ETHIOPIA'S DEBT SUSTAINABILITY: FROM PARIS CLUB TO THE MDGS

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1. 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 analyse 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.

As discussed elsewhere in this volume, developing country debt renegotiations and debt relief for the poorest countries have been conducted within the framework of a small number of international fora and initiatives. The main elements of the framework concerning 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 proportion of debt cancellation to debt rescheduling has grown to 90%:10% for the poorest and most heavily indebted countries.[1]

- The *IDA Debt Reduction Facility*. This is a facility established in 1989 for IDA-only countries, through which IDA, in cofinancing with bilateral donors, provides 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.[2]

- 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, African Development Bank and other international and regional organisations). 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.[3]

Ethiopia's debt restructuring and debt relief negotiations are summarised 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 Buyback Facility, and received two treatments of its debt under the HIPC Initiative.

Ethiopia's debt renegotiations are best analysed 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.

[1] For more on the history and gradual development of Paris Club debt relief terms, see Vilanova and Martin 2001.
[2] For more details of the IDA Debt Reduction Facility, see IDA 2004.
[3] For more detailed analysis of the original and enhanced HIPC Initiatives, see Martin and Johnson 2001.

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.
** - These Paris Club agreements were part of (ie not additional to) the HIPC relief.

2. ETHIOPIA'S PRE-HIPC DEBT RELIEF NEGOTIATIONS

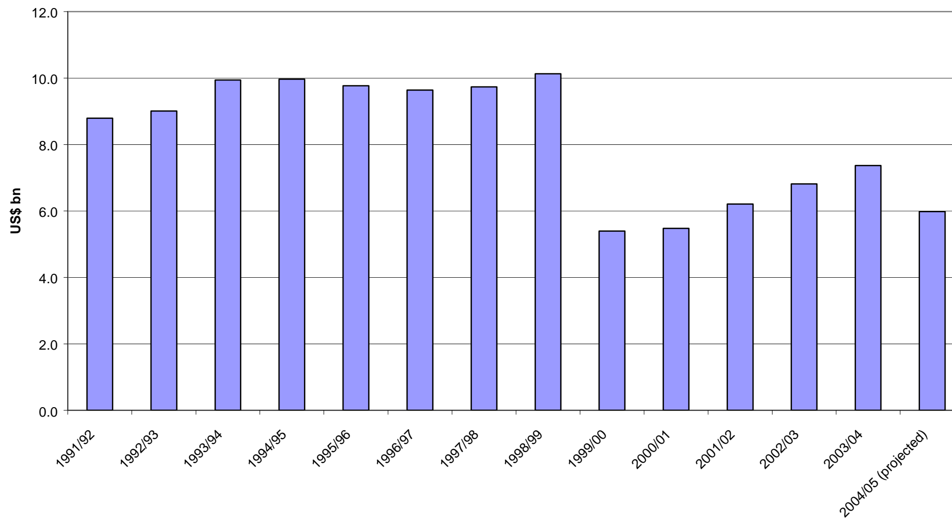
2.1. Bilateral Debt

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 inclusion of interest arrears in agreements (such as for Ethiopia in 1997 and 2001) meant that these were added into 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 succeed n getting slightly better or worse 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.



Source: Government of Ethiopia

As a result, as can be seen from Chart 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[4].
- 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, effectively compensating for the fact that these debts were still being valued at the original rouble exchange rate of 0.65/US $, although the rouble had devalued more than 12-fold. The Government of Ethiopia's 80% up-front cancellation of its Russian debt was worth US$ 4.8 billion.

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 have 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 which provided debt reduction before the advent of the HIPC Initiative were the Czech and Slovak Republics.

[4] All figures in this paper are presented in Ethiopian fiscal years, in line with Ethiopian government practice.

2.2. 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 buyback 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, is 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 Chart 1, but did not have a major impact on total debt stock because commercial debt represented only 3%.

2.3. Multilateral Debt

Prior to the advent of the HIPC Initiative in 1996, there were no formal mechanisms for multilateral debt relief and Ethiopia, in common with all other developing countries, was 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.

3. ETHIOPIA'S DEBT RELIEF UNDER THE HIPC INITIATIVE

In 2001, Ethiopia became eligible for relief under the HIPC Initiative. As described in detail in Box 1, 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). 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 allowed the debtor country to have a say in the overall amount of debt relief it received, as well as to negotiate "front-loading" of its debt relief (ie its provision during the early years after the decision point), so that more money could be channelled into higher poverty reduction spending.

Box 1 The HIPC Initiative

The main features of the HIPC Initiative are as follows:

- To be eligible, a country must be IDA-only and PRGF-eligible and have established a performance track record (usually of at least three years) under adjustment programmes with the IMF and the World Bank.
- A country is eligible for HIPC if, after the receiving Naples Terms (67% stock reduction) from the Paris Club, its present value of debt to exports ratio (PV/XGS) exceeds 150% *or* its present value of debt to budget revenue ratio (PV/DBR) exceeds 250%. Access to relief via the latter *fiscal window* (PV/DBR ratio) also requires a country to meet two further thresholds: the *openness criterion* of an export to GDP ratio of 30% or more and the *revenue effort criterion* of a budget revenue to GDP ratio of 15%.
- Although it is not a binding criterion, the debt service to exports ratio should fall within the 15%-20% range or below by the Completion Point.
- A country's eligibility for HIPC relief and the amount of relief required to reach its threshold are calculated on the basis of a debt sustainability analysis just prior to the decision point. Relief pledged at the decision point is irrevocable and is to be delivered on an equal burden-sharing basis, using creditor-specified modalities.
- Once a country has reached its decision point, it enters the interim period between decision and completion points, during which it receives relief on debt service from its Paris Club bilateral and some major multilateral creditors, such as ADF, IDA and IMF. It is only when a country achieves its completion point that it receives debt stock reduction from various creditors. No multilateral creditor provides stock reduction at completion point: instead, relief is delivered by annual debt service reductions over a period of up to 20 years.
- The time period between decision and completion point usually lasts at least one year as this is the minimum time required for implementing the country's Poverty Reduction Strategy Paper (PRSP) and meeting the other country-specific completion point trigger conditionalities.
- If, at its completion point, the amount of relief pledged to a country at its decision point is insufficient to reach its debt threshold, it may be eligible for 'topping up' of relief (see Box 2).
- The debt service savings arising from the HIPC Initiative are to be used almost exclusively to fund poverty reduction expenditures, as set out in a country's Poverty Reduction Strategy Paper (PRSP).

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Table 2: HIPC Debt Relief by Creditor Category			
	Prior to decision point	**Between decision and completion points (interim period)**	**At completion point**
Bilateral:			
Paris Club	67% Naples flow reduction	90% Cologne flow reduction (or more if needed to achieve sustainability) ***Additional to HIPC***: cancellation of 100% of service payments	90% Cologne stock reduction (more if needed to achieve sustainability) ***Additional to HIPC***: cancellation of 100% ODA and some non-ODA
Non-Paris Club	Paris Club comparable	Paris Club comparable terms	Paris Club comparable terms
Multilateral:			
World Bank/ IMF	None	Debt service reduction with emphasis on front-loading	Debt service reduction with emphasis on front-loading
Others	None	Debt service relief on burden sharing basis, front-loading where possible	Debt relief on burden sharing basis, front-loading where possible
Commercial:			
All creditors	Paris Club comparable	Paris Club comparable terms	Paris Club comparable terms

3.1. 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 which were taken into account in the final HIPC decision point document:

- 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 did enable 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 AfDF relief was provided over only 11 years), albeit not as much as it would have liked.
- The 2001 analysis also helped Ethiopia to analyse why a September 2001 decision point would provide more debt relief, and to establish that lower exports than expected for 2000/01 were likely to push up relief from US$1 billion to US$1.3 billion, which was subsequently confirmed in the decision point document.

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 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 almost immediately again, due to high "essential borrowing for….postwar reconstruction and recovery programmes" (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, which indicated a risk that debt sustainability would not be achieved by HIPC 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 the short "hump" of unsustainable PV/exports through to 2007/08 might last much longer.
- The high level of domestic debt stock (though service was low because of low interest rates).

3.2. 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 concessional ODA[5] debt. In some cases, they have also agreed to cancel some, or all, export credit or non-ODA debt[6]. The total amount of such additional debt relief has been US$ 284 million in present value terms. Given that Ethiopia's debt was projected to become unsustainable rapidly after 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, that this additional relief should be added to and not counted as part of HIPC relief, so as to give it more of a cushion to keep debt sustainable. However, after much debate among creditors, it was decided that the cancellations be treated as part of HIPC relief. The additional cushion to keep Ethiopia's debt sustainable was removed.

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, negotiating such relief proved extremely difficult. Between the decision and completion points, only Bulgaria, China and Hungary agreed to participate.

For multilateral creditors, the ADF, IDA and IMF are the main providers of interim relief, on terms set out in the decision point document. However, since relief is often provided by cancelling specific loans, officials need to validate the creditor statements to ensure the correct amount of relief is being provided and applied to the relevant loans in the national debt database. In the case of the ADF, however, it simply provides a statement of the relief being given, without indicating to which loans it is 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 Programme's networks of Finance Ministers and officials.[7]

3.3. Preparing for 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 debt sustainability analysis to ascertain whether its debt would be sustainable at completion point, after the full delivery of HIPC relief. If its debt was not sustainable, then it could needed to analyse how much benefit it would get from 'topping up' as described in Box 2.

Box 2 Topping up HIPC relief

If, after full delivery of the relief pledged at the decision point, a country's debt is unsustainable, then it is eligible for additional relief (topping up) "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 is the amount needed to bring its relevant ratio down to the threshold level at completion point.

In practice, the factors which 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 earnings denominated 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 lower discounting of debt service and 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

[5] Official development assistance, defined by the OECD as loans with a grant elements of more than 25%

[6] Australia, Canada, Italy, Norway, UK and USA will effectively cancel all bilateral debt, additional to HIPC, while Belgium, Spain and Switzerland will do so on a case-by-case basis.

[7] For more on these, see www.hipc-cbp.org.

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 own analysis, the Ethiopian Government concluded that its debt burden was unsustainable at completion point and Ethiopia would be eligible for an additional US$ 707 million of "topping up". The impact of each key factor on Ethiopia's debt indicators is set out in Table 2.

Table 2: Ethiopia topping up to of HIPC debt relief

Factors underlying topping up of relief	PV/exports ratio	Percentage points impact (%)
PV/exports 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
Lower 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**	

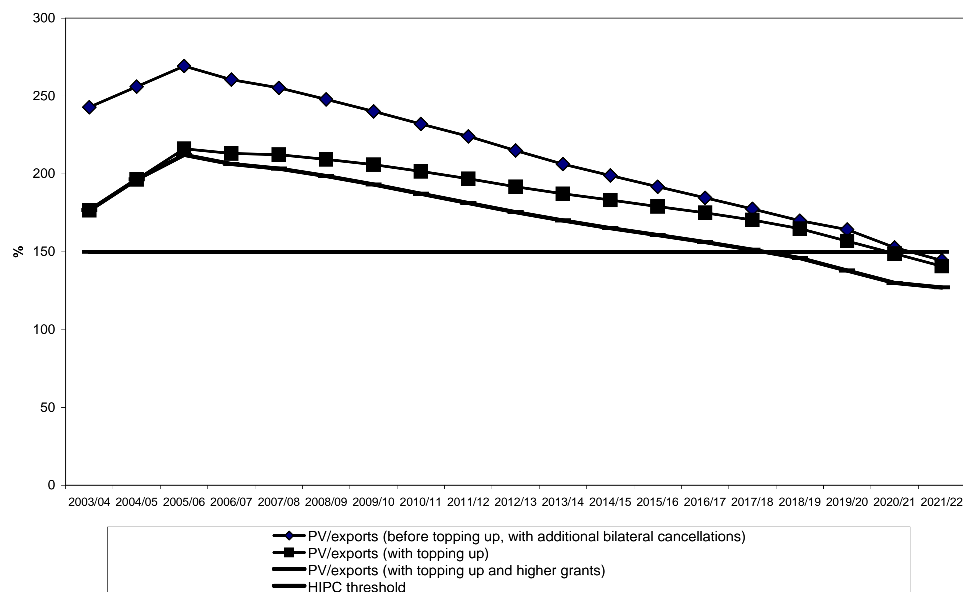
Source: HIPC Completion Point Document (April 2004).

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 amongst 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 the G8 countries, 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 all of the Paris Club creditors' share of 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 organisations. They were joined in this campaign by other countries which were expecting to get topping up – notably Niger and Rwanda. Eventually, the BWI Boards agreed to topping up of US$ 707 million (in present value terms), of which 78% would be provided by multilateral creditors, and 22% by bilateral and commercial creditors. 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 reach 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 of 150% for the PV/exports ratio until 2020/21, as shown in Chart 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 2018/19, two years earlier than in the base case, as shown in Chart 2.

Chart 2: Ethiopia's Debt Sustainability at HIPC Completion Point



Source: HIPC Completion Point Document (April 2004).

The fact that Ethiopia was allowed to project borrowing considerable amounts of concessional funds after 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 mobilising 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 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 programme) this new precedent was set.

3.4. 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 have continued trying to negotiate with their non-Paris Club creditors and the results to date are summarised in Table 3. Three creditors (Algeria, Libya and Serbia) have to date not yet agreed to negotiate relief. In common with a number of other creditors, it is possible that Ethiopia may face a lawsuit regarding the Serbia debt. There is still a small amount of commercial credits outstanding (US$30 million), on which the Government is trying to negotiate relief – though it has already lost and paid a lawsuit to a Bulgarian commercial creditor.

Table 3: Outcomes of Ethiopia's Non-Paris Club Negotiations, April 2005

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

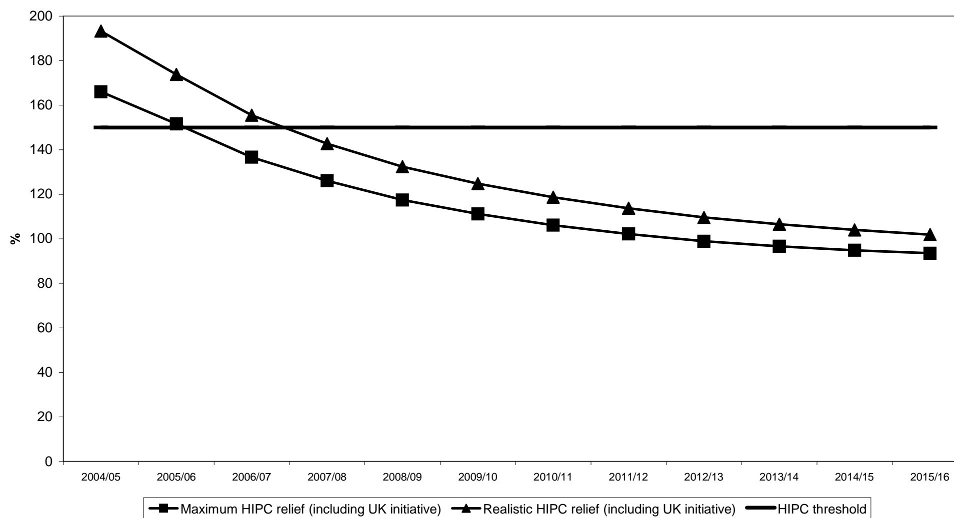
Source: Government of Ethiopia

4. POST-HIPC DEBT SUSTAINABILITY

4.1 Future financing needs

Although Ethiopia is now a post-HIPC country, the Government continues to conduct regular debt and new financing strategy analysis, to assess its debt sustainability under alternative scenarios. This includes comparing the impact of obtaining maximum possible HIPC relief, with what will happen if Ethiopia is not able to obtain the maximum HIPC relief, particularly from its non-Paris Club bilateral and commercial creditors, as shown in Chart 3. The non-delivery of debt relief from outstanding non-Paris Club bilateral and commercial creditors pushes 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 the next two years. Thereafter non-delivery of relief still adds on average 12 percentage points to Ethiopia's debt ratio until 2015, even though the country's debt does become sustainable in HIPC terms. The improvement in debt sustainability since Ethiopia's HIPC completion point analysis reflects a much stronger than anticipated recovery from the 2002/03 drought and hence faster GDP and export growth.

Chart 3: Ethiopia's Debt Sustainability, April 2005
(Present value of debt/exports)



Source: Government of Ethiopia, April 2005

However, the key factor determining Ethiopia's debt sustainability will be its future new financing strategy. The central determinant underpinning the Government's external resource needs is its desire to attain the Millennium Development Goals (MDGs) for poverty reduction by 2015. The Government, in collaboration with the Millennium Project and the World Bank, has been revising its poverty reduction costings and expenditure plans on a sector-by-sector basis and it is this revised poverty reduction strategy, and the associated infrastructure investment needed to achieve the MDGs, which will form the basis of the Government's future new financing and debt strategy.

Preliminary results from such costings exercises indicate a need to multiply aid flows to 3-4 times their current levels.

To finance this, the Government has been 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 the next three years. As a result of the anticipated new grant commitments from IDA, the African Development Bank and from other major donors, the composition of Ethiopia's new external resources is expected to shift from the average of 62%:38% grants to loans in the last four years to closer to 80%:20% by 2008/09. As can be seen from Chart 3, this higher proportion of grants (together with faster economic growth) is projected to have a dramatic positive effect on Ethiopia's debt sustainability, bringing its ratios to sustainable levels in 2008 and keeping them there thereafter.

It will also be vital that Ethiopia mobilises the highest-quality financing in order to ensure maximum effectiveness of the aid flows on poverty reduction and on meeting the MDGs. Ethiopia has therefore been active in launching a programme for donors to harmonise their procedures and policies and to align them more closely with those of government, in June 2002. 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
- donor commitments on harmonisation and mutual accountability.

The global-level undertakings to improve aid effectiveness currently being finalised by DAC donors, are also expected to assist Ethiopia in improving the quality of its aid flows. Nevertheless, to ensure that donors continue to make progress in improving the quality of their aid, Government has in 2003-2005 been monitoring the quality of its external financing, on 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.[8]

4.2 New framework for debt sustainability

In April 2005, the Bretton Woods Institutions agreed a new debt sustainability framework for low income countries, which includes post-completion point HIPC countries. This new framework links a country's risk of debt distress (and hence sustainability) to the quality of a country's policies and institutions, as measured by the World Bank's Country Policy and Institutional Assessment (CPIA) scores, on the basis that better performing countries are able to bear a higher debt burden. Table 4 sets out the debt indicators and sustainability thresholds under this framework.

Table 4: New Framework for Debt Sustainability Thresholds (%)

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%

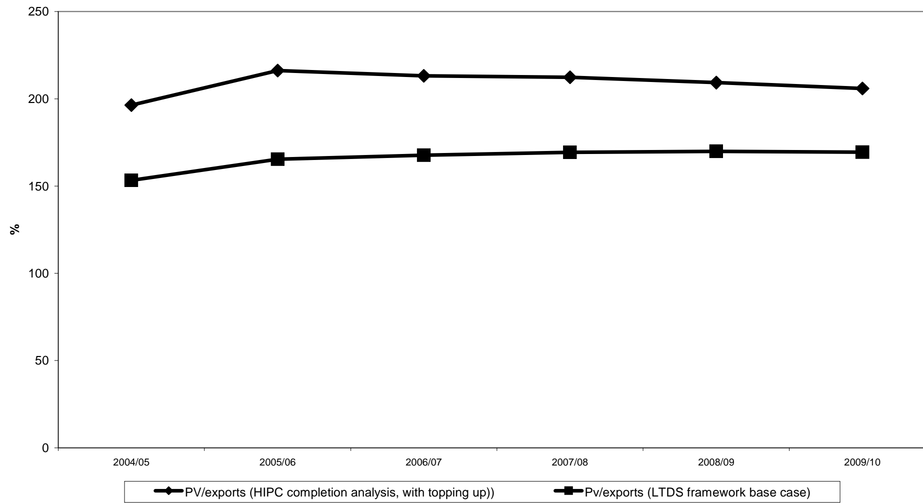
Source: IMF

On the basis of its policies and institutions, Ethiopia's CPIA score classifies it as a medium country, so its debt sustainability will be assessed on thresholds which are 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 current exports, rather than the 3-year average exports under HIPC. In addition, the new methodology replaces the currency-specific discount rates of HIPC with one US Dollar discount rate.

With the new framework, Ethiopia's debt indicators are much lower than those calculated under HIPC, a shown in Chart 4. In large part this reflects its continued export growth – but it also reflects the use of current exports and one US dollar discount rate, and slightly lower borrowing than projected.

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

Chart 4: Ethiopia's Debt Sustainability using Different Methodologies



Source: IMF, January 2005 and April 2004

The key implications for Ethiopia of this new framework are as follows:

- The impact of Ethiopia's new borrowing plans on its debt burden will be assessed on the basis of the debt indicators and thresholds, listed for a medium policy country in Table 4.
- The vulnerability of its debt sustainability to export shocks and alternative new borrowing plans will be evaluated.
- This framework is being used to assess countries' eligibility for IDA grants in accordance with their risk of debt distress. Under the framework, Ethiopia is classified as being a 'red light' country as its debt ratios are in excess of the thresholds for a medium policy country. As a result, it will receive 100% grants under IDA-14, equivalent to US$ 1.22 billion during July 2005– June 2008.

This will allow Ethiopia to keep its debt much more sustainable - but, as discussed above, it will need to fund its achievement of the MDGs with around 80% grants to maintain a sustainable debt burden. For this to be feasible, it will be vital that OECD governments in particular follow the signal provided by the World Bank and provide only grants rather than loans. In this context, it is quite worrying that some governments have recently been offering Ethiopia substantial (albeit concessional) new loans.

5. CONCLUSION

The last seven years have seen a major change in the way the international community looks at debt sustainability for Ethiopia. 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. Now the Government of Ethiopia is using its own calculations of financing needs to reach the MDGs, and of the quality of this financing, to determine how much debt it should contract, and to analyse its own debt sustainability on an annual basis. The international community looks set to assist Ethiopia by providing large amounts of additional high-quality grant finance, making it possible to attain the MDGs while keeping its debt sustainable.

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