

# Leveraging Enhanced SDR Allocations to Finance Resilient Economic Recovery in Ethiopia

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## List of abbreviations and acronyms

|          |  |
|----------|--|
| ADLI     | Agricultural Development Led Industrialisation |
| AERC     | African Economic Research Consortium           |
| AfDB     | African Development Bank                       |
| AfDF     | African Development Fund                       |
| BADEA    | Arab Bank for Economic Development in Africa   |
| BoP      | Balance of Payment                             |
| CEPR     | Centre for Economic Policy Research            |
| CGD      | Centre for Global Development                  |
| COVID-19 | Corona Virus Disease 2019                      |
| CPI      | Consumer Price Index                           |
| DRM      | Domestic Resource Mobilisation                 |
| DSA      | Debt Sustainability Assessment                 |
| DSF      | Debt Sustainability Framework                  |
| DSSI     | Debt Service Suspension Initiative             |
| EAL      | Ethiopian Airlines                             |
| ECA      | Economic Commission for Africa                 |
| ECF      | Extended Credit Facility                       |
| EIB      | European Investment Bank                       |
| ETB      | Ethiopian Birr                                 |
| FDI      | Foreign Direct Investment                      |
| FDL      | Finance for Development Lab                    |
| FDRE     | Federal Democratic Republic of Ethiopia        |
| GDP      | Gross Domestic Product                         |
| GTP      | Growth and Transformation Plan                 |
| HER      | Homegrown Economic Reform                      |
| IMF      | International Monetary Fund                    |
| IDA      | International Development Association          |

|        |   |
|--------|---|
| IFAD   | International Fund for Agricultural Development                 |
| LICs   | Low Income Countries  |
| MDBs   | Multilateral Development Banks                                  |
| MDGs   | Millennium Development Goals                                    |
| MoF    | Ministry of Finance   |
| MTDMS  | Medium Term Debt Management Strategy                            |
| NBE    | National Bank of Ethiopia                                       |
| NDF    | Nordic Development Fund   |
| NDPs   | National Development Plans                                      |
| NEER   | Nominal Effective Exchange Rate                                 |
| OFID   | OPEC Fund for International Development                         |
| PASDEP | Plan for Accelerated and Sustainable Development to End Poverty |
| PRGT   | Poverty Reduction and Growth Trust                              |
| RCF    | Rapid Credit Facility   |
| REER   | Real Effective Exchange Rate                                    |
| RST    | Resilience and Sustainability Trust                             |
| SCF    | Standby Credit Facility   |
| SDGs   | Sustainable Development Goals                                   |
| SDPRP  | Sustainable Development and Poverty Reduction Programme         |
| SDR    | Special Drawing Rights  |
| SoEs   | State Owned Enterprises   |
| SSA    | Sub-Saharan Africa  |
| ToT    | Terms of Trade  |
| UNDP   | United Nations Development Programme                            |
| UNICEF | United Nations Children's Fund                                  |
| USD    | United States Dollar  |
| WB     | World Bank  |
| WDI    | World Development Indicators                                    |

# 1. Introduction

## Background

Special Drawing Rights (SDRs) allocation is a mechanism used by the International Monetary Fund (IMF) to provide its member countries with additional reserve assets. SDRs are a type of international currency that can be used to supplement a country's official reserves or for international transactions. Countries could immediately use a new allocation of SDRs for debt relief, to import life-saving necessities, and to support key public services. In many cases, SDRs provide important financial support without being converted to hard currency. They help reduce capital flight balance of payments deficit and fiscal crises. These additional reserves can also lower countries' borrowing costs<sup>1</sup> (Centre for Economic Policy Research [CEPR], 2022). Historically, there has been one special allocation and four general allocations, the latest of which was in 2021, when the IMF allocated SDR 456 billion (US\$650 billion) to help deal with the economic impact of the global COVID-19 pandemic.

Global economic conditions have continued to deteriorate since the COVID-19 pandemic, putting pressure on the short-term liquidity and long-term financing needs of countries in Africa, including Ethiopia. In addition to the external shocks commonly facing other countries, Ethiopia has been enduring the consequences of conflict and drought, which have exacerbated the already precarious economic conditions of the country. The conflict in northern Ethiopia and other parts of the country caused skyrocketing defence spending, crowding out expenditures in social and economic sectors. It led to disruption in agricultural production, trade flows, foreign direct investment (FDI), and external borrowing. Also, failing rainfall in six consecutive agricultural seasons led to severe drought in the southern part of the country, leading to loss of livelihood for a quarter of the country's population.

To finance resilient recovery and reconstruction, an estimated US\$20 billion is required over the next five years, with as much as US\$5 billion needed in the first year, according to Ethiopia's Ministry of Finance. The combined effect of the overlapping shocks put Ethiopia in a low growth trajectory, with sharp decline in investment. The country is forced to put austerity measures to meet its international debt obligations. The budget for debt servicing in 2022/23 is three times larger than the previous year's. It exceeds the combined budget for health, education, water and energy, agricultural development, and trade and industry (United Nations Children's Fund [UNICEF], 2023). As a result, the

country is sliding backwards from the important economic and social gains of the previous two decades. Poverty rate rose from 24% in 2014 to 27% in 2020/21 (World Bank, 2023). The country's progress towards achieving SDG targets has been poor, with a ranking of 144th out of 166 countries.

Given a mounting debt distress in the global south, there is a growing call for enhanced SDR allocation to developing countries as part of a broader need for SDR reform. The call for SDR reform in the context of African countries involve shortening the time taken for allocation after a need is triggered by a shock, revising the allocation formula to involve need and structural condition of countries in addition to the current IMF quota based on economic size and reserve position of countries, and the need to re-channel the excess SDR currently held by developed countries with the least need for liquidity (Economic Commission for Africa [ECA], 2022). The International Monetary and Financial Committee, and leaders of the G7 and G20, called on the IMF to explore ways in which countries with strong external positions could voluntarily channel some of their SDRs to poorer and more vulnerable countries.

Following the call for SDR reallocation and new allocation, the African Economic Research Consortium (AERC) initiated country case studies in four African countries, including Ethiopia, to explore the possibilities for SDR to ease short- to medium-term liquidity shortages, as well as leverage long-term economic development in Africa. In so doing, it aims to amplify the advocacy for enhanced SDR allocation to Low Income Countries (LICs) through evidence from country case studies.

The study tries to address the following research questions:

- Given the multiple internal and external shocks Ethiopia is going through, to what extent can SDR be utilised to ease the short- to medium-term liquidity shortage?
- To what extent can SDR be used to support the long-term development financing needs of the country (investment in building resilience to climate shocks, etc.)?
- What kind of SDR channelling mechanism would suit Ethiopia best?

## Objective

The overall objective of this study is to generate evidence to make a case for enhanced SDR allocation for Ethiopia, and indicate the possible instruments towards enhanced SDR, given the specific needs and policy priorities of the country. Specifically, the study aims to do the following:

- Show trends in governments' fiscal positions and the state of balance of payment.
- Show trends in debt profile of Ethiopia and present the state of debt restructuring talks.
- Support evidence-based policy advocacy on the role of SDR in easing debt distress and supporting economic recovery in Ethiopia and similar countries in Africa.
- Indicate the merits and demerits of various instruments for rechanneling SDR to countries like Ethiopia.

## 2. Data and methodology

The study mainly relies on secondary data sources, including the government, the IMF, and the World Bank. Among others, secondary data from these sources would include revenue and expenditure, debt, current account and capital account indicators, and official reserve position. Document reviews and in-depth interviews will also be made to gather information on the history of SDR allocation and use, and debt restructuring discussions with creditors.

The methodology is mainly descriptive. Based on the secondary data, the study will discuss trends and projections in key social and economic indicators, and how they are affected by the overlapping domestic and global shocks. More specifically, the study will demonstrate the trend in fiscal, Balance of Payment (BoP), and debt indicators for the years 2000-2022, where data availability allows. The study assesses debt sustainability based on the IMF and World Bank Debt Sustainability framework. The study will also present trends in SDR allocation and utilisation.

### 3. Overview of the Ethiopian economy

Since the early 2000s until the late 2010s, the Ethiopian economy has registered one of the highest growths in the world. During 2003-2019, the country grew at an average rate of 10%. The sustained growth for more than a decade and half helped the country reduce poverty substantially. Poverty rate fell from 44% in 2000 to 24% in 2015 (World Bank, 2020). Ethiopia had also made substantial progress in health and education sectors by meeting most of the indicators anchored in the Millennium Development Goals (MDGs).

The country devised its overarching economic development strategy—Agricultural Development Led Industrialisation (ADLI) in 1993. Although ADLI provided guidance to policy choices, there was no specific national development policy until 2003. Subsequently, the government implemented four successive national development plans (NDPs) during 2003-2018 (see Table 1). At the beginning of the current millennium, Ethiopia's poverty rate stood at 44%. For this reason, the first NDP implemented during 2003-2005 was focused on poverty reduction and strengthening government capacity on disaster and emergency response. As such, the government implemented rural development programmes; improving rural infrastructure to ease access to health, education, and markets in rural areas where most of the poor live. During 2006-2010, the government implemented policies aimed at achieving agricultural productivity of small-scale farmers, poverty reduction, and sustained economic growth.

In the first Growth and Transformation Plan (GTP I), the government explicitly targeted to achieve a greater contribution of the industry sector to GDP, and a lower share of agriculture in the GDP. To this end, the government embarked on aggressive infrastructure development in electricity generation, road and railway construction, as well as construction of industry parks to enhance industrial production and productivity. The second GTP was a continuation of GTP I with more ambitious targets in structural transformation including enhancing the share of manufacturing and export in GDP.

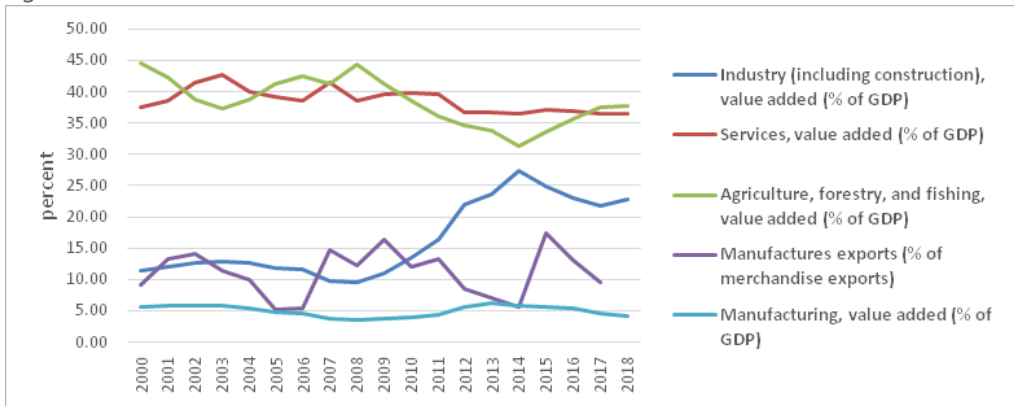
By implementing successive NDPs, Ethiopia achieved sustained economic growth for more than a decade and a half. The country also reduced poverty substantially. The share of agriculture declined from 45% in 2000 to 36% in 2018 (see Figure 1). The decline in the share of agriculture in GDP is accounted for by a small increase in share of service and a greater increase in industry's share to GDP. Industry's share of GDP rose from 13% in 2003 to 26% in 2014, before it declined to 23% in 2018.

Table 1: Ethiopia's successive national development plans (2003-2018)

| Year            | Name of Development Plan   | Key Goals   |
|-----------------|--|---|
| 2003-2005       | Sustainable Development and Poverty Reduction Programme (SDPRP)          | <ul style="list-style-type: none"> <li>• Enhance access to food</li> <li>• Poverty reduction</li> <li>• Strengthen emergency response capabilities</li> </ul>   |
| 2006-2010       | Plan for Accelerated and Sustainable Development to End Poverty (PASDEP) | <ul style="list-style-type: none"> <li>• Register sustained growth of 7-10%</li> <li>• Increase agricultural productivity</li> <li>• Increase export by focusing on selective export-oriented sectors</li> </ul>  |
| 2010/11-2015/16 | Growth and Transformation Plan I (GTP I)                                 | <ul style="list-style-type: none"> <li>• Poverty reduction</li> <li>• Structural transformation (increase share of industry in overall GDP)</li> <li>• Infrastructure development in energy, transport</li> </ul> |
| 2015/16-2019/20 | Growth and Transformation Plan II (GTP II)                               | <ul style="list-style-type: none"> <li>• More ambitious target in structural transformation than in GTP I</li> <li>• Increase share of manufacturing and share of export in GDP</li> </ul>                        |
| 2018-2028       | Homegrown Economic Reform (HER)  | <ul style="list-style-type: none"> <li>• Macroeconomic rebalancing</li> <li>• Control inflation</li> <li>• Reduce debt vulnerabilities</li> <li>• Create healthy financial sector</li> </ul>                      |

Source: GTP I, GTP II.

Figure 1: Sectoral contribution to GDP



Source: Authors' computations using data from WDI (2023)

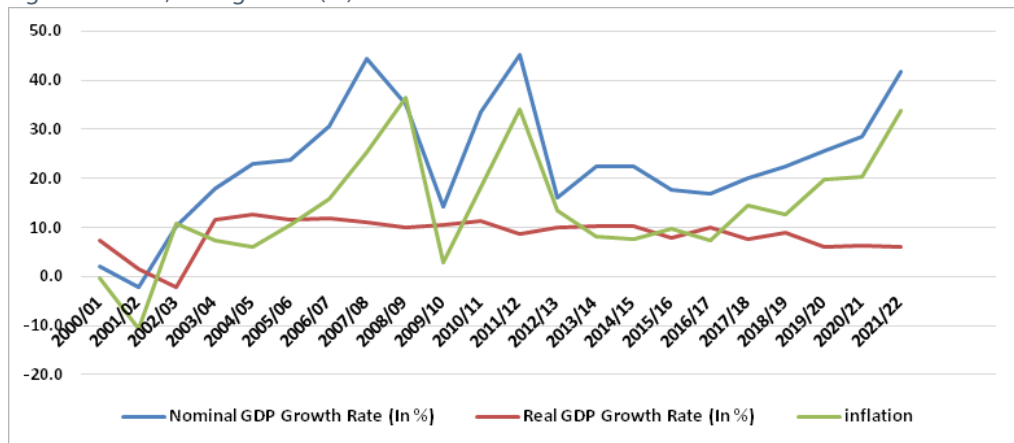
Despite the increase in the share of industry to GDP, much of the increase was due to a booming construction sector than a rise in manufacturing as targeted in GTP II. While the share of construction in GDP rose from 4% in 2010 to 17.5% in 2017, manufacturing accounted for only 5% of GDP in 2018. Likewise, even if the target for manufacturing exports in GTP II was 20.6%, actual performance stood at only 7.7% (Gebrehiwot, 2020). In comparison, manufacturing export account for 21% of merchandise export in sub-Saharan Africa (SSA) and 28.4% in Kenya. Thus, even if

Ethiopia managed to sustain high economic growth fuelled by public investment in construction for over a decade and half, it achieved very little in structural transformation, demonstrated by a stagnant share of manufacturing value added in GDP and manufacturing share in export.

The construction- driven growth in Ethiopia largely relied on import of equipment and expertise, causing significant rise in the country's import bill during GTP I and GTP II periods, while it failed to improve export meaningfully over the same period, resulting in widening current account deficit. Moreover, the bulk of the construction was financed through external borrowing, as contractors came with their own finances and expertise (see Woldeyes, 2020).

The heavy reliance on external borrowing, led to escalation of external debt, tripling during 2007/08-2017/18 to reach 30.4% of GDP. External debt service also rose from 2.5% of export in 2008/09 to 26.6% of export in 2018/19. As a result, the IMF put Ethiopia's external debt at a high risk of distress (IMF, 2020), putting pressure on the country's ability to access external finance. The new administration that came in 2018 put debt management as one of its priorities, as part of the overall macroeconomic rebalancing agenda (Federal Democratic Republic of Ethiopia [FDRE], 2020). It embarked on fiscal consolidation and increasing reliance on domestic borrowing in 2018. Although government expenditure share of GDP declined by 3.3 percentage points during 2017/18-2021/22, government revenue also declined by the same proportion, making budget deficit to hover around 3% during the same period.

Figure 2: CPI, GDP growth (%)



Source: WDI (2023).

Two years after the new administration took over, the Ethiopian economy was hit by successive external and internal shocks, making it difficult to implement the HER agenda which puts fiscal consolidation and debt management as its core target. The already struggling macroeconomy endured through the COVID-19 pandemic, the Russia-Ukraine war, devastating civil war, and drought, which all had revenue contraction and expenditure expanding effect.

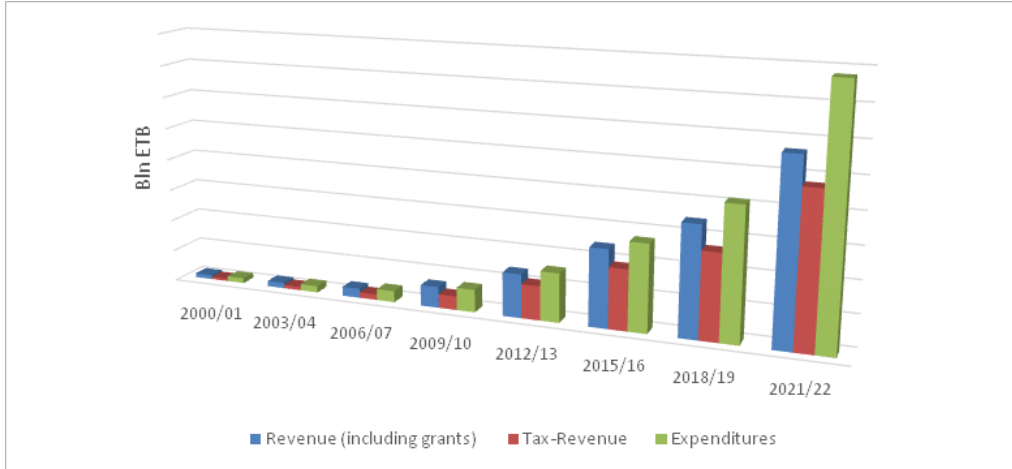
The macroeconomic malaise has been exacerbated by the multi-layered economic shocks. Inflation has been steadily rising, and it reached a staggering 35% in 2021/22 (see Figure 2). Real GDP growth declined from 10% in 2018/19 to 6% in 2021/22. Debt servicing and defence spending took precedence over spending in social and economic sectors such as health, education, and energy and transport infrastructure. As a result, Ethiopia spiralled backwards in important social and economic indicators. Poverty rate rose from 24% in 2014 to 27% in 2020/21. The country's progress towards achieving sustainable development goals (SDGs) has been hampered. Ethiopia is now ranked 144th out of 166 countries in progress towards achieving SDG targets. It performs much lower than Kenya (ranked 123rd), Rwanda (ranked 126th), Tanzania (ranked 134th), and Uganda (ranked 141st).

# 4. State of public finance

## Primary balance of government

Both government revenue and expenditure have been steadily rising since 2000/01 (see Figure 3). However, a marked increase in both is observed since 2009/10, when the country's aggressive infrastructure investment under GTP I began. During this period, the government also substantially improved its domestic resource mobilisation (DRM) capacity, particularly tax collection, in line with the mounting public spending needs. However, the improvement in government revenue failed to keep up with the faster growth in expenditure, causing a widening budget deficit.

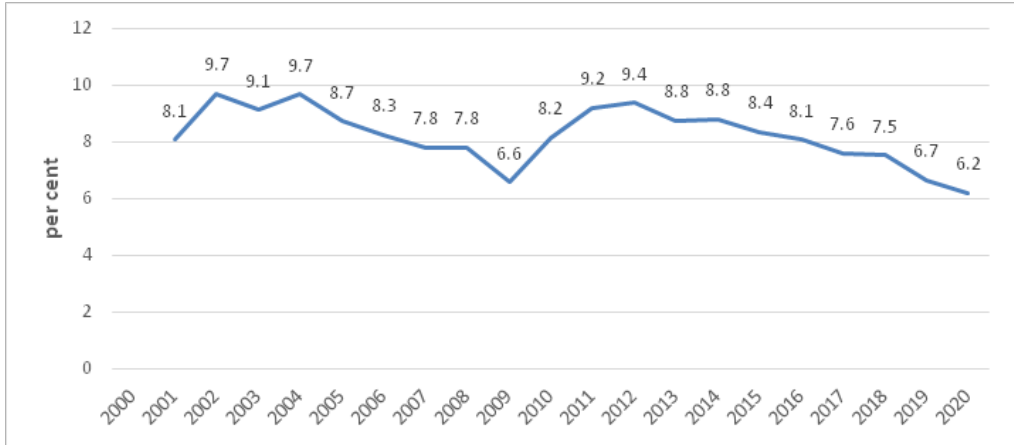
Figure 3: Revenue and expenditure (billion ETB)



Source: Ministry of Finance (MoF, 2022).

The increase in tax revenue over the last 20 years seems like an improvement at face value. However, the performance relative to GDP has been dismal, averaging 8.2% during 2000-2020. The performance has even worsened in recent years, declining to 6.2% in 2020. Putting Ethiopia's tax mobilisation performance in perspective with other countries', the picture is starker. SSA's average tax share of GDP was 15.6% in 2020. Kenya's and Uganda's tax share of GDP in the same period was 13.3% and 12.5%, respectively.

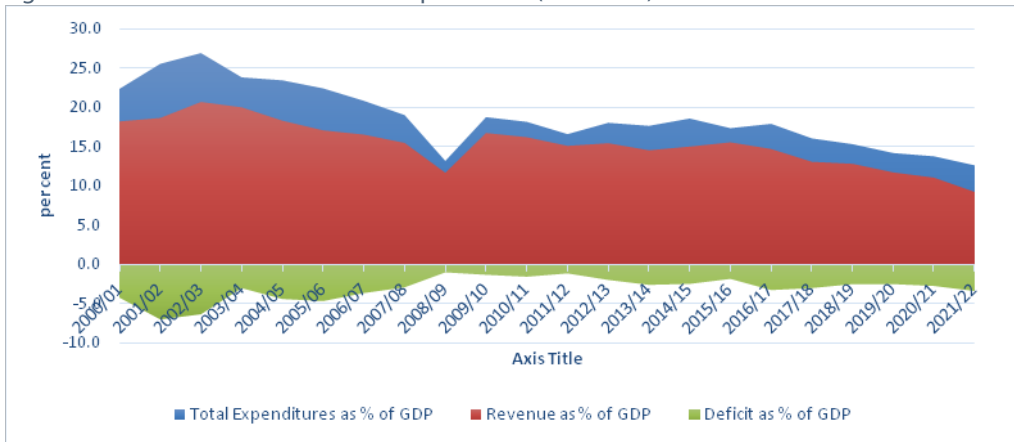
Figure 4: Tax revenue (% of GDP)s



Source: WDI (2023).

Consistent with the declining tax share of GDP, government revenue share of GDP declined during 2000-2021/22, with a sharp fall in 2008/09 due to the global recession (see Figure 5). Government expenditure share of GDP manifested a similar declining trend. The budget deficit share in GDP was declining until 2009 where it hit a bottom 1.3%, before it began to slowly expand, reaching 3.4% in 2021/22.

Figure 5: Government revenue and expenditure (% of GDP)



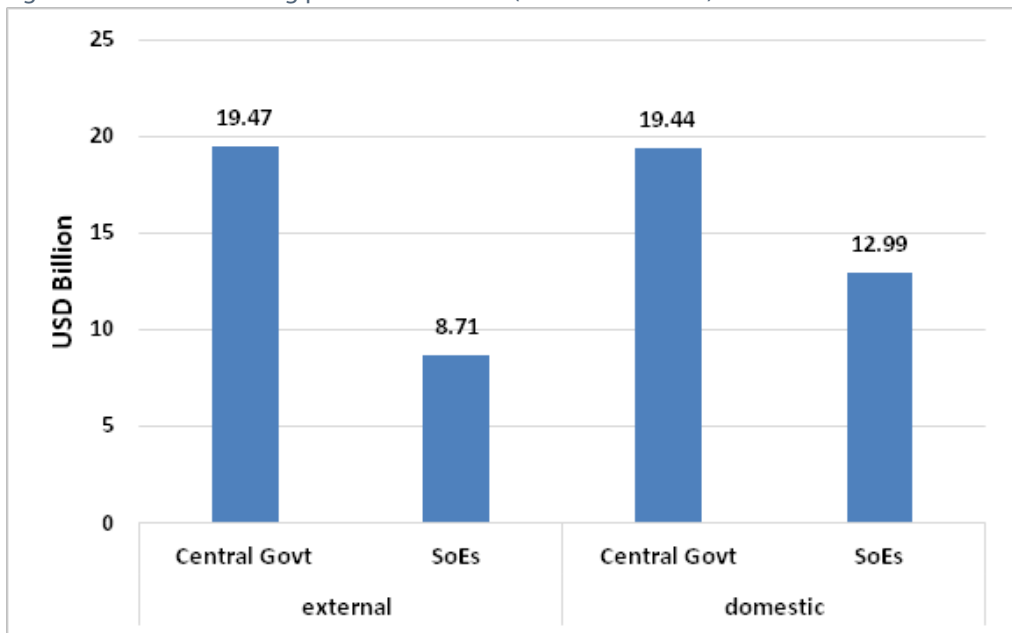
Source: Authors' Computations using data from MoF.

## Public sector debt

### Ethiopia's debt profile

Ethiopia's public sector debt was largely driven by increased borrowing to finance huge investment in public infrastructure projects during 2007-2017. The total outstanding public sector debt stock as of March 2023 stood at US\$60.61 billion, of which US\$28.18 billion was external and US\$32.43 billion domestic (see Figure 6). Among the total public sector debt, 64.2% was owed by the central government and 35.8% by state owned enterprises (SoEs)<sup>2</sup>.

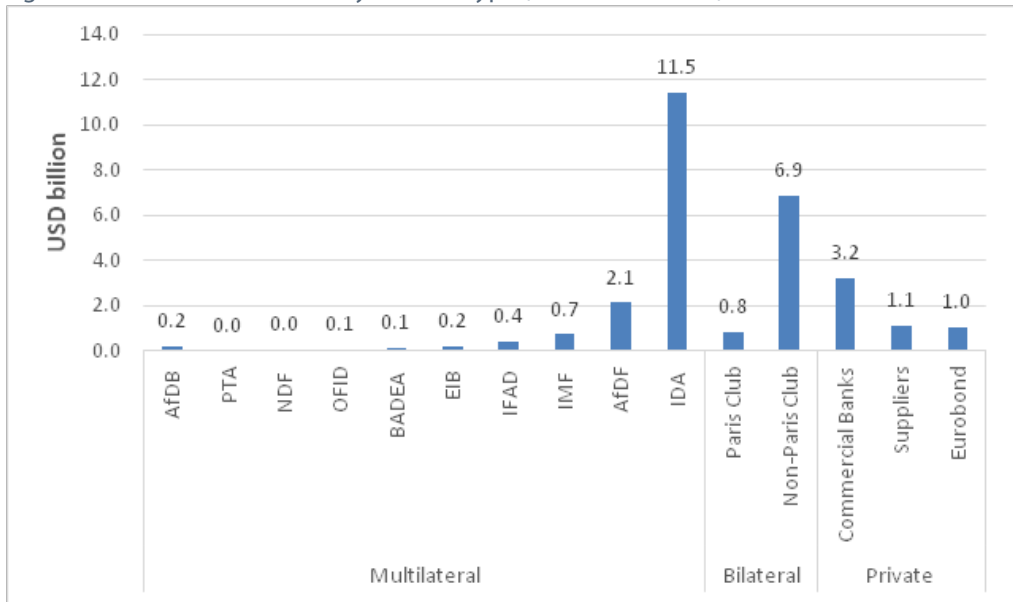
Figure 6: Total outstanding public sector debt (as of March 2023)



Source: MoF (2023).

Ethiopia's external debt composition shows that more than half of its debt stock is owed to multilateral creditors, while 27.3% and 28.7% is owed to bilateral and private creditors, respectively. Among multilateral creditors, the lions share is owed to IDA (see Figure 7). Much of the country's bilateral debt is owed to non-Paris club countries, mainly China, accounting for 70% of Ethiopia's total bilateral debt. Accordingly, most of Ethiopia's debt is acquired through concessional borrowing.

Figure 7: Total external debt by creditor type (as of March 2023)



Source: MoF (2023).

## Trends in public debt

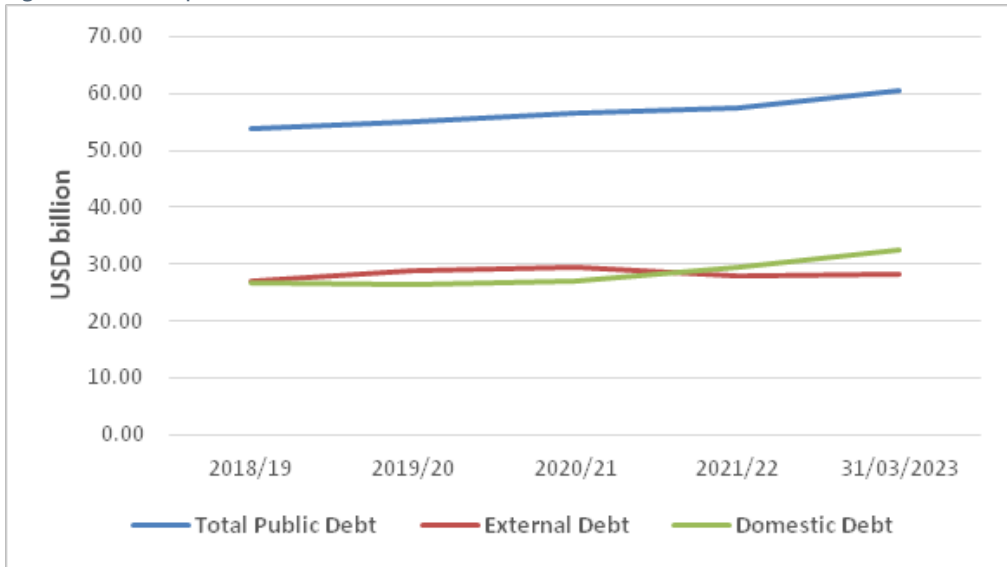
Ethiopia's total public sector debt rose from US\$53.8 billion in 2018/19 to US\$60.61 billion in March 2023 (see Figure 8). The trend in the stock of debt shows that domestic debt rose by 21% during the last four years, while external debt stock rose only by 4%, as the country relied more on domestic borrowing due to increasing difficulty to access external finance. The increase in overall domestic debt was due to the government's increasing tendency to resort to direct advance from the central bank and partly to issuance of five-year treasury bonds.

Public debt as a share of GDP also rose from 40.1% in 2011 to 59.8% in 2017/18, before it declined to 54.1% in 2021.

The increasing reliance on external borrowing led to an escalation of external debt, rising from 14.5% of GDP in 2006 to 33% of GDP in 2018 (see Figure 9). The fiscal consolidation policies anchored in the HER agenda that began in 2018 and the subsequent difficulty to access external finance by the central government due to domestic political instability, resulted in a declining share of external debt % of GDP since 2018. Except Ethiopian Airlines (EAL), other state-owned enterprises (SoEs) also have also had difficulty to access external finance since 2018 due to their low debt carrying capacity. Domestic borrowing also played an increasing role in financing government budget deficit. As can be seen from Figure 9, domestic debt as % of GDP rose from 21% in 2012 to 27% in 2021. As of March 2023, the share of domestic debt in total public sector debt was 54%, exceeding the share of external debt, which

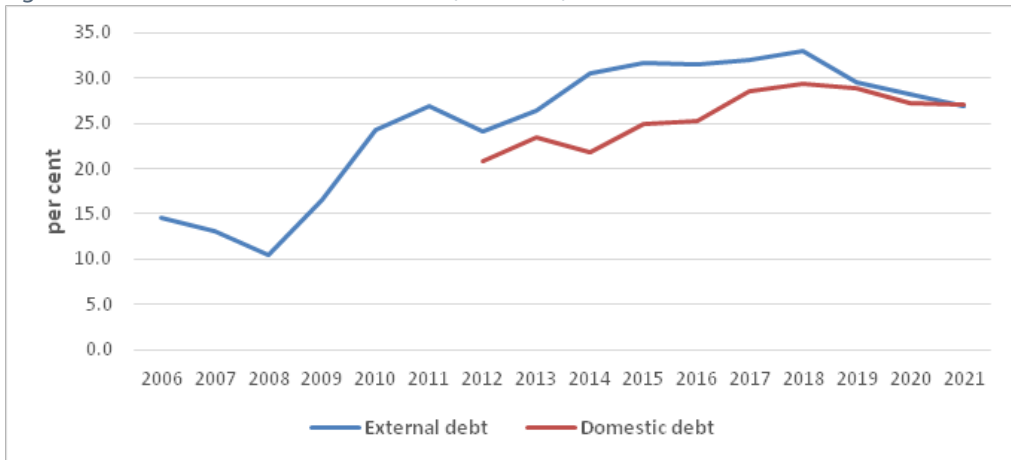
stood at 46%.

Figure 8: Total public sector debt (2018/19-31/03/2023)



Source: MoF (2023).

Figure 9: Domestic and external debts (% of GDP)

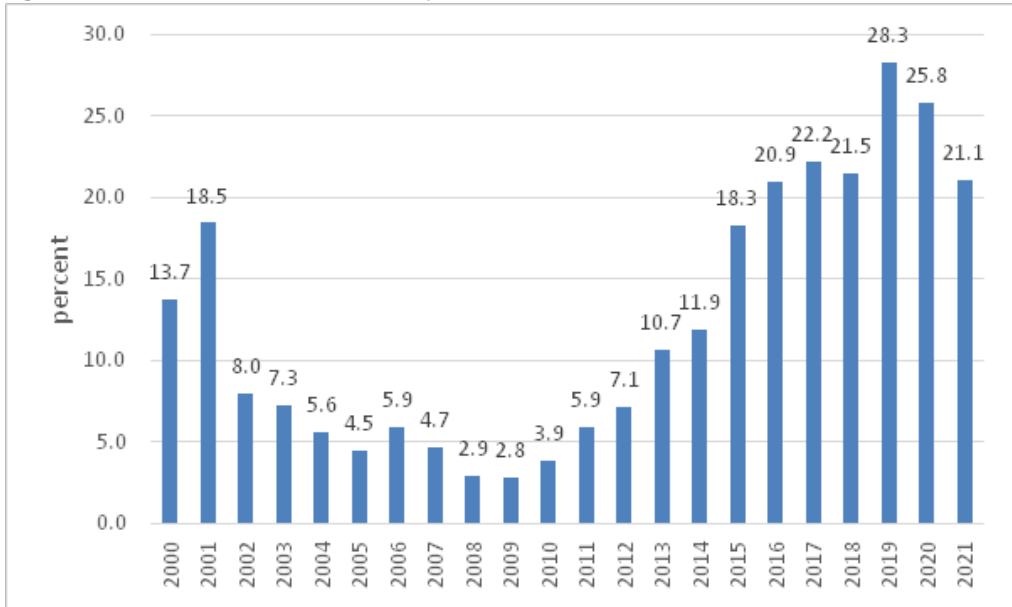


Source: World Development Indicators (WDI, 2023).

External Debt service (% of GDP) declined during 2000-2010 due to low debt servicing and an improving export from a very low base. From 2010 onwards, debt servicing began to pick up pace, while export growth was slow, leading to a growing debt service (as % of export). It grew from 2.8% in 2009 to 28.3% in 2019, before it

declined to 21.1% in 2021.

Figure 10: Total debt service (% of exports)



Source: WDI (2023).

## Debt sustainability

As of 2021/22, the present value of Ethiopia's total public debt as a share of GDP stood at 33.3%. Given Ethiopia's 'medium' debt carrying capacity under the Debt Sustainability Framework (DSF) (IMF, 2020), these figures fall below the debt sustainability requirement threshold of 55% (see Table 2). Likewise, the present value of external debt as a share of GDP is 12.4%, which falls below the 40% threshold for 'medium' debt carrying capacity low-income countries. This implies that Ethiopia's current and medium-term debt challenge is not a solvency problem.

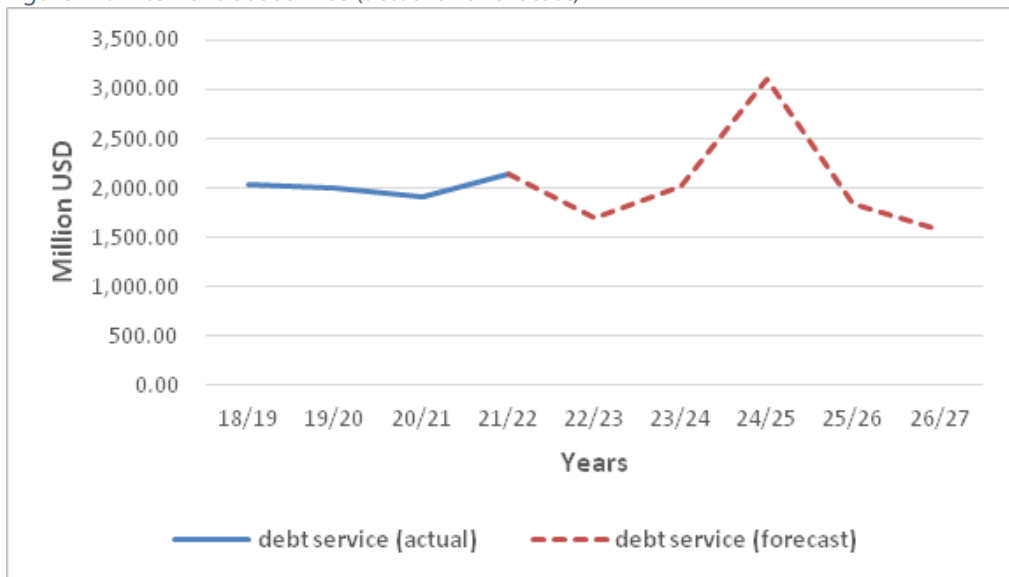
Table 2: Ethiopia's debt sustainability indicators based on IMF-WB DSA thresholds

| Debt Sustainability Indicators     |              | DSA Thresholds | Actual as of 2022 |
|------------------------------------|--------------|----------------|-------------------|
| Present value of total public debt | % of GDP     | 55             | 33.2              |
| Present value of external debt     | % of exports | 180            | 185               |
|                                    | % of GDP     | 40             | 12.4              |
| External debt service              | % of revenue | 18             | 19                |
|                                    | % of exports | 15             | 18                |

Source: MoF (2023).

However, the present value of external debt as a share of exports is about 185%, which exceeds the sustainability threshold under the DSF. External debt service as a share of GDP was 18% in 2021/22, which also exceeds the sustainability threshold of 15%, implying a liquidity pressure on Ethiopia. As a result, the latest IMF debt sustainability assessment (DSA) puts Ethiopia's overall debt and external debt at high risk of debt distress, limiting the country's ability to access further external debt (IMF, 2020). External debt service is projected to rise during 2022/23-2024/25 before it returns to its current level in 2025/26 (see Figure 11). The spike in 2024/25 is due to full principal repayment of Ethiopia's US\$1 billion Eurobond set for December 2024.

Figure 11: External debt service (actual and forecast)



Source: MoF (2023).

Although DSA is the most comprehensive measure of debt sustainability, critics argue that it often overestimates future debt projections and underestimates export projections in Africa, lowering the threshold for debt carrying capacity of African countries. Using a simple debt dynamics model and parameters (government budget balance, nominal export growth, and long-term interest rate projections), Abebe (2021) has shown that Ethiopia's sustainable debt to export ratio is computed to be 340%, which is much higher than the 180% threshold implied from the DSA framework.

Various credit rating agencies downgraded Ethiopia's credit rating since 2017 and depicted mostly a negative outlook in the medium term (see Table 3). Such rating would increase the cost of external borrowing for Ethiopia, particularly in the form of issuing sovereign debt. Fitch has continuously downgraded Ethiopia's

credit rating, the latest of which was in December 2023. The country's credit rating was downgraded to restricted default (RD) from C, after it failed to make a US\$33 million coupon payment on its Eurobond. Ethiopian authorities argued that it did not make the coupon payment to treat its creditors equally after it agreed to a temporary debt relief of US\$1.5 billion with its bilateral creditors for the period January 1, 2023- December 31, 2024.

Table 3: Trend in credit ratings and outlook by various agencies (June 2017-December 2023)

| Agency            | Rating | Outlook      | Date           |
|-------------------|--------|--------------|----------------|
| Fitch             | RD     | NR*          | 27/12/2023     |
| Fitch             | C      | NR*          | December 2023  |
| Moody's           | Caa3   | Stable       | September 2023 |
| Fitch             | CCC    | NR*          | January 2022   |
| Standard & Poor's | CCC    | Negative     | November 2021  |
| Moody's           | Caa2   | Negative     | October 2021   |
| Moody's           | Caa2   | Negative     | October 2021   |
| Moody's           | Caa1   | Under Review | May 2021       |
| Moody's           | Ba2    | Stable       | March 2021     |
| Moody's           | B2     | Under Review | March 2021     |
| Fitch             | CCC    | Developing   | February 2021  |
| Moody's           | B1     | Negative     | August 2020    |
| Standard & Poor's | B      | Negative     | April 2020     |
| Standard & Poor's | B      | Negative     | April 2020     |
| Fitch             | B      | Negative     | October 2019   |
| Moody's           | B1     | Negative     | September 2019 |
| Fitch             | B      | Stable       | July 2018      |
| Moody's           | B1     | Stable       | February 2018  |
| Fitch             | B      | Stable       | December 2017  |
| Fitch             | B      | Stable       | June 2017      |

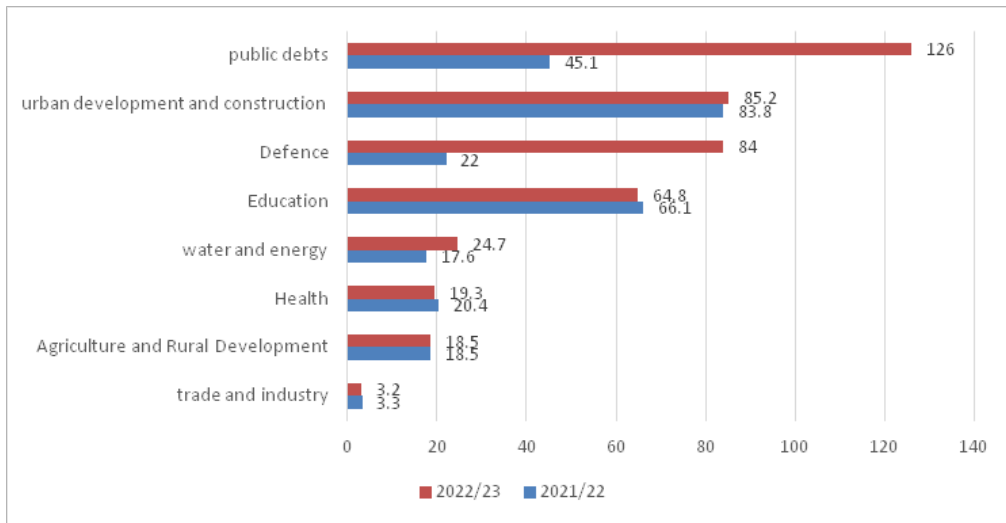
Note: \*NR stands for no rating or rating has not been assigned.

Source: Various sources.

## Recent developments in debt management

In the face of narrow fiscal space and widening Balance of Payment (BoP) deficit, a growing external debt servicing poses a crippling challenge to Ethiopia's liquidity. Ethiopia currently allocates disproportionately high share of its budget to fulfil its debt servicing obligations, hurting spending on important social services such as health and education. As Figure 12 shows, Ethiopia's budget for servicing public debt in 2022/23 exceeds the combined budget for health, education, water and energy, agricultural development, and trade and industry. Also, the budget for servicing public debt in 2022/23 is three times larger than the previous year.

Figure 12: Budget allocation (in ETB billion)



Source: United Nations Children's Fund (UNICEF, 2022).

The mounting challenge of external debt sent alarm bells to Ethiopia's policy makers, triggering a need for concerted effort to bring back the country's debt to sustainable levels. This led to the establishment of a medium-term debt management strategy (MTDMS) in 2016 to guide public borrowing for the subsequent four years. The MTDMS aimed to achieve a well-diversified and sustainable debt portfolio by striving to meet the government's financing needs at a minimal cost and with prudent degree of risk over the medium to long term (MoF, 2019). As was during the decade prior to the MTDMS, multilateral and bilateral sources were identified to be the main sources of concessional external finance during 2016-2020<sup>3</sup>. New loans were required to have at least 35% grant element when calculated at appropriate discount rate. As concessional loans are insufficient and subject to unpredictability of disbursements, financial conditionality, and tied to specific projects, the MTDMS had also provisions for semi-concessional borrowing for strategic projects with high returns (MoF, 2019)<sup>4</sup>.

As Table 4 shows, the external public borrowing during 2018/19-2021/22 are consistent with the guidelines in the MTDMS. Average interest rates for the four-year period stood at 1.06%. Maturity of the loans is on average 21 years, and the grace period is on average four years, fulfilling the requirement of concessional or semi-concessional loans.

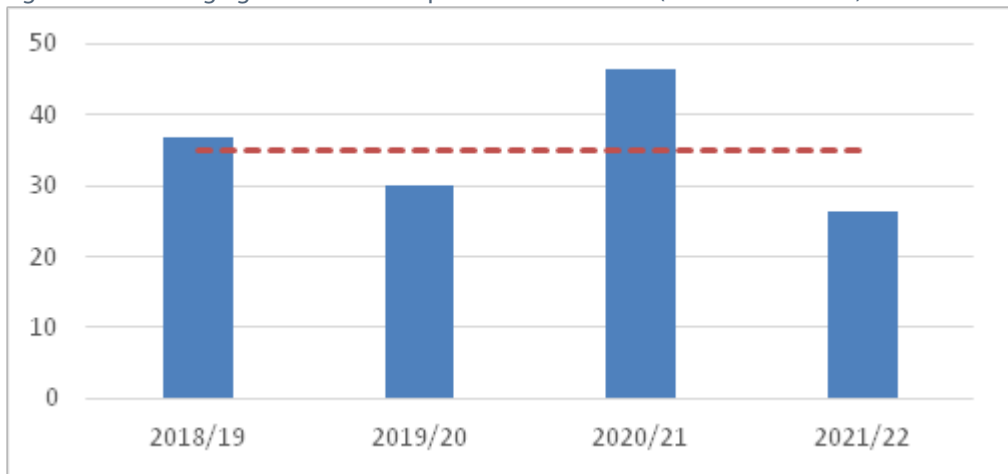
Table 4: Public external borrowing: New commitments and terms

|                                | 2018/19  | 2019/20  | 2020/21  | 2021/22 |
|--------------------------------|----------|----------|----------|---------|
| Committed amount (million USD) | 2,822.30 | 4,728.05 | 1,983.52 | 290.74  |
| Interest rate (avg. %)         | 1.71     | 1.16     | 1.01     | 0.37    |
| Maturity (avg. yrs.)           | 28.5     | 15.65    | 31.48    | 12.69   |
| Grace period (avg.yrs)         | 5.79     | 5.43     | 5.01     | 0.74    |

Source: MoF (2023).

The average grant element also stands at 35% as shown in Figure 13.

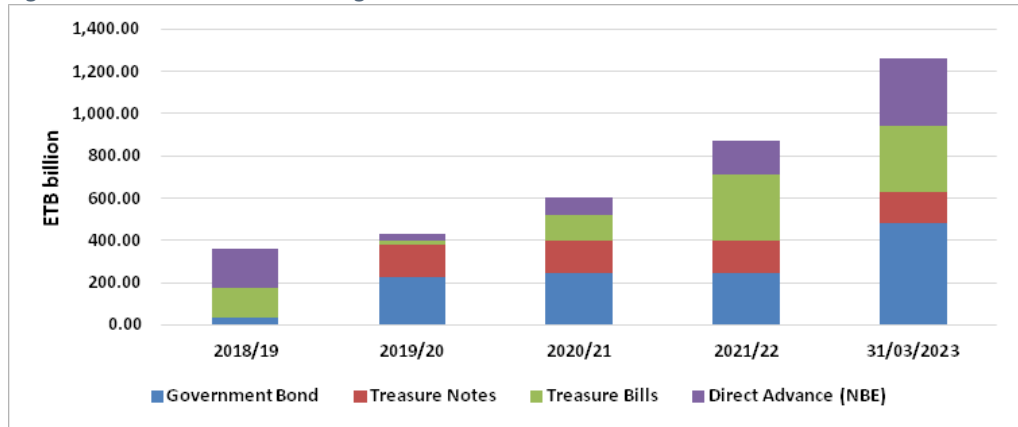
Figure 13: Average grant element of public external debt (2018/19-2021/22)



Source: MoF (2023).

With regards to domestic borrowing, the MTDMS emphasised the need to diminish access to direct advance from the National Bank of Ethiopia (NBE), and rely more on treasury bills and treasury bonds. Issuance of treasury bills and bonds were set to be determined at a ratio of 80:20. Treasury bonds had 3-5-year maturity. As in the MTDMS, share of treasury bills and bonds in domestic borrowing increased during 2018/19-03/2023, although the proportion was not consistent with the 80:20 rule. During 2018/19-2021/22, the treasury bills and bonds ratio was 42:58. The share of direct advance also began to increase after 2020, against the provision in the MTDMS.

Figure 14: Domestic outstanding debt (2018/19-03/2023)



With the provision for increasing reliance on domestic credit, The MTDMS helped to stabilise external debt stock. As shown in Figure 9, domestic debt took prominence surpassing external debt stock in 2021 and accounting for 54% of Ethiopia's total debt. Failure to reduce direct borrowing from the NBE, as stipulated in the MTDMS, added fuel to the already rising inflation, making Ethiopia one of the few high inflation countries in Africa. This had an indirect negative effect on external debt sustainability. The relatively very high inflation in Ethiopia led to an appreciation of real effective exchange rate (REER), hurting the country's export, which was critical for sustainability of external debt servicing.

## Discussions on debt reprofiling and resolution with creditors

To improve the DSA from 'high risk' of debt distress to 'moderate' level, Ethiopia needs to bring down its debt service to export ratio to 15%. This requires restructuring of its debt profile. Accordingly, in February 2021, Ethiopia filed an application for debt treatment under the G20 Common Framework—a framework for debt treatment for LICs with unsustainable debt. Under this framework, the IMF assesses the need for debt restructuring operation based on the debt sustainability analysis (DSA), which determines the level of restructuring to restore sustainability. In the case of Ethiopia, whose debt challenge is liquidity rather than solvency, this framework is hoped to ease financial pressure by providing the necessary debt service payment relief. The key element in the common framework is debt reprofiling from all bilateral and private creditors, i.e., maturity extension without reduction in total debt stock.

A recent United Nations Development Programme (UNDP) report estimated Ethiopia's debt service-export ratio to be 17%, 25%, and 23% in 2022/23, 2023/24, and 2024/25, respectively, all exceeding the sustainability threshold of 15%. To reduce these figures to a sustainable level of 15%, Ethiopia needed relief on debt service for a total of US\$4 billion over the three-year period (UNDP, 2023). This is about 40% of the total

US\$9.3 billion debt service the country is scheduled to pay over the next three years.

As has been the case for Zambia, debt treatment under the common framework has also been slow for Ethiopia. The framework requires broad consensus among multilateral, bilateral (Paris club vs non-Paris club) and private creditors, which is often difficult to come by, given the lack of common perspective among them, particularly the difficulty to bring private creditors on board.

In September 2021, creditors formed a committee chaired by China and France. The creditors committee has met four times so far, the latest being in February 2023. The process has been painfully slow from Ethiopia's policy makers' point of view. IMF cites domestic challenges for the slow progress of treating Ethiopia's debt under this framework. Ethiopia is currently waiting for the DSA result by the IMF and World Bank. The DSA result would help determine the extent of debt restructuring to bring the country's external debt position from 'high risk' of debt distress to 'moderate risk' level, which would be critical for Ethiopia to be able to access external finance.

On 23 November 2023, Ethiopia agreed with its official creditors committee on temporary suspension of the country's debt service due from 1 January 2023 to 31 December 2024. The agreement will provide temporary relief ahead of discussions on wider debt treatment, which will gain momentum as soon as Ethiopia and the IMF agree on the parameters for an IMF programme.

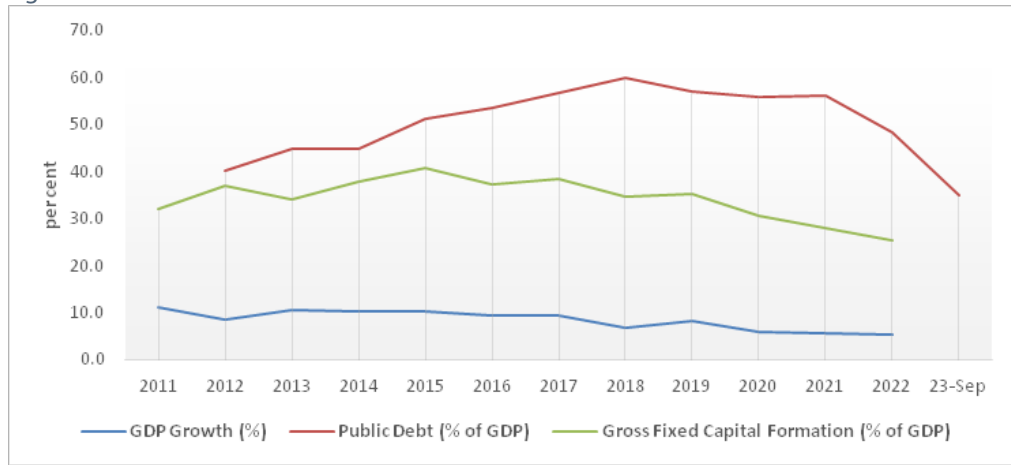
Debt restructuring provides a short- to medium-term relief. Looking beyond, Ethiopia's policy makers should revise the country's debt management strategy to include binding legal requirements to govern borrowing and spending of the central government as well as SoEs. The parliament should have a stronger oversight role over the executive in this regard. Public investment projects in Ethiopia are characterised by high time and cost overruns, contributing to the indebtedness of the country (Woldeyes, 2020). Thus, concerted efforts should be made to enhance efficiency in project and contract management.

## Debt-Investment-Growth nexus

Debt management strategy should focus on leveraging debt for long-term growth rather than focusing on stock of debt. This requires maintaining the optimal mix between debt, investment, and growth, which can be supported by debt, investment, and growth models (Abebe, 2021).

Sound public investment always improves long-term credit worthiness indicators such as debt to GDP ratios, regardless of the current level of debt. This is because public infrastructure projects boost GDP growth directly by adding to the country's capital stock, and because capital stock enhances productivity of private capital, it also raises the rate of return to private investment, adding a further boost to growth (Kharas & Dooley, 2021). In the first half of 2010s, the rise in public debt (% of GDP) was followed by a corresponding increase in investment shown by an upward trend in gross capital formation (% of GDP), leading to persistent GDP growth (Figure 15). In the second half of the 2010's, the low rate of return for investment made it difficult to continue to finance investment through borrowing, leading to slowing down of investment growth and GDP growth.

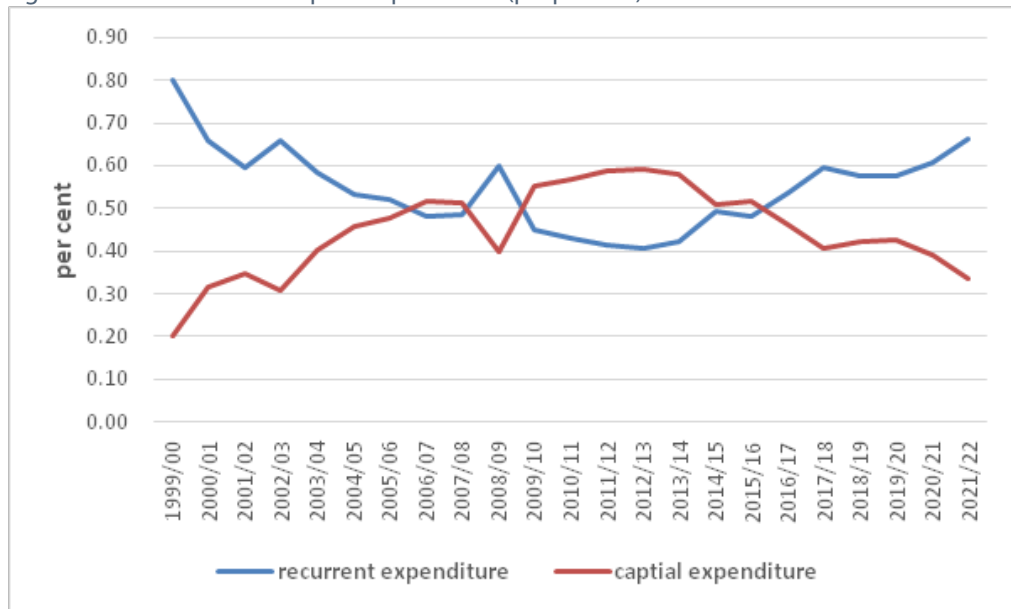
Figure 15: Debt-Investment-Growth nexus



Source: World Development Indicators (WDI, 2023).

As discussed before, Ethiopia sustained high economic growth since 2004, largely due to increased public investment fuelled by public debt. This can be observed from a marked change in the relative importance of capital and recurrent expenditure during 2000/01-2021/22. Recurrent expenditure accounted for the bulk of government expenditure in early 2000s, accounting for as much as 80% of the total expenditure (see Figure 16). The share of capital expenditure began to increase since then, reaching 50% in 2006/07.

Figure 16: Recurrent vs capital expenditure (proportion)

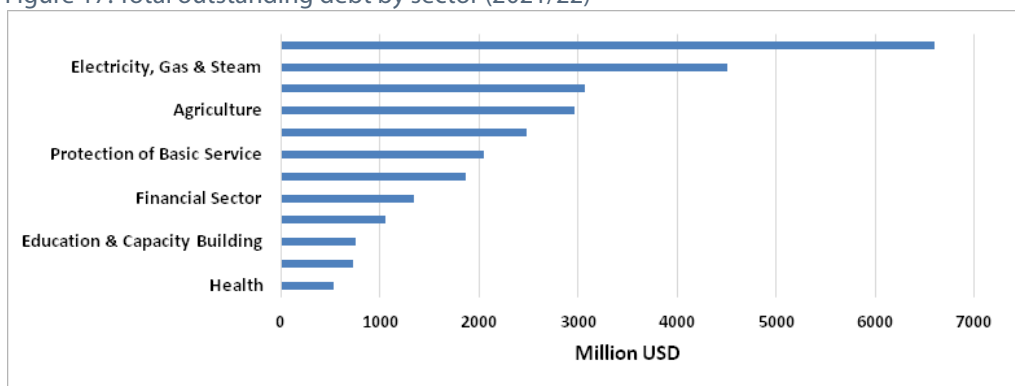


Source: WDI (2023).

During 2010/11-2015/16, capital expenditure exceeded recurrent expenditure, reaching 58% in 2013/14. This is the period where the government embarked on huge infrastructure investments. The relative share of capital expenditure started to decline in 2017/18, reaching a low of 34% in 2021/22. This period coincided with political turbulence in Ethiopia. It's also the period where government's access to external finance was curtailed, making it difficult to continue large infrastructure investment.

Looking at the sectoral debt composition, one can observe that the country's debt was largely channelled to finance productive capacity of the economy. More than 50% of the total outstanding debt was used to finance highways and railways, electricity, and communication (see Figure 17).

Figure 17: Total outstanding debt by sector (2021/22)



Source: MoF (2023).

The high economic growth sustained over a long period helped to shoulder the escalating debt. As of 2022, the present value of debt as a share of GDP stood at 33.2%, which is much lower than the 55% sustainability threshold. Likewise, the present value of external debt as a share of GDP stood at 12.4%, which is less than half of the 40% sustainability threshold for Ethiopia, according to the DSA.

As such, Ethiopia's debt management strategies should be revisited from the point of view of growth strategies, particularly export growth. Ethiopia's debt carrying capacity is significantly tied with its export performance. The negative outlook in external debt servicing would have changed if the country managed to register high export growth during the previous two decades (Abebe, 2021).

The country made concerted efforts to enhance its export performance in successive industrial growth strategies since 2005. The increased investment in transport and energy infrastructure, construction of industry parks, and introduction of various incentives to attract foreign direct investment, were primarily to boost export in the country. However, its performance has been dismal. One key reason behind Ethiopia's dismal export performance has been the overvalued Ethiopian birr against major trading partners. The continually appreciating real effective exchange rate (REER) has rendered Ethiopia's export not competitive in international markets, as discussed in the next sub-section, in greater detail.

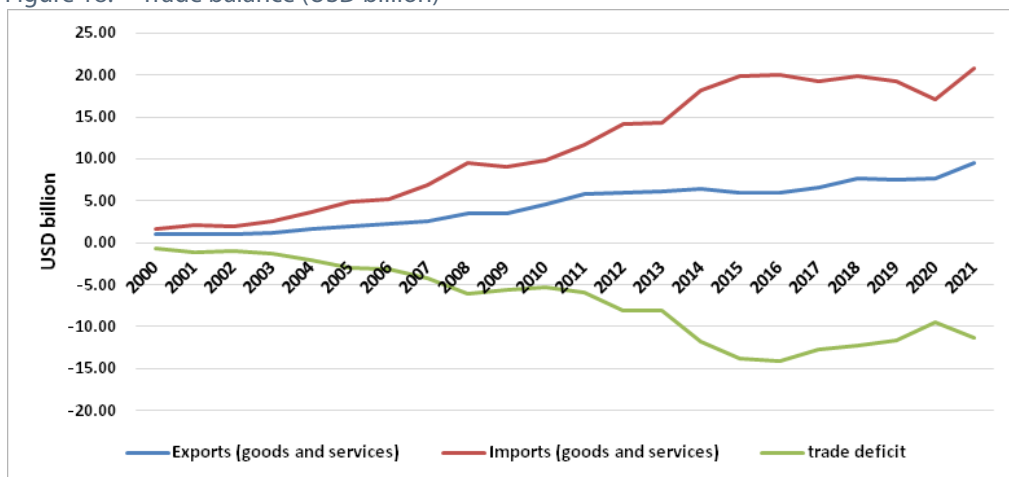
It's also worth noting that the improvement in credit worthiness that comes from higher public investment depends on the rate of public investment which in turn depends on public sector capabilities (Kharas & Dooley, 2021). One of the challenges in Ethiopia's public sector operations in general and infrastructure investment in particular, is inefficiency in project and contract management, which reduces the rate of return on investment. Infrastructure projects are characterised by time and cost overrun (Woldeyes, 2020). Thus, enhancing public sector capacity in identifying viable investment projects, contract, and project management, is critical for debt sustainability. Other factors the country's debt management strategy should focus on include sub-optimal economic decision-making due to political economic consideration and political instability, which all contribute negatively to Ethiopia's long-term debt sustainability.

## 5. External balance

### Current account balance

As discussed in the previous sections, the aggressive public infrastructure investment that took place for more than a decade in Ethiopia had a huge import spending component, which accounted for much of the steady rise in the import bill of the country since 2003. Although exports grew over the same period, it did not keep pace with the rise in imports, leading to a widening trade deficit over the last two decades as shown in Figure 18. Trade deficit rose from US\$0.63 billion in 2000 to US\$11.6 billion in 2021.

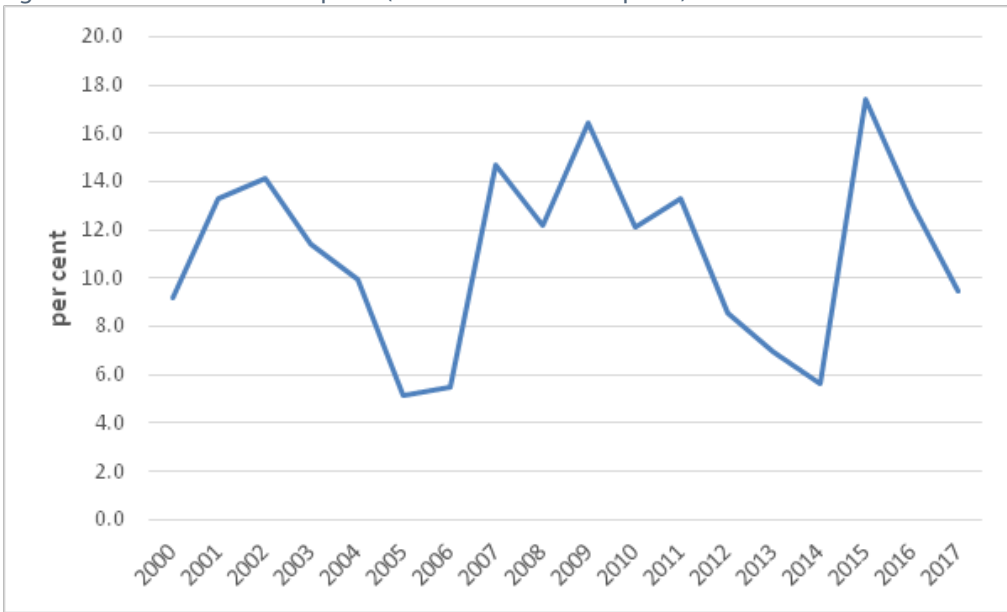
Figure 18: Trade balance (USD billion)



Source: WDI (2023).

Despite the concerted efforts to transform Ethiopia's export sector from predominantly agricultural to manufacturing through successive industrial policy strategies, the country's export sector remains largely agricultural. As Figure 19 shows, the share of manufacturing exports in total exports in 2017 was 9.5%, comparable to that of 2004.

Figure 19: Manufactures exports (% of merchandise exports)



Source: WDI (2023).

## Movements in Terms of Trade (ToT)

As of 2022, the major export items in share of total export earnings include coffee, gold, flower, and oil seeds. Primary exports are vulnerable to commodity price shocks. As Figure 20 shows, Ethiopia's export performance is driven by terms of trade (ToT) movements. Abebe (2021) argues that most of the country's export volatility (54%) is due to movements in ToT. The major import items include non-durable consumer goods, semi-finished products, fuel, and industrial capital goods, accounting for 35.8%, 22.8%, 19%, and 13.8%, respectively. It's also notable that Ethiopia's import share is substantially shifting from capital goods to non-durable consumer goods in the last few years (NBE, 2021).

Ethiopia's ToT improved substantially in the 2000s. Perhaps this was associated with the global commodity boom following a rise in global demand for commodities during this period. Moreover, Ethiopia's imports were also largely consumer goods with comparable price to its exports. During 2010-2021, ToT manifested significant fluctuation, leading to instability in goods export (see Figure 19).

Figure 20: Movements in ToT and goods export



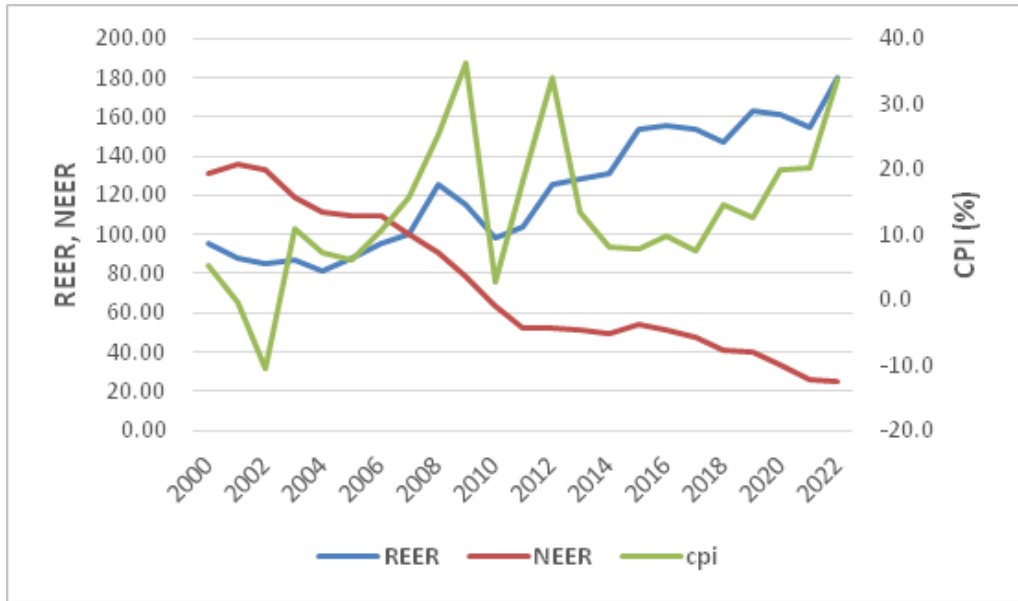
Note: 2015=100  
Source: WDI (2023).

### Movements in Real Effective Exchange Rate (REER)

Ethiopia followed a crawling peg exchange rate policy throughout the 1990s with an average 7% annual depreciation rate of the Ethiopian birr (ETB) against the USD (Mengistu, 2020). During the 1990s, the peg was adjusted in line with the inflation differential between Ethiopia and major trading partners, leading to depreciation of ETB against trading partners, throughout this period. Since early 2000s, however, domestic inflation picked up pace relative to inflation in Ethiopia's trading partners. The crawling peg of exchange rate allowed the Nominal Effective Exchange Rate (NEER) to depreciate (Figure 21). However, it was insufficient to keep up with the inflation differential with trading partners, causing an appreciation of the REER (see Figure 21).

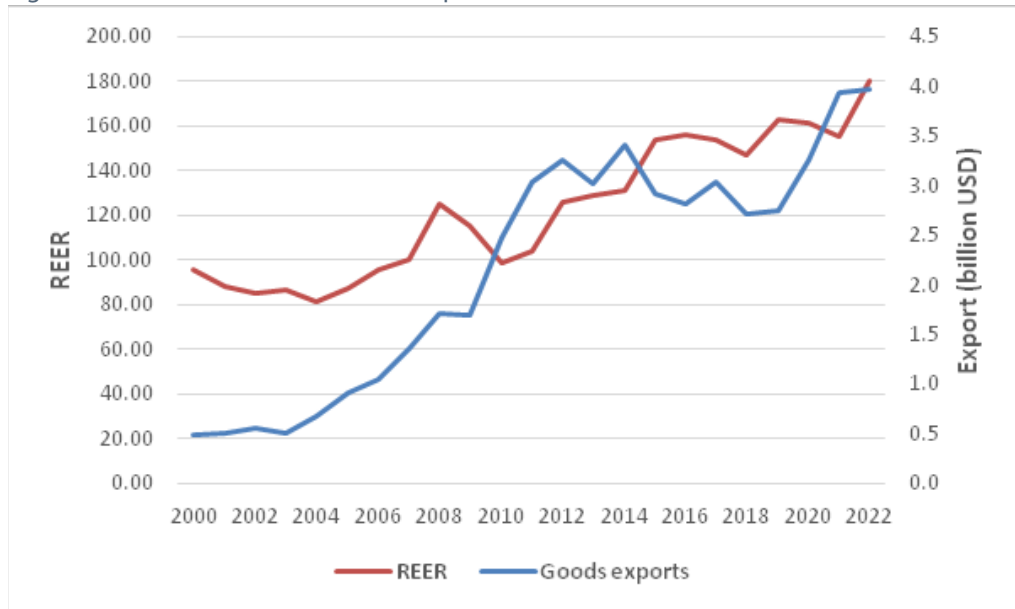
The continually appreciating REER, particularly since 2010, has made Ethiopia's exports uncompetitive in international markets, playing a role in the underwhelming export performance during this period. As Figure 22 shows, there is some level of association between REER and goods export. Foreign Direct Investment (FDI), which also is a potential engine for export growth, depends on the movements in REER (see Abebe 2021). Thus, continual adjustment of the NEER against the inflation differential between Ethiopia and its trading partners is critical to keep the REER stable and maintain the competitiveness of Ethiopia's export.

Figure 21: NEER, REER, CPI



Source: Darvas (2021).

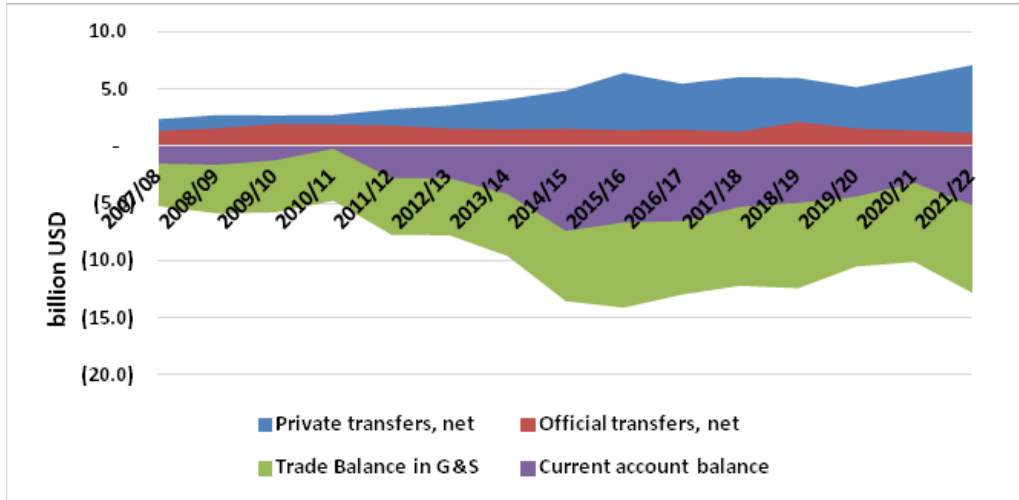
Figure 22: Movements in REER and exports



Source: WDI (2023), Darvas (2021).

The current account deficit largely mirrors the deficit in external trade as Figure 23 demonstrates. The large trade deficit persistent over the last two decades has predominantly been financed through private transfers, FDI, and foreign borrowing. Remittances make up the bulk of private transfers, which has been steadily rising since 2007, and reached US\$7.1 billion in 2021/22. Official assistance, albeit much lower than private transfers, has been an important source to finance the trade deficit.

Figure 23: Trends in current account (billion USD)

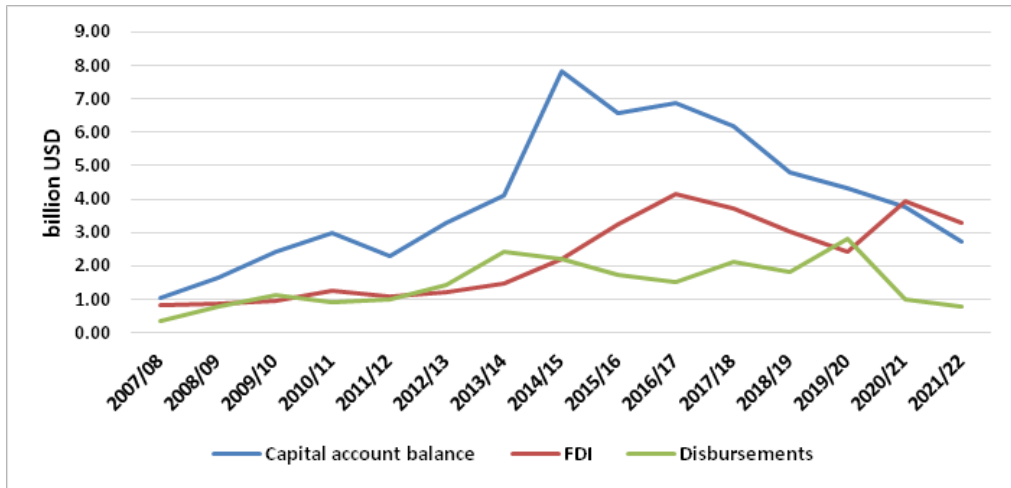


Source: NBE (2021).

### Capital account balance

External borrowing and FDI have been important sources of finance for the persistent current account deficit, particularly during the post- 2003 period. As Figure 24 shows, capital account balance was largely driven by movements in FDI, and to some extent by external borrowing. It rose during 2007/08-2016/17, following the steady increase in external disbursements and FDI during the country's sustained infrastructure investment. FDI was on a downward spiral after this period, despite the spike in 2020/21 that was associated with entry of foreign telecom firms following liberalisation of the telecommunication market for the first time in the country's history.

Figure 24: Capital account balance (billion USD)

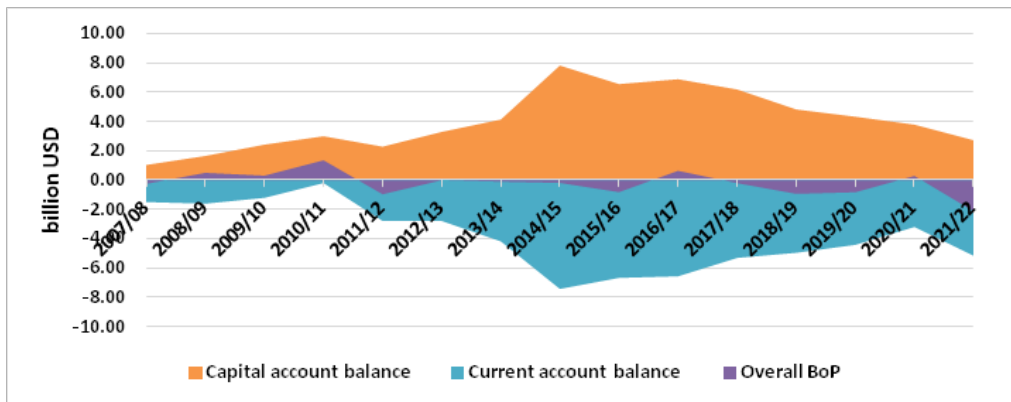


Source: Authors' computations using data from NBE

## Overall Balance of Payments (BoP)

During 2007/08-2011/12, the capital account surplus more than offset the current account deficit resulting in a small BoP surplus (see Figure 25). For most of the period after 2012/13, the widening current account deficit surpassed the capital account surplus, causing an overall BoP deficit. The BoP deficit as of 2021/22 stood at US\$2.1 billion.

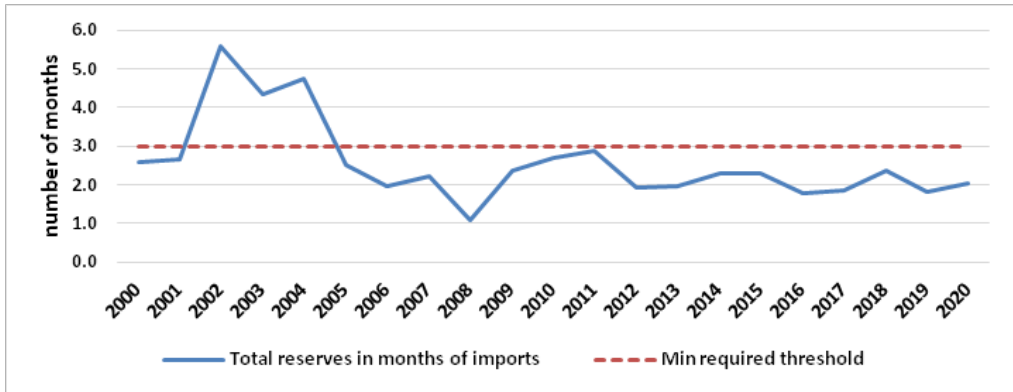
Figure 25: Overall BoP (billion USD)



Source: Authors' computations using data from NBE (2023).

Ethiopia's foreign exchange reserve has been below the three-month import threshold for most of the last 20 years, as shown in Figure 26, except during 2001-2005. This trend worsened in the last few years due to dwindling access to external finance and declining FDI. As of February 2023, the country's foreign exchange reserve was barely enough to finance less than one month of imports (UNDP, 2023).

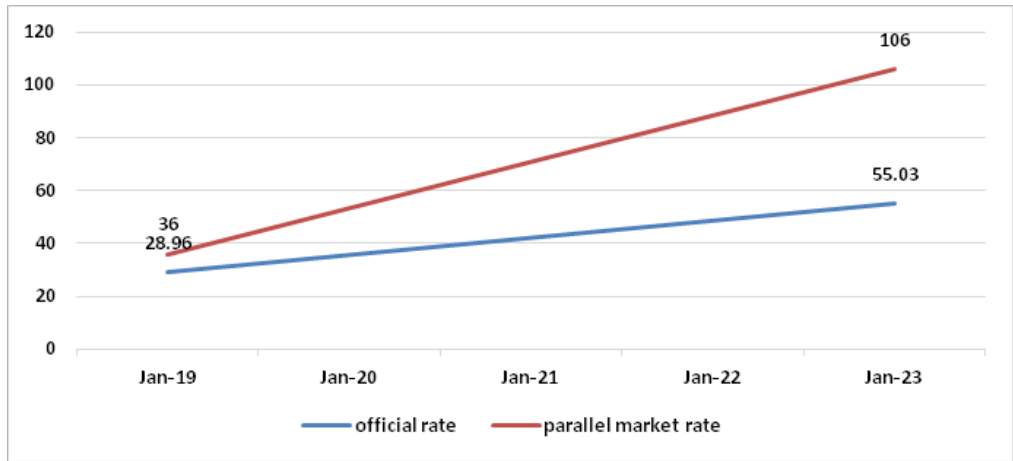
Figure 26: Total reserves in months of imports



Source: WDI (2023).

The deteriorating foreign exchange reserve put pressure on the exchange rate and exposed it to speculative attack. Figure 27 shows the quickly widening parallel market premium during January 2019-January 2023. During this period, the parallel market premium rose from 24% to 93%.

Figure 27: Exchange rate premium



Source: Authors' computation using data from various sources.

## 6. SDR allocations and need for reform

### SDR allocations

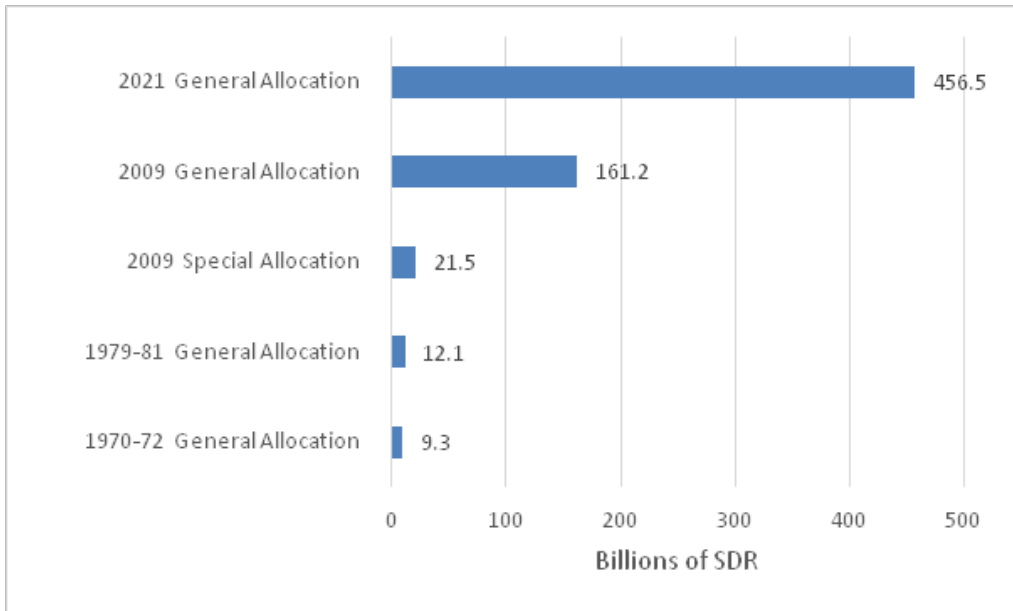
SDR allocations are made to supplement International Monetary Fund (IMF) member countries' foreign exchange reserves, particularly in times of global liquidity shortages to support long-term global needs. SDR is not money in the usual sense. However, it can be converted to hard currency based on voluntary exchange between member countries. SDR's value is based on a basket of five leading currencies (USD, euro, yen, renminbi, and pound).

The IMF's articles of agreement allow the fund to create unconditional liquidity through "general allocations" to its members in proportion to their quotas in the IMF. The IMF has also made "special allocation" to enable countries that joined the fund after 1981 to take part in the SDR system on equitable basis. There have been historically four "general allocations" and one "special allocation" (Figure 28).

The largest general allocation, amounting to SDR 456.5 billion (equivalent to US\$650 billion) was made in 2021 following the global COVID-19 pandemic, with the aim of addressing the long-term global need for reserves, build confidence and support recovery (IMF, 2021). It helped member countries' efforts to cope with the impact of COVID-19.

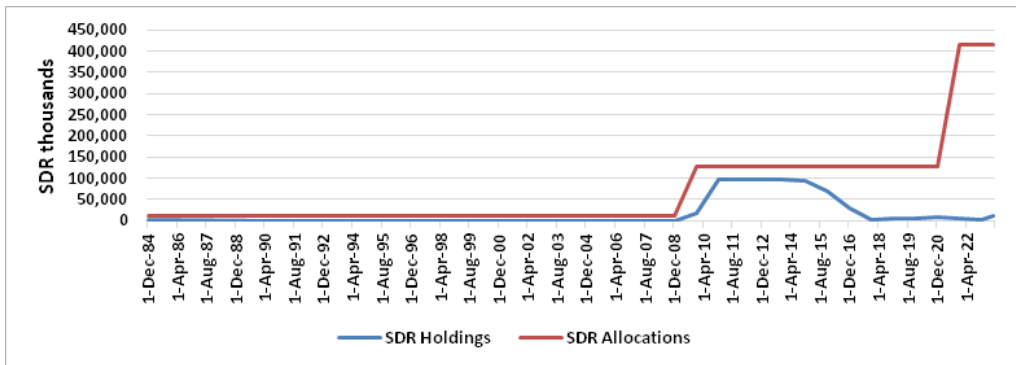
Ethiopia received general allocation of 11,160 SDR, 127,931 SDR, and 416,138 SDR in 1984, 2009, and 2021, respectively (Figure 29). Ethiopia has used the SDR allocation to finance its pandemic response package. Ethiopia's SDR holdings as of July 2023 stood at SDR 10.14 million. Low-income countries like Ethiopia have had low international reserves positions even before extraordinary worldwide shocks struck the global economy to trigger the need for general allocation. This is because of the slow structural transformation that kept them in a vulnerable balance of payment positions. Thus, by the time general allocations are made, their SDR holdings are quickly depleted as was the case for Ethiopia (Figure 29).

Figure 28: SDR allocations: General and special



Source: IMF (2021).

Figure 29: Ethiopia's SDR allocation vs holdings (1984-2023)



Source: Authors' computations using data from IMF (2023).

In addition to the general allocation, IMF mobilises SDR from countries with extra reserve positions on a voluntary basis to augment its concessional financing under its Poverty Reduction and Growth Trust (PRGT) lending facilities. The PRGT is a mechanism to provide concessional lending to low-income countries (LICs) that have short- to long-term BoP problems. It has three lending facilities, i.e., the Extended Credit Facility (ECF), the Standby Credit Facility (SCF), and the Rapid Credit Facility (RCF). About US\$15 billion of the total US\$24 billion PRGT fast track loan mobilisation by the IMF were from existing SDRs (see IMF, 2023)

Concessional support through the PRGT is currently interest-free. However, they come with strings of conditionalities attached, hindering the full utilisation of these loans by some countries in need. For example, out of the SDR 1.2 billion loan agreement with Ethiopia under the extended credit facility, Ethiopia was able to utilise only 11.5% of it (see Table 5).

Table 5: IMF's history of lending commitments with Ethiopia as of 29 February 2023 (thousands SDR)

| Facility                                  | Date of Arrangement | Expiration Date | Amount Agreed | Amount Drawn | Amount Outstanding |
|---|---------------------|-----------------|---------------|--------------|--------------------|
| Extended Credit Facility                  | 20-Dec-19           | 19-Dec-22       | 1,202,800     | 133,640      | 133,640            |
| Extended Fund Facility                    | 20-Dec-19           | 19-Dec-22       | 751,750       | 90,210       | 90,210             |
| Rapid Financing Instrument                | 30-Apr-20           | 4-May-20        | 300,700       | 300,700      | 300,700            |
| Exogenous Shock Facility                  | 26-Aug-09           | 22-Nov-10       | 153,755       | 153,755      | 0                  |
| Extended Credit Facility                  | 22-Mar-01           | 31-Oct-04       | 100,277       | 100,277      | 0                  |
| Extended Credit Facility                  | 11-Oct-96           | 22-Oct-99       | 88,470        | 29,490       | 0                  |
| Structural Adjustment Facility Commitment | 28-Oct-92           | 8-Nov-95        | 49,420        | 49,420       | 0                  |
| Standby Arrangement                       | 8-May-81            | 30-Jun-82       | 67,500        | 67,500       | 0                  |
| Total                                     |                     |                 | 2,714,672     | 924,992      | 524,550            |

Source: IMF (2023).

The IMF is also considering augmenting its Resilience and Sustainability Trust (RST) by mobilising resources from the existing SDRs. RST aims to support long-term BoP needs of countries in response to long-term structural changes such as pandemic preparedness and climate change (Finance for Development Lab [FDL], 2023). To qualify for the RST, a potential beneficiary country would need a package of what IMF deems to be high quality policy measures, simultaneous financing or non-financing IMF support programme that has appropriate macroeconomic policies and sustainable debt and adequate finance capacity to repay the loan. Among African countries, Rwanda is the only country that has reached an agreement with the IMF.

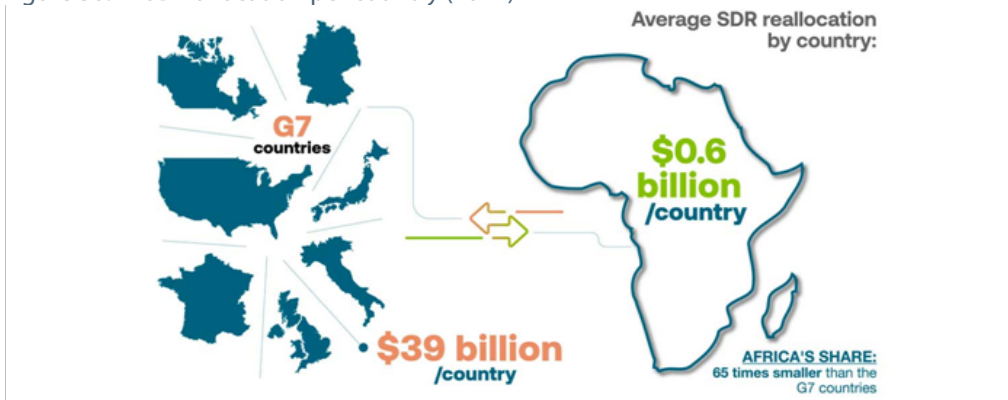
## Reform in SDR allocations

There is a growing call for a reform in SDR allocation, particularly from countries in the global south. The debate around SDR reform from the point of view of the developing countries involves three key issues: First, the current practice takes a long time to respond to economic shocks. It took about a year to respond to the global financial crisis in 2009, and a year and half to respond to the global COVID-19 pandemic. This is mainly because proposals for SDR allocation cannot be approved without the consent of countries with a total of 85% voting quota. This also means it can't be approved without the consent of the USA alone, which holds 16% of voting rights at the IMF. After the global COVID-19 pandemic hit the world, it took the IMF one year and half

to approve a new allocation, mainly because the Trump administration refused to approve the proposal. It took a change of administration in the USA before it was approved in 2021.

Second, the current allocation formula is based on countries' economic size and reserve position, without due consideration of liquidity needs and structural vulnerability. This means SDR allocations don't end up where it's needed most. As discussed earlier, out of the US\$650 billion in SDR allocation, G20 and advanced economies received US\$500 billion, while emerging and LICs received US\$274 billion. As Figure 30 shows, per country SDR allocation among the G7 countries is US\$39 billion, per country, while that of Africa is just US\$0.6 billion per country.

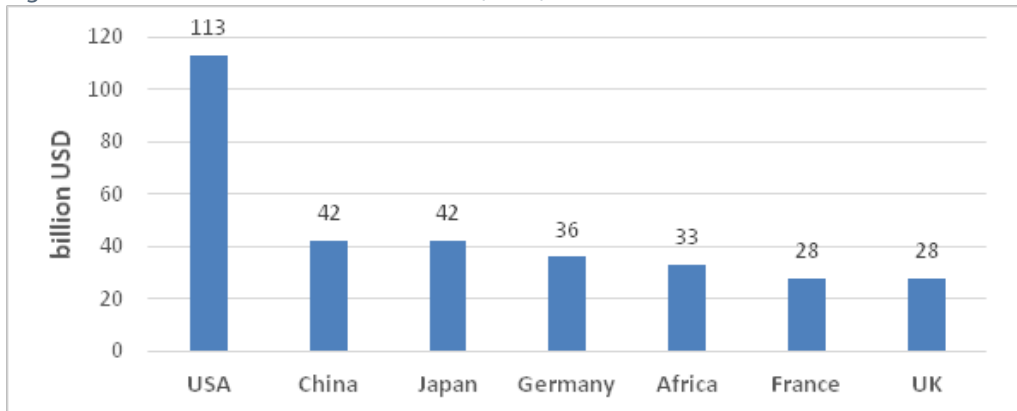
Figure 30: SDR allocation per country (2021)



Source: IMF [2021]

Africa's share of SDR in 2021 allocation was US\$33.6 billion, which is less than German's US\$36 billion<sup>5</sup> (see Figure 31). This is inconsistent with the key role of SDR allocation, which is to ease liquidity pressures of countries due to economic shocks. Thus, African countries are calling for a new allocation formula that considers countries' liquidity needs in addition to the economic size and reserve positions.

Figure 31: SDR allocation in USD billions (2021)



Source: IMF (2022).

Third, currently, wealthy countries are holding on excess SDR reserve. There is increasing call to find a mechanism to re-channel some of the excess reserve to developing countries, that are going through severe liquidity shortages and financing challenges, for long-term recovery from COVID-19 and climate change shocks. In this regard, the merits and demerits of different rechanneling mechanisms are being debated as discussed below. African finance ministers prefer to use the African Development Bank as an SDR prescribed holder to re-channel SDR from countries with excess reserve to those in Africa (Economic Commission for Africa [ECA], 2022).

While African countries continue to call for SDR reallocation, there are challenges to its implementation. First, SDRs belong to individual countries, not to the IMF. Any decision to reallocate SDR can only be done by individual countries on a voluntary basis. The role IMF could play is in crafting facilities for its own lending, for which SDRs can provide sources of funding (Centre for Global Development [CGD], 2021). Second, there is a cost to each country when its SDR holding falls below its allocation—interest is paid on the difference. Thus, rich countries that donate their SDRs will pay interest which has to be budgeted. Third, rich countries often want to maintain the “reserve asset characteristics” of SDRs. This means, while lending their SDRs, they consider the risk of non-repayment and liquidity of the loan.

Despite the challenges for rechanneling SDR, different channelling mechanisms with their own merits and demerits are currently being debated. The two most relevant mechanisms for African countries are discussed below:

- 1) Relocating SDRs through the IMF's Poverty Reduction and Growth Trust (PRGT) and Resilience and Sustainability Trust (RST)

Channelling SDRs through the IMFs existing lending facilities (PRGT and RST) are attractive to high income countries because they involve risk guarantee for lenders. As of February 2023, the IMF had received pledges from 17 members with a total amount of 30.4 billion SDRs. China has also officially contributed six billion SDR to the IMF's RST (FDL, 2023). However, while PRGT and RST provide concessional lending to African countries, the stringent IMF requirement means that many countries in need would not qualify.

- 2) Reallocating SDRs through Multilateral Development Banks (MDBs)

MDBs, including the World Bank and the African Development Bank (AfDB), are prescribed holders of SDR. SDR rechanneling through the MDBs work in two ways: countries can lend SDRs to MDBs, which in turn can lend to countries in need. SDRs can also be used to boost the balance sheet of MDBs, whereby SDRs can be leveraged to raise more lending resources in the capital market.

As the call for reform in international financial system continues, there has been a major push to find alternatives to channel SDR outside of the IMF, especially via the MDBs. The strong standing of MDBs in capital market, with their excellent credit rating, makes them very attractive avenues to re-channel SDR to African countries. AfDB, for example, has AAA credit rating and can absorb risk in its balance sheet, allowing it to provide lending in more affordable terms to member states. AfDB also has country-specific expertise and no stringent policy conditionality, making it the most attractive option to re-channel SDR to African countries. This is a sentiment echoed by African finance ministers in their meeting at Sharm El Sheikh in June 2023.

The key challenge in rechannelling SDR through MDBs is the requirement by lender countries to keep its reserve asset characteristics, where lenders can quickly access if they have liquidity needs.

## SDR's potential use for Ethiopia

Given a multitude of external and domestic shocks Ethiopia has been going through, it would benefit from a new SDR allocation or rechannelling of excess SDR. However, given the sheer size of the current liquidity crunch and financing needs for its long-term recovery, a new allocation based on the current IMF quota would only be a small fraction of the country's needs. Ethiopia's humanitarian response plan for 2023 alone required a little below US\$4 billion of funding. As indicated earlier, the country needs an estimated US\$4 billion debt reprofiling over the next three years to improve its debt status from 'high risk' of debt distress to 'moderate risk' level. To finance resilient recovery and reconstruction following the conflict in northern Ethiopia, an estimated US\$20 billion is required over the next five years, with as much as US\$5 billion needed in the first year (MoF, 2021/22)

Out of a historically high SDR allocation of US\$650 billion in 2021 to respond to a global pandemic, Africa received just US\$33 billion, of which Ethiopia's allocation was US\$414 million. This amount was just a fifth of Ethiopia's annual debt servicing expense. If IMF were to make a new allocation based on the current IMF quota, Ethiopia's allocation would be a small fraction of its short-term liquidity needs, not to mention its financing needs for medium- to long-term recovery. This is true for many other African countries going through severe liquidity shortfalls and difficulty to finance resilient recovery. The story of Ethiopia is a case in point to amplify the call for revision in SDR allocation formula as part of the broader call for SDR reform. A new SDR allocation formula shall incorporate parameters indicating liquidity shortage and structural vulnerability of countries, in addition to the existing parameters.

## 7. Policy lessons and implications

Ethiopia's economy has been hit by a series of internal and external shocks over the last few years. The combined effect of the COVID-19 pandemic, the Russia-Ukraine war, domestic conflict, and drought, have put the country on a lower growth trajectory. Capital investment has plummeted. Budget deficit and BoP deficit have widened, and its external debt position has been on high risk of distress. The country put austerity measures to meet its international debt obligations. Debt servicing is taking a toll on important social and economic sectors. This can be seen by the crowding out effect of debt servicing over other sectors. Ethiopia's budget for servicing public debt in 2022/23 exceeds the combined budget for health, education, water and energy, agricultural development, and trade and industry. The budget for servicing public debt in 2022/23 is three times larger than the previous year. As a result, the country is sliding backwards from the important economic and social gains of the previous two decades. Poverty rates are rising. Moreover, Ethiopia's performance towards achieving the SDGs has been poor, and it is ranked 144th among 166 countries.

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Thus, enhanced SDR allocation or rechanneling of SDR from countries with excess reserve would benefit Ethiopia. This would require revising the current SDR allocation formula to incorporate liquidity needs and underlying structural vulnerabilities of countries, in addition to the IMF quota. Ethiopia's case study demonstrates the need for enhanced SDR allocation. Policy makers in Ethiopia or at the AU level should use the evidence to strengthen the collective voice for enhanced SDR allocation.

Regarding instruments to re-channel SDR, the PRGT and RST provide concessional lending to African countries. However, the stringent IMF requirement means that many countries in need, such as Ethiopia, would not be able to fully utilise these concessional lending facilities. As the call for reform in international financial system continues, there has been a major push to find alternatives to channel SDR outside of the IMF, especially via the MDBs. MDBs such as the AfDB have strong standing in the capital market (AfDB has AAA credit rating). AfDB also has country-specific expertise and less stringent policy conditionality for lending.

It's important to realise that SDR reform takes time and enhanced SDR allocation should only be complimentary to individual countries' effort to improve their own domestic resource mobilisation. Enhanced SDR allocation cannot substitute the need for countries to address structural challenges and the need to build resilience to shocks. Accordingly, Ethiopia needs to address political economy challenges that lead to sub-optimal economic decision-making, public sector inefficiency, corruption, and illicit financial flow that contributed to the macroeconomic imbalances.

As Ethiopia's risk of debt distress largely depends on its export performance, there needs to be concerted efforts to address bottlenecks hindering the growth of exports. Studies have shown that continual adjustment of the exchange rate to the inflation differential between Ethiopia and its trading partners is critical to maintain its export competitiveness.

Ethiopia lags many African countries in domestic resource mobilisation (DRM), particularly in tax revenue collection. Improving the operational strength of tax administration agencies can go a long way in improving tax revenue collection.

Development partners have an important role in supporting low-income countries like Ethiopia to ease the effect of global shocks on debt burden and strengthen resilient recovery. Development partners need to be more willing to provide medium-term debt relief to countries in high risk of debt distress, including Ethiopia. The Debt Service Suspension Initiative (DSSI) in 2020/21 helped postpone debt payments for low-income countries, including Ethiopia, for a year. Given the severity of the pandemic, however, the relief period should have been longer. More broadly, the international debt resolution mechanism needs a new set of principles and discussion forums designed to find consensus among indebted countries and creditors, including private bond holders.

Developed countries look at the consequences of global shocks such as the pandemic and climate change on developing countries as a common global challenge. Climate change induced political instability and displacement in the global south would pose challenges to countries in the north. Hence, addressing global challenges such as climate change is a global public good. In this regard, the G20 countries need to keep their pledge to support 30% of the earth's land and water resources by 2030. Many developing countries are home to vast biodiversity and need to be supported to preserve this global public good. Ethiopia, having vast arable land and water resources, would benefit from supporting sustainable land use and water preservation programmes, which in turn would contribute to sustainable global food supply.

## Notes

1. Centre for Economic Policy Research (CEPR). 2022. "The case for more Special Drawing Rights: Rechanneling is no substitute for a new allocation".
2. Ethiopian Railway Corporation, Ethiopian Electric Power, Ethiopia Sugar Corporation, and Ethio telecom in that order, are the biggest debtors.
3. Multilateral loans are generally concessional (e.g., IDA with interest rate of 0.75 % , 38 years maturity, and six years grace period).
4. Semi-concessional loans are assumed to be contracted from official bilateral creditors. These loans have a maximum fixed interest rate of 2% and a maturity of 20 years, including a 5-year grace period.
5. Ethiopia's allocation in 2021 was US\$414 million. This amount was just 21% of Ethiopia's external debt service in the same year.

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