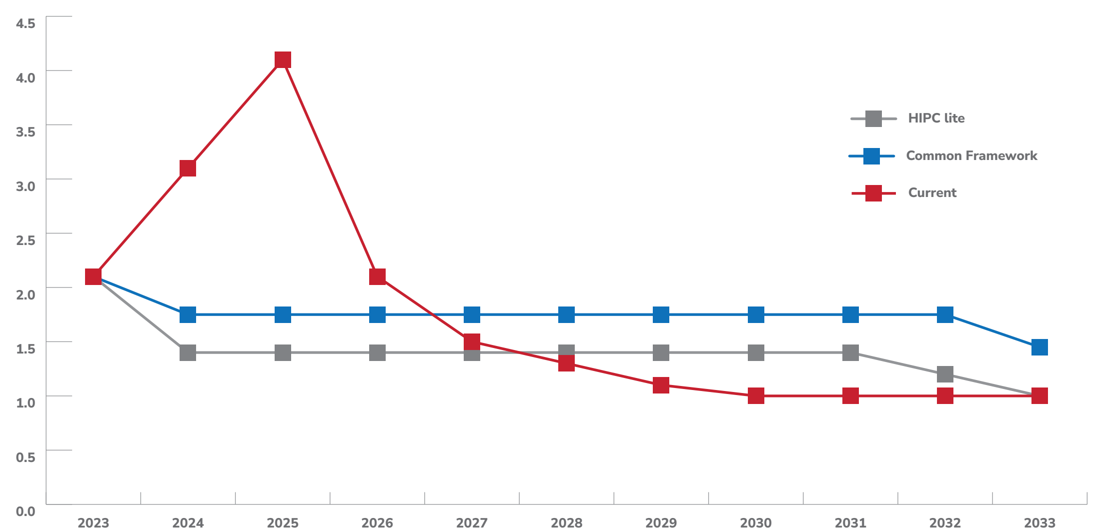
> **Status quo.** This scenario assumes no debt restructuring. It assumes no change in the existing debt service obligations owed by Ethiopia to all creditors between 2023 and 2035. This assumes no new borrowing, especially non-concessional borrowing.

> **Common Framework.** Under this scenario, there is a Common Framework maturity extension. The repayment is fixed at a ceiling of USD 1.75 billion per year with a payment extension until 2033. No nominal stock reduction and no interest rate reductions are needed but there is simply an extension of the repayment period. This operation provides up to USD 4 billion of debt service reduction (equal to what is needed). Multiple options are possible depending on the amount of desired annual debt service and number of years for the extension of repayment. This analysis assumes no debt service reduction for 2023. The operation would result in no debt reduction but rather a reduction in debt service during 2024-2026 which, in turn, would result in slightly higher debt service in the period up to 2033.

> **HIPC-lite.** This scenario involves a reduction in the total volume of debt service payments between 2024 and 2033 by 20 percent. It implies haircuts and/or interest rate reductions on outstanding debt. It assumes no debt service reduction for 2023. The scenario is based on a more ambitious negotiation strategy with bilateral creditors like China, involving agreements on the maximum amounts to be repaid and the number of years for repayment. This scenario leads to lower debt service payments compared to the Common Framework scenario.

One of the major considerations that policymakers should make relates to the future evolution of macroeconomic parameters. The success of debt restructuring will depend on Ethiopia's economic performance, particularly the external sector. In any debt sustainability analysis (DSA), there is an inherent risk of an overoptimistic projection of exports in the years to come. Such a projection may artificially lower the debt service to exports ratio and indicate a sustainable debt when it may not be sustainable. In other words, debt restructuring must consider macroeconomic realities.

Figure 13: Alternative Debt Service Payments under Alternative Scenarios (USD billion)



Source: UNDP projections

Table 5 below presents various options and the advantages and disadvantages of each.

Table 5: Policy Options for Ethiopia

OPTIONS	ADVANTAGES	DISADVANTAGES
HIPC-LITE DEBT RELIEF	In principle, debt relief would address both liquidity and solvency issues Bring debt to sustainable levels Provide government with fiscal space to tackle urgent development needs	Difficult to get creditors to buy into large stock reductions Complex negotiations Government concern about increased borrowing costs in commercial markets Could lead to delay in potential IMF programme Could trigger moral hazard
G-20 COMMON FRAMEWORK	Balanced and fair approach that addresses the liquidity problem Debt relief is equally spread across private and public lenders Multilateral support from leading organizations, including IMF and Paris Club Can involve private separate discussions with creditors	Very slow pace of progress of Common Framework for Chad, Ethiopia and Zambia Inability to get China and private creditor on the same page. Lack of enforcement mechanism Does not address long-term solvency and not able to resolve debt problem Reprofiling requires an updated DSA and a comprehensive dataset of all debt
BOND RESTRUCTURING	Allows one to decrease amount of debt service Addresses liquidity challenges Can be done in parallel with CF options	Complex with low returns and exorbitant fees High legal complexities
DEBT SWAPS	Can only be done once there is debt reprofiling or debt relief Allows resources to be used for development or SDG-related projects rather than debt service Relief on forex reserves	May be difficult for donors to buy into this Requires high levels of management, transparency and integrity Potentially inflationary

ANNEX 1: EXISTING DEBT RELIEF MECHANISMS

There are a number of debt restructuring frameworks available to countries to reprofile the existing cash flows. Some of these options may also include debt relief but that is not always the case. The relevant existing frameworks for Ethiopia include the following:

G20 COMMON FRAMEWORK DEBT RESTRUCTURING

The G20 recognized that some debtor countries may face debt vulnerabilities beyond the Debt Service Suspension Initiative (DSSI) and set out a Common Framework on Debt Treatment (endorsed in November 2020), in agreement with the Paris Club. The G20 agree to review on a case-by-case basis countries facing debt difficulties. The review and the amount of relief will be based on a Debt Sustainability Analysis to be conducted by the International Monetary Fund and the World Bank.

PARIS CLUB DEBT RESTRUCTURING

The terms of the debt restructuring offered by Paris Club creditors has varied over the years. Over time, practice and theory have evolved, and two trends have emerged in the terms of Paris Club agreements:

- Longer repayment periods have been considered. In early Paris Club agreements, repayment terms did not exceed ten years including a grace period (in which only payments of interest on the consolidation are due). For poorer countries, these terms have been constantly extended. The maximum repayment period is now 23 years (including 6 years of grace) for commercial loans and 40 years (including 16 years of grace) for official development aid loans.
- Debt cancellation has been increasingly used. The first concessional agreement was concluded with Mali in 1988 under the Toronto terms (33,33 percent cancellation in PV terms). The cancellation rate has been regularly raised, achieving 90 percent (in PV terms) or more when necessary to reach debt sustainability in the framework of the Heavily Indebted Poor Countries Initiative.

The Paris Club has used different mechanisms to provide debt relief which are described below:

Debt Flow Rescheduling: This mechanism is used in conjunction with a flow treatment whereby debt service payments during a certain period are consolidated and repaid with a new grace period and maturity as well as new interest rate. Terms may vary whether the debt is classified ODA or non-ODA.

Debt Stock Reprofiling: This option provides a new debt service profile for the whole stock of debt outstanding.

Debt Stock Reduction: Under this option, a portion of the debt outstanding is cancelled, and the remaining is consolidated and repaid with a new grace period and maturity as well as a new interest rate. The debt reduction can be on a nominal or on a present value basis. On a present value basis, depending on the amount forgiven, the terms and options offered can be equivalent to those provided under Naples terms. These terms are offered only on an exceptional basis depending on whether this clearly demonstrated in the DSA. Although these terms can be provided under the Evian approach, for former HIPC countries, the Paris Club and the G20 might be willing to go further.

Debt Buyback: This mechanism allows the debtor country to prepay certain types of debt at a discount or at face value. This option has been introduced with Nigeria in 2005 which repurchased all its post-cut off debt. Gabon also used this technique to buy back 100 percent of its Paris Club debt financed by a Eurobond.

Debt Swap: Since the Houston terms, the Paris Club has allowed, on a voluntary basis and under certain conditions., debtor countries to conduct debt conversion (debt for nature swap, debt for equity swap, debt for aid swaps) Under the Evian approach, the Paris Club has maintained this option and includes the Debt Swap clause in its Agreed Minutes of Negotiations. The clause stipulates that Government and Participating countries may on a voluntary and bilateral basis enter into debt swap agreement and sets the following limits: 100 percent of the Official Development Assistance loans and 20 percent of the amounts outstanding at a specific date or up to a certain amount.

Contingency Clauses: These clauses provide certain recommendations on future actions on the part of the Paris Club creditors to their authorities. For example, under the HIPC initiative, such clause corresponded to the possible stock treatment at the end of the Completion Point of the initiative. In the case of Myanmar, such clause was inserted to give a signal that Paris Club creditors would recommend the cancellation of 50 percent of the arrears at a certain date if certain conditionalities had been fulfilled.

NON-PARIS CLUB DEBT RESTRUCTURING

As stated above, debt countries have to seek comparable treatment with their remaining creditors (pari passu clause). Based on the HIPC experience, few non-Paris Club have chosen to provide debt cancellation, but instead have chosen to reschedule with more favourable terms such as extending the grace period and maturity. This was the case for the Arab creditors such as the Saudi Fund, Kuwaiti Fund, and the Abu Dhabi Find. On the other hand, China has only agreed to cancel debt denominated solely in yuan and originated from the government, but never for the Exim-Bank China whose loans were reprofiled.

Debt swaps have not been used by non-Paris club creditor as a mechanism to provide debt relief. The exception was Argentina whose debt was used as a vehicle for conversion under the UNICEF debt for development swap program.

Debt buybacks has been used to repurchase commercial banks as well as supplier's credits at a deep discount and interest rate arrears being cancelled. These debt buybacks were mostly financed by the Debt Reduction Facility of the World Bank.

ANNEX 2: CREDITOR DATA

Figure 1: Creditor Decomposition (Million USD)

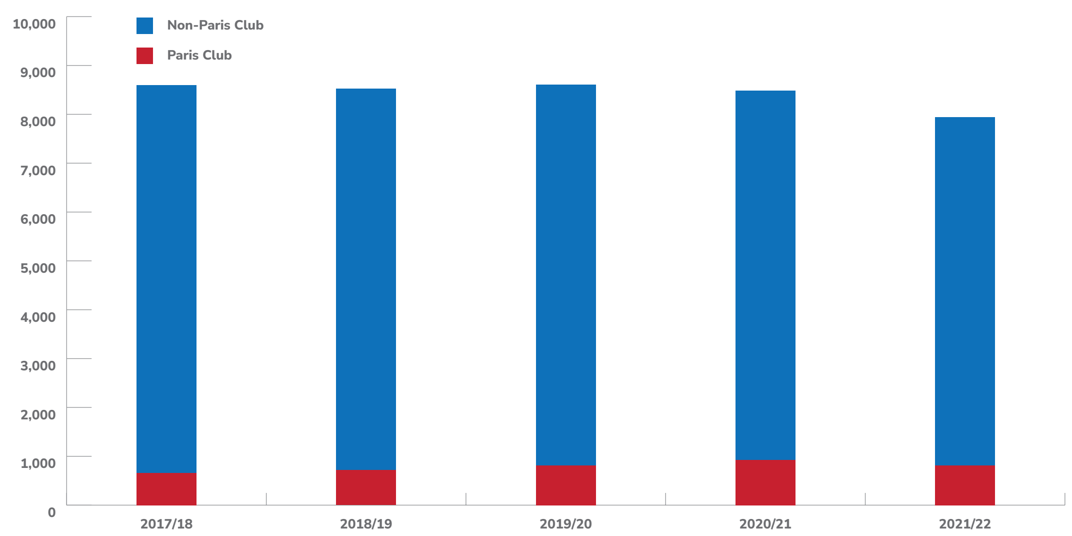
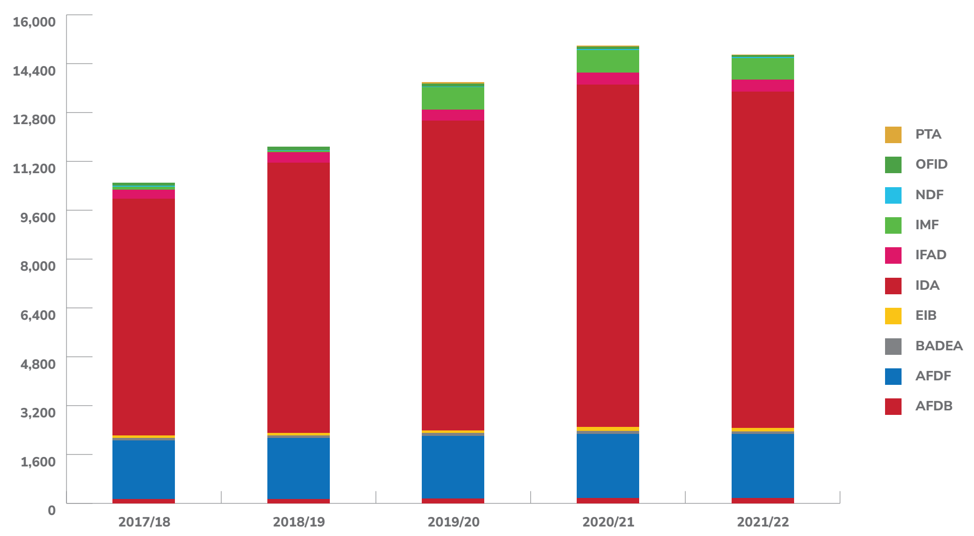


Figure 2: Multilateral Debt by Creditor Type (million USD)



Source: Constructed based on data from MoF

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