MIKHAIL NIKOLAEV
Director, Sovereign and Regional Ratings Group
+7 (495) 139 04 80, ext. 179
mikhail.nikolaev@acra-ratings.ru

Media contact:
SVETLANA PANICHEVA
Head of External Communications
+7 (495) 139 04 80, ext. 169
svetlana.panicheva@acra-ratings.ru

MACROECONOMICS | WORLD

ETHIOPIA: THE ROAD TO DEFAULT

Reserves and budget discipline as essential factors for economic sustainability

For further details, see ACRA's analytical commentary Sri Lanka in Default: Causes and Consequences from July 19, 2022.

In December 2023, the Federal Democratic Republic of Ethiopia (hereinafter, Ethiopia, or the country) failed to pay the USD 33 mln coupon on its sole USD 1 bln Eurobond issue. Since the end of the COVID-19 pandemic, Ethiopia has become the fourth emerging economy — after Sri Lanka, Zambia and Ghana — to default[1]. In addition, Ethiopia has the lowest creditworthiness among the BRICS+ countries.

Ethiopia's default can be seen as stemming from the accumulated effect of a number of factors, including its civil war (which is ongoing and began in 2018), a long drought, and the impossibility of receiving humanitarian aid due to the war. Due to this, the UN estimates that around 20 mln people, or a fifth of the country's population, are experiencing food shortages. Global growth of food and energy prices have exacerbated the situation, while the aggravation of the global geopolitical situation has led to a multiple reduction in wheat imports. As a result, Ethiopia's external position has weakened substantially (*Table 1*); it does not have any foreign exchange resources left to fulfill its obligations.

Table 1. Selected Ethiopian debt indicators as of the end of 2022

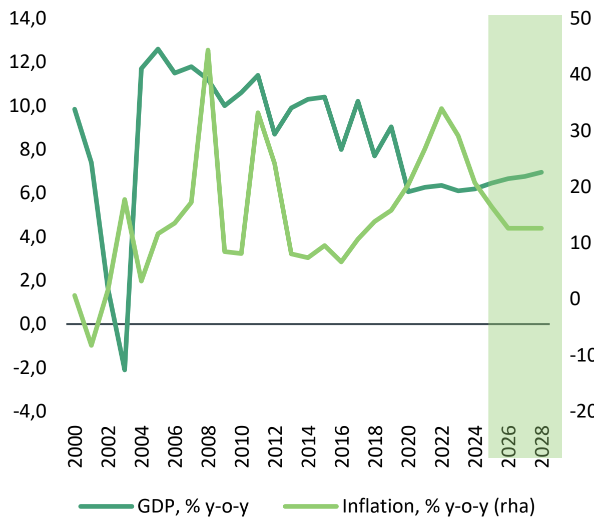
PUBLIC DEBT % of GDP	PUBLIC DEBT % of budget revenues	INTEREST PAYMENTS ON PUBLIC DEBT % of budget revenues	TOTAL EXTERNAL DEBT % of GDP	RESERVES % of GDP	SERVICING OF EXTERNAL DEBT % of exports
46.6	543.6	8.2	22.8	0.1	18

Sources: IMF, World Bank

The UN classifies Ethiopia as one of the world's least developed countries (LDCs). In 2022, it ranked 170th out of 196 countries in terms of USD per capita GDP. According to the IMF's data for 2022, Ethiopia's economy is relatively large (fourth largest by size of GDP in sub-Saharan Africa — USD 120 bln — behind South Africa, Nigeria, and Angola, and 62nd globally). At the same time, the country is one of the most densely populated (the second most populous in the region with a population of 105 mln, ranking second after Nigeria and 13th globally). Before the civil war broke out, international investors considered Ethiopia to be a successful country, which actively raised investment and demonstrated annual growth of more than 10%. Nevertheless, according to the IMF's forecasts, the country has economic potential, and rather fast economic growth rates are expected in forthcoming years (*Fig. 1*).

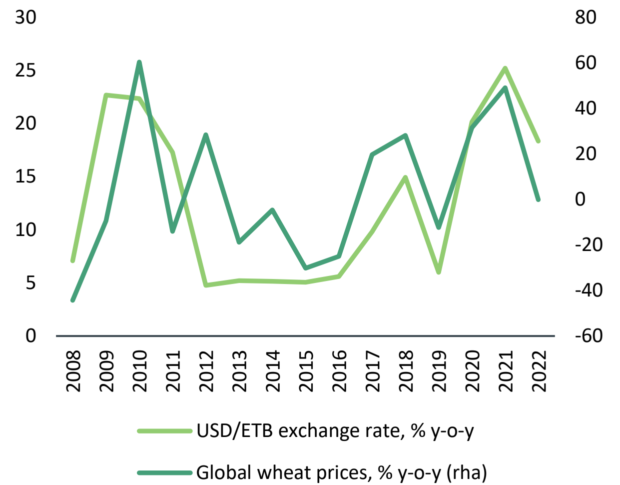
[1] Rating agencies have downgraded Ethiopia's credit ratings. In December 2023, Fitch downgraded the country's foreign currency rating to RD (restricted default), the local currency rating remained at CCC-, and the Eurobond issue rating was set at D. In the same month, S&P downgraded the country's foreign currency rating to SD (selective default), the rating remained at CCC in national currency, and the rating of the Eurobond issue was D. In September 2023, Moody's downgraded Ethiopia's rating from Caa2 to Caa3.

Figure 1. GDP growth and inflation



Source: IMF

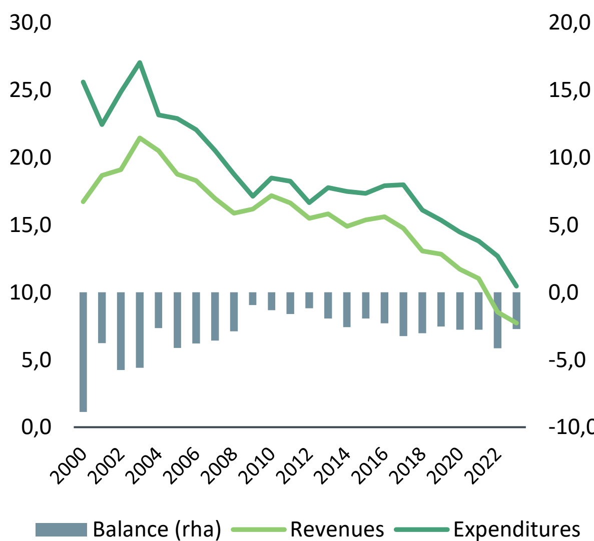
Figure 2. The exchange rate of Ethiopia's national currency correlates with wheat prices



Source: IMF

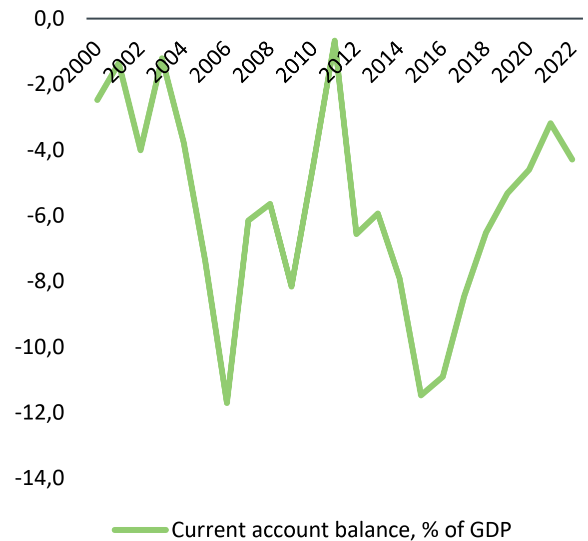
Sanctions imposed by the US against Ethiopia due to the civil war not only impacted certain individuals, but also deprived the country of beneficial access to the US market as part of the African Growth and Opportunity Act, which has been in place since 2000 and is aimed at stimulating economic growth by reducing foreign trade barriers. Ethiopia's main imported commodities are wheat and petroleum products. Their prices have grown significantly in recent years, which largely determined the dynamics of the national currency, the Ethiopian birr (*Fig. 2*). The drought, which lasted six years, led to increased demand for wheat, and increased geopolitical tensions in the world caused an increase in energy and food prices (including wheat) and a decrease in physical volumes of wheat imports by almost half. Ethiopia's main exports are coffee, gold, and flowers. High gold prices have only partially supported the country's external position, resulting in a significant current account deficit, as shown in *Fig. 4*. Taking into account the combination of these factors, the country was forced to spend its reserves rather than accumulate them.

Figure 3. Budget balance, % of GDP



Source: IMF

Figure 4. Current account balance, % of GDP



Source: IMF

Along with the current account deficit, Ethiopia has a negative budget balance (*Fig. 3*), i.e. the country has lived with a double deficit. Fiscal policy weakness has become an additional default factor. The government's role in the allocation of resources is strong in countries where the domestic market is underdeveloped. Budget sustainability largely depends on the government's ability to effectively collect taxes and determine spending priorities. Ethiopia's example shows the government's fiscal policy weakness. Since 2022, budget revenues have been steadily declining to less than 10% of GDP, due to, among other things, wider tax evasion and new tax exemptions. At the same time, budget expenditures were also reduced, but they were still consistently higher than revenues. As a result, the national debt was almost five times higher than the country's income (*Fig. 5*), although it remained at a relatively safe level relative to GDP (less than 60%). As of the end of 2020, Ethiopia's public debt was dominated by non-market borrowings: loans from international financial organizations (including the IMF, the World Bank, and the African Development Bank), bilateral loans (China, France, and the United States), loans from commercial banks, and Eurobonds accounted for 51.6%, 28.6%, 16.3%, and 3.5% of public debt, respectively. This public debt structure explained the relatively small interest payments (0.6% of GDP and 7.3% of revenues in 2022), since loans from international financial organizations and bilateral sovereign loans are generally issued on preferential terms. The structure of interest payments on public debt in 2021 was as follows: international financial institutions accounted for 14%, China accounted for 35%, and Eurobonds accounted for 4%.

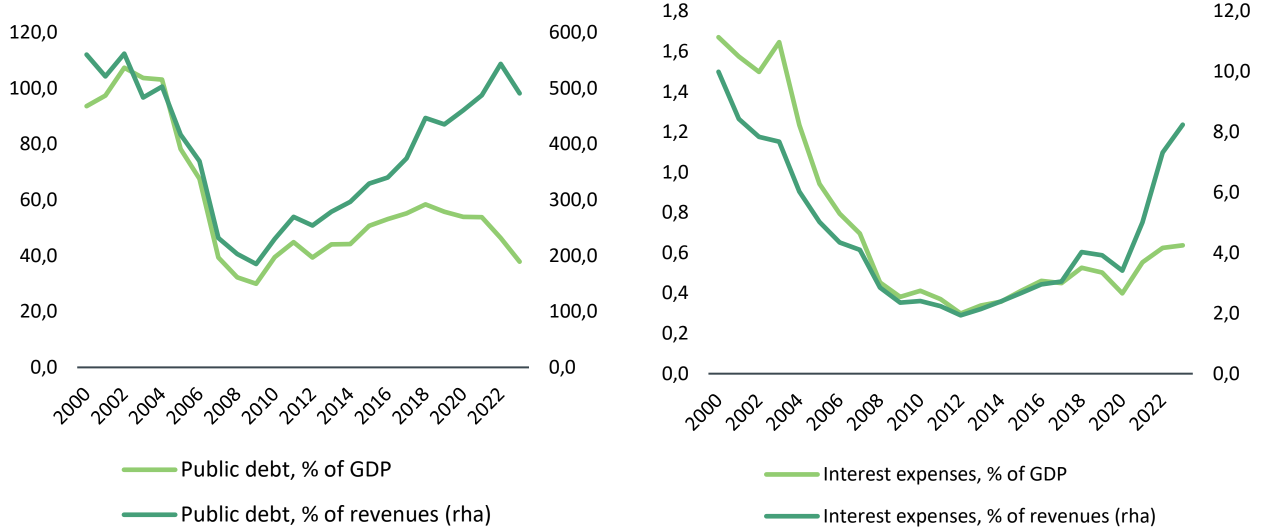
In 2021, at the height of the COVID-19 pandemic, Ethiopia, anticipating public debt servicing challenges, joined the IMF and World Bank's **Debt Service Suspension Initiative (DSSI)**, as well as the **Common Framework for Debt Treatments beyond the DSSI**, in order to resolve its debt with creditors. Moreover, the country was seeking USD 2 bln under the IMF's reform program. In addition to sovereign debt restructuring mechanisms designed by developed countries, at the end of 2023, Ethiopia supported the creation of the **Common Leveraging Union of Borrowers (CLUB)**, which was designed to raise concessional loans and potentially negotiate debt restructurings.

For further details, see ACRA's analytical commentary New (in)stability? from June 13, 2023.

In November 2023, the Chairman of the National Bank of Ethiopia announced that agreements had been reached with bilateral creditors, including China, to suspend interest payments worth USD 1.5 bln. According to media reports, the country's debt to China is about USD 14 bln.

Ethiopia is also in talks with the IMF on a USD 3.5 bln loan. IMF personnel have already visited the country to discuss the terms of the loan. On the one hand, this agreement will help Ethiopia negotiate debt payment suspension with other creditors, since the joint program with the IMF is a precondition for suspension. On the other hand, the IMF's loan terms may turn out to be too tight and increase inflationary pressures in the short term in view of the potential requirement to depreciate Ethiopia's national currency. An example of this is Tunisia, which in October 2022 agreed a USD 1.9 bln loan from the IMF, but last year the Tunisian president canceled the agreement as its terms could "exacerbate inequality and social tensions".

Figure 5. Lower revenues impair debt metrics

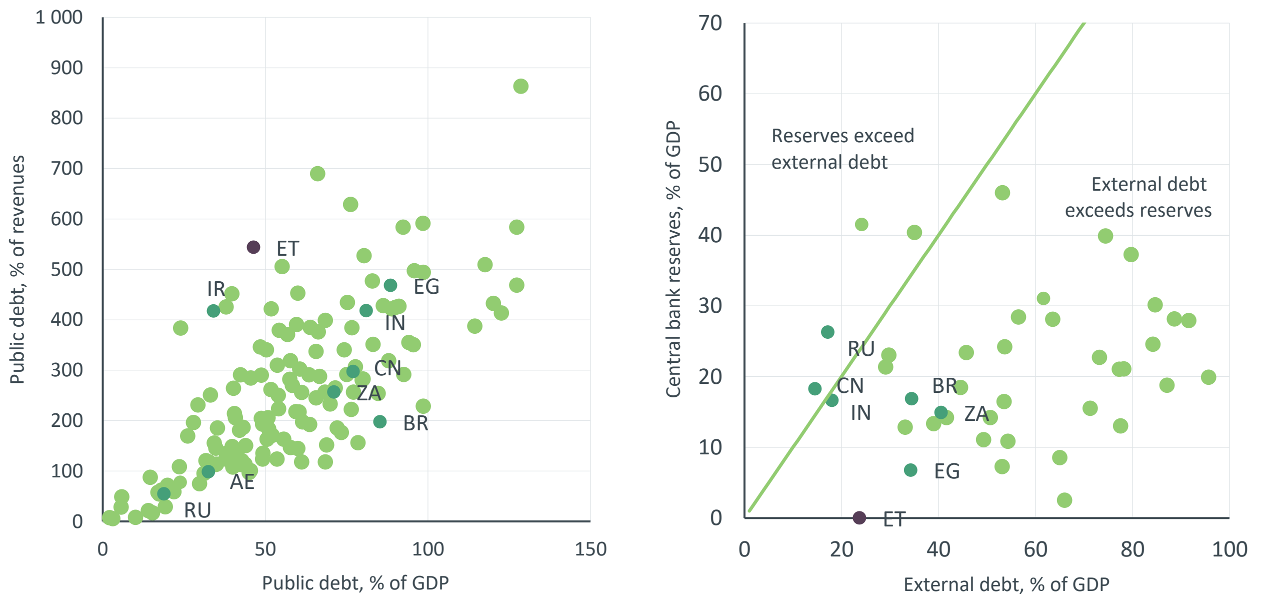


Source: IMF

Source: IMF

Ethiopia and Egypt are the most economically unstable BRICS+ countries (*Fig. 6*), whose public debt is heightened relative to budget revenues and the amount of international reserves is limited relative to external debt. In March this year, Egypt managed to negotiate an increase in the volume of IMF loans from USD 3 bln to USD 8 bln, while the country's currency depreciated by almost a third. In this regard, in ACRA's opinion, it is necessary to monitor the economic sustainability of these countries and to develop BRICS+ support mechanisms such as, for example, the **Contingent Reserve Arrangement (CRA)**.

Figure 6. Ethiopia is the least creditworthy BRICS+ country



Source: IMF

Source: IMF

Ethiopia's example shows that commonly applied ratios — public debt to GDP (46.6%) and external debt to GDP (22.8%) — may not be enough to assess a country's creditworthiness. Additional indicators should be analyzed, such as the ratio of public debt to income (543.6%) and the ratio of reserves to external debt (about 0% of GDP). The example of Ethiopia allows us to conclude that for an emerging economy:

- One of the key factors for maintaining external sustainability is to reduce the risks associated with critical imports;
- A sufficient tax base and strict budget discipline are necessary for maintaining debt sustainability;
- If the domestic market is underdeveloped, access to external markets is important, but it is necessary to monitor the volume and types of external debt.

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Analytical Credit Rating Agency (Joint-Stock Company), ACRA (JSC)
1 Bldg. 2 Bolshoi Gnezdnikovsky Lane, Moscow, Russia
www.acra-ratings.com

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