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Table of Contents

List of Figures iv
List of Tables v
Foreword vi
Acknowledgments vii
1. Introduction 1
2. Key Highlights 2
3. Inflation 3
4. Public Debt 9
5. Exchange Rate Developments 22
6. Concluding Remarks 27
References 29

List of Figures

Figure 1: Trends of inflation rates across months (year-on-year, %), Sep. 2022—Sep. 2023 .. 4
Figure 2: Food and non-food inflation from Sep. 2022 to Sep. 2023 (year-on-year, %) 5
Figure 3: Inflation at regional levels (year-on-year, September 2023)........................ 6
Figure 4: Inflation in Ethiopia and selected countries and regions........................ 7
Figure 5: Ethiopia's public debt stock ($billion), QI, Jul-Sep 2023........................ 10
Figure 6: Per capita public debt burden and GDP per capita (current prices), 2018/19-2022/23 and 2023/24, QI........................ 11
Figure 7: External debt outstanding ($27.7 billion) by lender category, QI, July-Sept 2023 (% of total external debt) 11
Figure 8: Public debts of SOEs (% total debt), QI, (Jul-Sep 2023)........................ 12
Figure 9: Defense spending (in Billion ETB), 2023........................ 13
Figure 10: Composition of domestic debt outstanding by instrument type (% of the total public domestic debt), QI, (Jul-Sep 2023)........................ 14
Figure 11: Share of domestic borrowing in public debt (%), 2018/19-2023/24 (QI)........................ 15
Figure 12: The trend of direct advances (Government borrowing from the NBE), million ETB 16
Figure 13: Quarterly debt service to export ratio........................ 19
Figure 14: Tax revenue (% GDP)........................ 20
Figure 15: Current account deficit, public debt, and inflation........................ 21
Figure 16: Official and Parallel Exchange Rates (Birr/USD), January-September 2023........ 23
Figure 17: Remittance flow (USD million) to Ethiopia and Kenya (2014-2023) 24
Figure 18: Trend of official development assistance (ODA) disbursements (US dollars, millions)........................ 25
Figure 19: Trend of export revenue and import (billion USD), 2014-2022 26

List of Tables

Table 1: Inflation in Ethiopia (QI, Jul-Sep 2023) 4
Table 2: Debt Sustainability Analysis Indicators 17
Table 3: Debt servicing by quarter (million USD) 18
Table 4: Debt service to export ratio by quarter 19
Table 5: Exchange rate in the official and parallel market 22

Foreword

The Quarterly Macroeconomic Updates, published by the Ethiopian Economic Association (EEA), is a flagship publication that provides vital insights into the Ethiopian macroeconomy. This publication used to be a significant source of information for policymakers, businesses, researchers, and anyone interested in understanding the latest economic trends in Ethiopia until it was discontinued for more than a decade.

Recognizing the growing need for a critical analysis of topical national issues changing the economic landscape in Ethiopia, the EEA has decided to resume the publication of the Quarterly Macroeconomic Updates on the Ethiopian economy. This renewed version will continue from where the previous volume left off, providing timely updates on key macroeconomic indicators and emerging challenges. The EEA is delighted to announce the relaunching of the report with this volume 09, number 01 issue.

The current issue covers the first quarter of the Ethiopian fiscal year that spans from July 1, 2023, to September 30, 2023, offering valuable insights into the state of the Ethiopian economy based on selected macroeconomic indicators.

We at the EEA are confident that this publication will once again become a valuable resource for all stakeholders interested in the Ethiopian economy.

The EEA

Acknowledgments

This Quarterly Macroeconomic Update is written by Dr. Tasew Tadesse, Leader of the Macroeconomy Research Theme of the Ethiopian Economics Association. The Association appreciates his contribution. The Association is also grateful to those who have edited, reviewed, and commented on the draft version of the report, including EEA's management members, EEA's senior researchers, and executive committee members of the Association. Furthermore, EEA appreciates Ms. Rahel Yilma for formatting and designing the report.

The views expressed in this publication do not necessarily reflect the views of the Ethiopian Economics Association.

1. Introduction

This quarterly macroeconomic report provides an update on the macroeconomic situation in Ethiopia. This quarter's macroeconomic report focuses on three key areas with significant implications for economic stability and growth: inflation, public debt, and the exchange rate market. The report analyses key developments and trends in inflation, and the state, evolution, composition, and sustainability of public debt and its potential implications for fiscal policy space and overall economic stability. Additionally, it highlights developments in the foreign exchange market, providing valuable insights into the issues of currency depreciation, foreign exchange shortage, and widening black market premiums. It covers the first quarter of the Ethiopian fiscal year (EFY 2016) that spans from July 1, 2023, to September 30, 2023. A discussion of the country's macroeconomic environment is provided for the three selected indicators in the following sections.

2. Key Highlights

Inflation: Despite some easing in recent months, inflation remains stubbornly high at 28.4 percent. It is significantly higher than the regional average of 10.6% for Sub-Saharan Africa; consequently, eroding the welfare of citizens.

Public debt: Ethiopia's public sector debt stock was USD 63.2 billion as of September 30, 2023, representing 38.7% of the GDP. At $588.5, the average Ethiopian has a significant and increasing per capita debt burden. Such high debt levels raise concerns about debt sustainability. Consequently, Ethiopia is found at a high risk of external debt distress.

Exchange rate: At 55.2 birr per US dollar, Ethiopia’s currency remained weak against major currencies. The exchange rate is not only weakening but also highly misaligned. The gap between the official and parallel market exchange rates has persisted over the past several years and has gradually widened to over 100% in recent months.

3. Inflation

Key facts and figures

Ethiopia continues to grapple with high inflation. The most recent figures indicate a slight slowdown compared to earlier quarters of 2023.

Headline inflation averaged 28.4 percent in the first quarter (Jul-Sep 2023). A quarter earlier (Apr-Jun 2022), the rate was 31.2 percent. Quarterly, headline inflation decreased by 2.8 percentage points.

At 30.6%, non-food inflation exceeded food and general inflation. The non-food component of the CPI had a year-on-year inflation rate averaging 30.6% in the first quarter, indicating a 30.6% increase compared to the same period in 2022.

Looking at inflation rate by region, Benishangul Gumuz, Addis Ababa, and Afar had the highest headline inflation rates, standing at 45%, 38.5%, and 36.9%, respectively.

In terms of food inflation, Benishangul Gumuz was leading at 44.3%, followed by Afar at 37.3%, and Addis Ababa at 35.5%.

Inflation is significantly higher in Ethiopia compared to other Sub-Saharan African countries and low-income nations. With a headline inflation rate of 28.3 percent in September 2023, Ethiopia experienced the highest inflation compared to the SSA average and its East African counterparts such as Rwanda (5.5%) and Kenya (6.7%).

Inflation remains stubbornly high, putting pressure on the cost of living and eroding the welfare of citizens. Despite slightly easing in recent months, Ethiopia continues to grapple with high inflation. Headline inflation (annual percentage change) averaged 28.4 percent in the first quarter (Jul-Sep 2023). A quarter earlier (Apr-Jun 2022), the rate was 31.2 percent. Quarterly, headline inflation decreased by 2.8 percentage points. This indicates that there was a sluggish reduction in the inflation rate in the review quarter (Table 1). The slight reduction in headline inflation is due to the reduction in non-food inflation and, also, to the decline in food inflation. Notwithstanding the slight reduction, inflation remains high, and the double-digit rate has persisted through the first quarter. This indicates that the issue remains a significant concern in Ethiopia as it poses a threat to the country's macroeconomic stability.

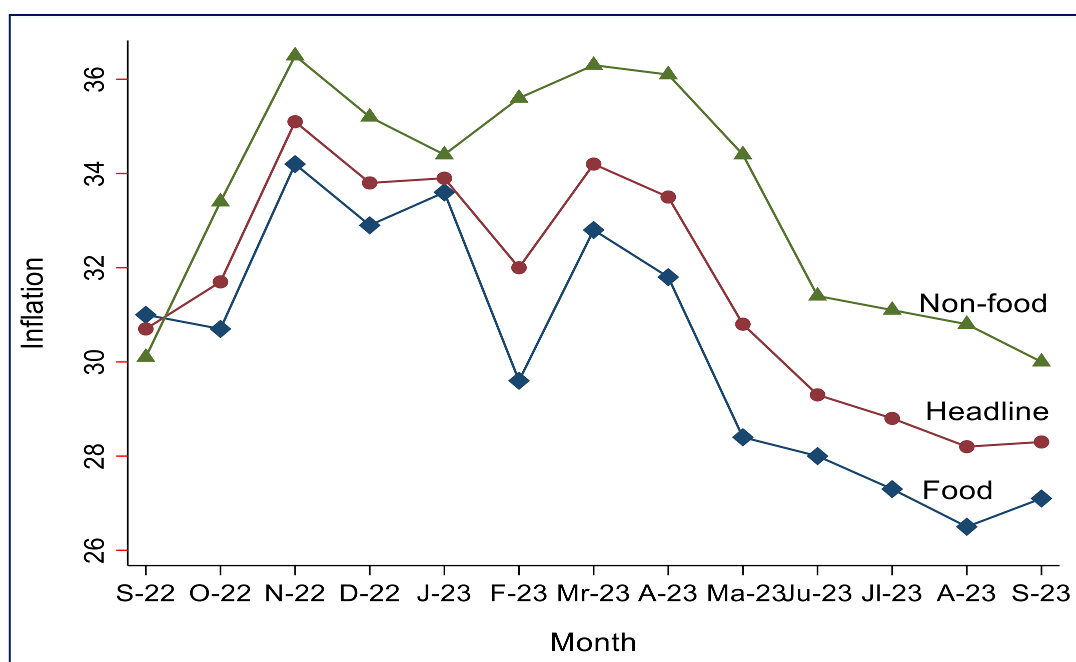
Table 1: Inflation in Ethiopia (QI, Jul-Sep 2023)

Quarter		Headline	Food	Non-food
Weights (%)		100	53.5	46.5
Apr-Jun 2023 (Q-IV) (A)		31.2	29.4	34
Jul-Sep 2023 (Q-I) (B)		28.4	27	30.6
Change in percentage points (B-A)		-2.8	-2.4	-3.4
Contribution to headline inflation in QI (%)	Absolute	28.67	14.44	14.24
	Relative	100	50.3	49.7

Source: Computation based on Ethiopian Statistical Services (ESS) data

The inflation rates for both food and non-food items have remained high. Food and non-food items contributed equally to headline inflation, each accounting for approximately 50% (Table 1). During Apr-Jun 2023 and Jul-Sep 2023, non-food inflation exceeded food and general inflation. The non-food component of the CPI had a year-on-year inflation rate averaging 30.6% in the first quarter, indicating a 30.6% increase compared to the same period in 2022.

Figure 1: Trends of inflation rates across months (year-on-year, %), Sep. 2022—Sep. 2023



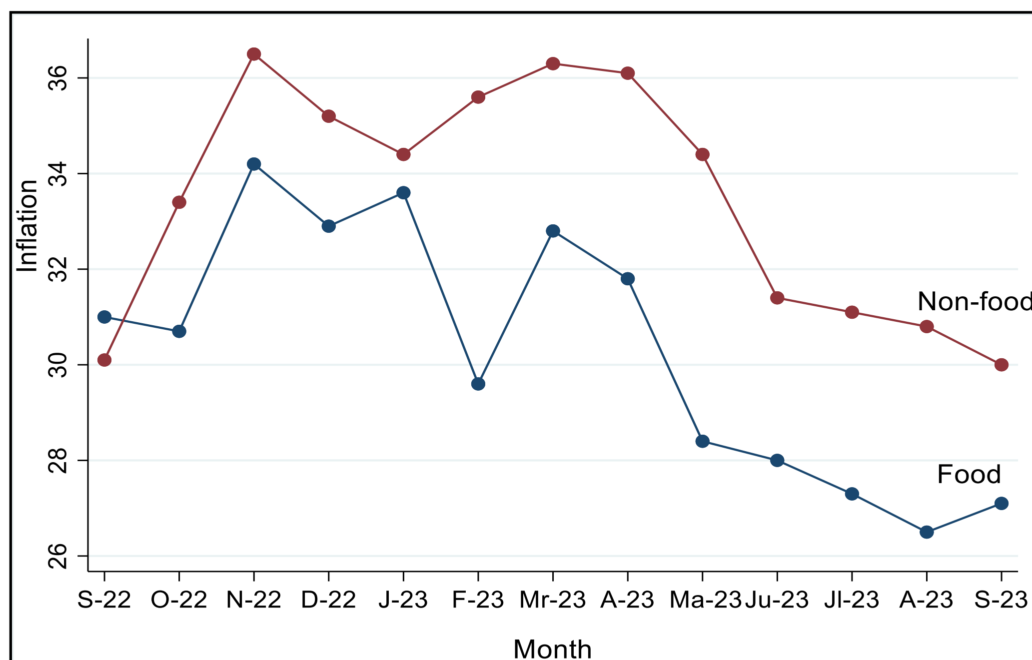
Source: Computation based on ESS and NBE data

The country's annual inflation rate has been under observation every month. According to the latest data, the year-on-year inflation rate dropped to 28.3 percent in September 2023. This was about 2.4 percent lower than the figure recorded in the same month of 2022 (Table 1). Although there has been a slight decrease in the headline inflation rate, double-digit inflation persists, indicating a high inflation rate.

The non-food inflation increased by 30 percent, while the inflation rate for food and non-alcoholic beverages rose by 27.1 percent in September 2023 compared to the same month in the previous fiscal year (Figures 1 &2). The relatively higher non-food inflation was due to the more pronounced price increment in the major non-food components of the CPI. According to ESS's data in September 2023, there was a significant increase in inflation rates in various non-food items. Health spending saw a rise of 47.6%, housing, and utility inflation increased by 36.3%, furnishings, household equipment, and routine maintenance of the house increased by 34.2%, restaurants and hotels inflation increased by 28.5%, and clothing and footwear rose to 27.3% from 15.4% in August 2023. These increments have played a significant role in the rise of non-food inflation rates during the review quarter.

Looking at the underlying causes, the relatively higher non-food inflation could be due to several factors. It can be explained by the shortage of foreign exchange limiting the volume of imports of such goods. The critical shortage and difficulty of obtaining foreign exchange in the formal market, which forces importers to rely on the black market, has made imports to be priced at parallel market rates. As the gap between the official and black-market rates is over 100 percent, this has significantly raised the import prices of non-food items. Moreover, domestically, there is limited supply as the local production of non-food items is not growing in line with the growing demand. Additionally, the phased removal of fuel subsidies is the other possible contributory factor for the higher non-food inflation. The relatively high non-food inflation is thus due to the limited growth of domestic production and the acute shortage of foreign currency.

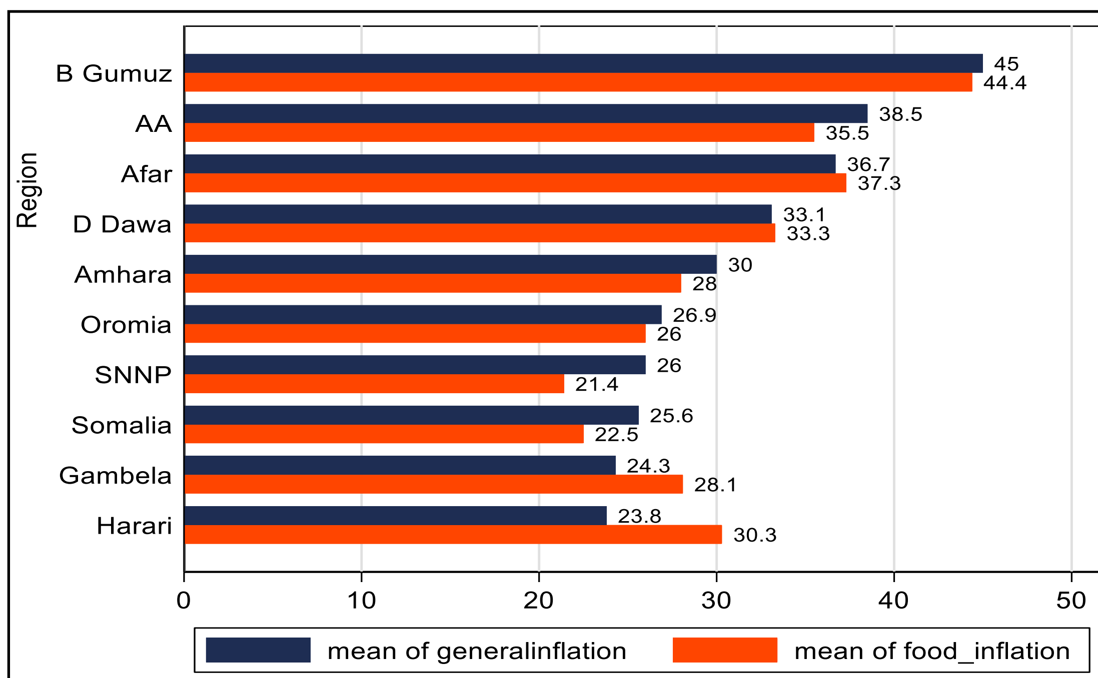
Figure 2: Food and non-food inflation from Sep. 2022 to Sep. 2023 (year-on-year, %)



Source: Computation based on ESS data

There is considerable variation in inflation rates across regional states. According to the regional inflation data from September 2023, Benishangul Gumuz, Addis Ababa, and Afar had the highest headline inflation rates, standing at 45%, 38.5%, and 36.9%, respectively. These regions also had the highest food inflation rates, with Benishangul Gumuz leading at 44.3%, followed by Afar at 37.3%, and Addis Ababa at 35.5% (Figure 3). The regional differences in inflation rates may be associated with differences in supply shocks that disrupt the supply chain, transportation costs, government spending, conflicts, and unrest.

Figure 3: Inflation at regional levels (year-on-year, September 2023)



Source: Computation based on ESS data

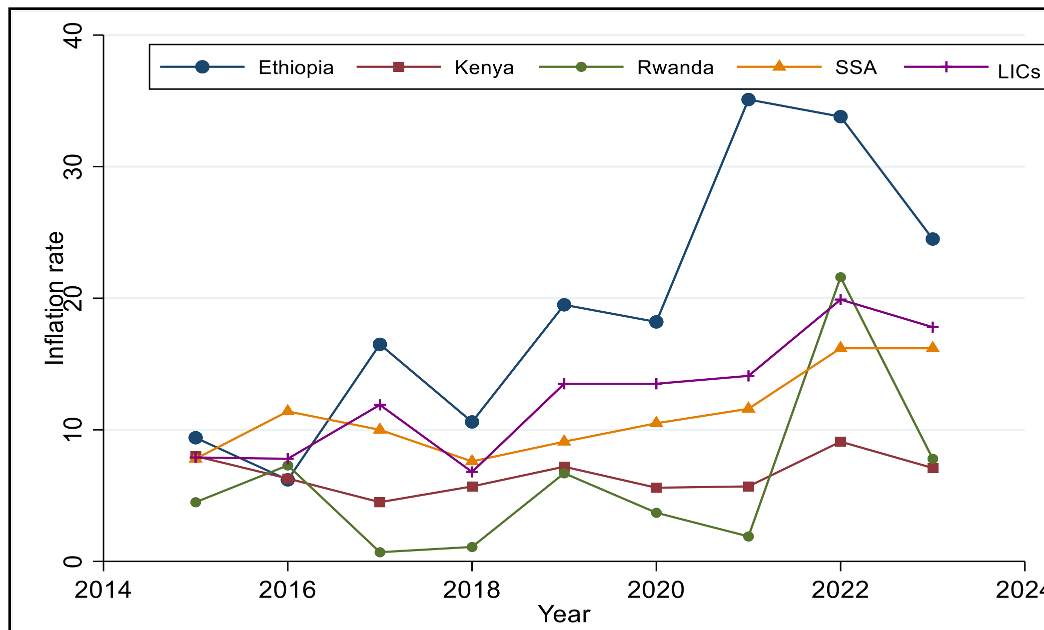
Inflation is significantly higher in Ethiopia compared to other Sub-Saharan African countries and low-income nations. According to International Monetary Fund (IMF) data, Ethiopia's average inflation rate was over 18% in the ten years leading up to 2023, higher than the regional average of 10.6% for Sub-Saharan Africa and 11.7% for low-income nations. With a headline inflation rate of 28.3 percent in September 2023, Ethiopia has also experienced the highest inflation compared to its East African counterparts such as Rwanda and Kenya. The corresponding inflation rates for Rwanda and Kenya at the end of 2023 were 5.7 and 6.5 percent, respectively (Figure 4).

Moreover, Ethiopia experienced one of the highest food inflations among Eastern African countries. Food inflation across Eastern Africa averaged 17.3 percent as of September 2023 (World Food Project, 2023) while the comparative figure for Ethiopia was a staggering 26.1 percent. A comparison of the inflation rates in Ethiopia to the inflation rates in some SSA countries and other regions is given in Figure 4.

Inflation has been one of Ethiopia's main macroeconomic issues over the last decade. Several internal and external factors were shown to be the main causes of inflation in recent

studies. Supply-side shocks like droughts, violence, and internal conflicts that continue to disrupt the supply chain are inflationary (Degye et al., 2022; Deloitte, 2023). Of note is the monetary financing of deficits, particularly the growing government borrowing from the National Bank of Ethiopia (NBE) (direct advances) (Figure 12). Such monetization of deficits significantly increased inflationary pressure because there has not been commensurate growth in production and productive capacities. Perhaps, due to a series of internal and external shocks Ethiopia faced in recent years, fiscal and monetary policies were relaxed to address and respond to the situation (NBE, 2023).

Figure 4: Inflation in Ethiopia and selected countries and regions



Source: Computation based on IMF data[1]

Moreover, the shortage and depletion of foreign exchange reserves, depreciation of the birr, widening of premiums in the black markets that exceeded 100 percent, and the attendant pricing of imports at the parallel market rate, which has led to expensive imports, have contributed to the inflationary pressure. Though it is easing recently, evidence also shows that cost-push factors of external origin attributable to a surge in world fuel, fertilizer, and food prices have also contributed to the high inflationary pressure in the country (NBE, 2023). Perhaps, on account of its net importer status, Ethiopia was particularly vulnerable to imported inflation (Deloitte, 2023).

The high inflationary pressure in Ethiopia is the cumulative effect of the public-investment-driven growth model, heavy reliance on domestic borrowing, monetization of deficits, and loose monetary and fiscal policies implemented in the recent past and now (UNDP, 2024), imported inflation, supply-side shocks and imprudent policies used by the government to combat the inflationary pressure. In general, an assessment by the NBE (2023) suggests that

[1] The data is available at: https://www.imf.org/external/datamapper/PCPIE_PCH@AFRREO/SSA/OEXP/OIMP

Ethiopia's recent inflation surge is due to supply-side factors, cost-push factors such as external shocks, and expansionary fiscal/monetary policy.

Inflation is still high because most government initiatives aimed at reducing inflation have proven to be largely ineffective. The nation's high rate of inflation is a sign of an unstable and unsteady macroeconomic environment. The government of Ethiopia has taken several measures to combat inflation. The measures include Sunday markets that connect producers and consumers directly, the Franco Valuta scheme, subsidies to essential consumables, and tighter monetary policy put in place since August 2023, among others.

Recently, to combat inflation with its limited monetary policy tools, the National Bank of Ethiopia (NBE) introduced a tighter monetary policy in August 2023. The monetary policy measures put in place to reduce inflation include limiting the growth of bank credit to the private sector at 14%, reducing NBE's direct advances to the government to one-third of the prior-year level, and raising the interest rate of NBE's emergency lending scheme from 16 to 18 percent. While the impact of the latest policy measure is yet to be seen, measures taken by the government to lower inflation so far remain largely ineffective.

The high inflation, particularly for essential food and non-food items, will continue to worsen the poverty and food insecurity situation of the population. For East African nations, Deloitte's (2023) review associates inflationary pressures with high cost of living and declining consumer demand in the region. An inflation rate that remains stubbornly high suggests a high cost of living for Ethiopians. The stubbornly high inflation continued to affect many Ethiopians' welfare and level of poverty. In particular, the country's significant domestic food price inflation has made matters worse for those who are net consumers of food, food insecure, and for the bulk of people working in the government and unprotected self-employment sectors, whose wages have been fixed. A study by the UNDP (2022) examined the impact of rising inflation on household purchasing power and poverty headcount rates. Evidence from a simulation analysis suggests that the rising inflation in the post-2020 period was found to harm households' purchasing power. Poverty has risen in Ethiopia due to the rising cost of living, especially for food. The investigation suggested that rising poverty has affected urban and war-torn areas the most. Moreover, according to Afrobarometer (2024), Ethiopians reported increased poverty levels and worsening economic conditions in 2023 compared to 2020.

Ethiopia continues to grapple with high inflation. The most recent figures indicate a slight slowdown compared to earlier quarters of 2023. The most recent monetary policy measure issued by the NBE in August 2023 foresees to control inflation through a combination of limiting credit expansion by commercial banks and government borrowing from the NBE. Though forecasts are uncertain, inflation is expected to slow down in the future. However, the outlook for the future depends on the efficacy of the newly introduced monetary policy measure, global price developments, and the magnitude of depreciation of the birr. It also depends on success in securing foreign currency to improve the official foreign exchange reserves, and whether domestic supply chain disruptions linked with conflicts and other shocks are addressed, among others. Given the fact that inflation is driven by a myriad of factors, it is highly likely that the inflation rate will remain in double digits.

4. Public Debt

Key facts and figures

Ethiopia's public sector debt stock stood at USD 63.2 billion, representing 38.7% of the GDP as of September 30, 2023. *In terms of composition, it was made up of USD 35.5 billion in domestic debt (21.7% of GDP) and USD 27.7 billion (17% of GDP) in external debt.*

At $588.5, the average Ethiopian has a significant and increasing per capita debt burden.

When examining the external debt by the lending entities, official creditors hold 82% of the total debt. The remaining 18% of the debt is owed to private creditors.

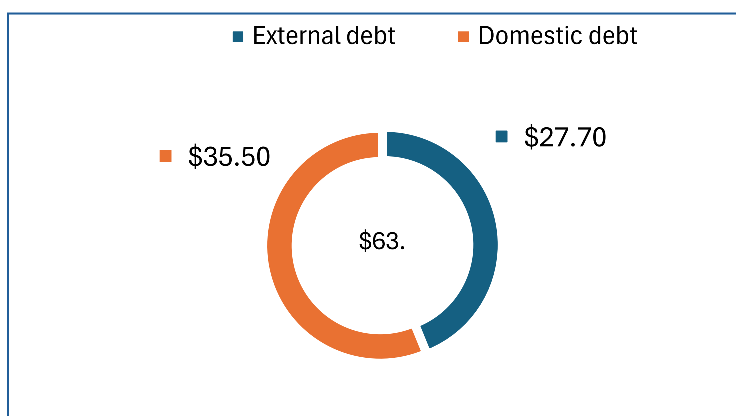
Quarterly, the debt service to export ratio has declined from 54.6% in the fourth quarter of the last Ethiopian fiscal year to 36.8% in the review quarter.

The debt service to export ratio is considerably high and persistently remained above the IMF threshold level to consider the country's debt repayment status at moderate or low-risk status.

a. State of Ethiopia's Public Debt

Ethiopia is at a high risk of (external) debt distress. High debt levels raise concerns about debt sustainability. Public debt in the country increased significantly over the last decade. Ethiopia's public sector debt stock was USD 63.2 billion as of September 30, 2023, representing 38.7% of GDP. In terms of composition, it is made up of USD 35.5 billion in domestic debt (21.7% of GDP) and USD 27.7 billion (17% of GDP) in external debt. This falls short of the low-income countries' debt sustainability requirements, which are set at 40% for external debt and 55% for total public sector debt. Examining the quarterly change, the total public sector debt increased marginally by 0.05 percent on September 30, 2023, from USD 63.1 billion in June 30, 2023, to USD 63.2 billion. This can be attributed to the fact that external debt decreased by 1.2 percent although domestic debt rose by a meager 1.07 percent (Figure 5).

Figure 5: Ethiopia's public debt stock ($billion), QI, Jul-Sep 2023



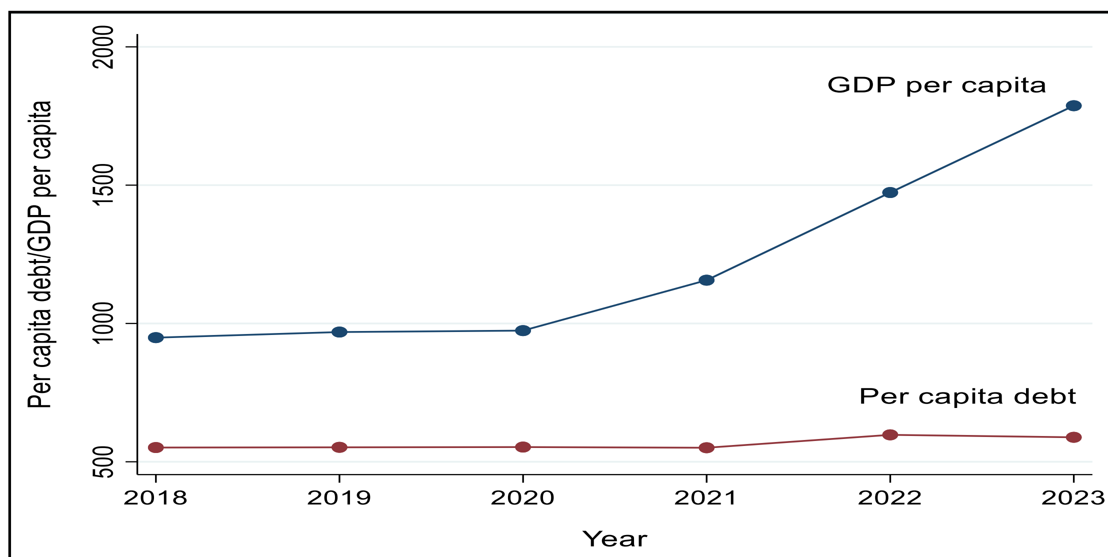
Source: Computation based on data from the Ministry of Finance

Compared to Ethiopia, Kenya had a debt-to-GDP ratio of 70.2%, which is far greater. In the same quarter, the ratio of external debt to total debt in Kenya was 54.3 percent, while the proportion of domestic debt to total debt was 45.7 percent in Kenya[2]. Moreover, Ethiopia's debt-to-GDP ratio is also relatively small compared to low-income developing countries. At about 88 percent of GDP in 2022, the latest IMF's Global Debt Monitor report shows that the level of debt in low-income developing countries was extremely high. However, this seemingly lower debt burden for Ethiopia can be significant considering the difficulties in effectively managing its debt in the face of high inflation, currency depreciation, stagnant export earnings, and limited foreign exchange generation capacity of the economy. Given the status of government revenue and foreign exchange generation capacities, external debt servicing has become onerous for the country.

The average Ethiopian has a significant and increasing per capita debt burden. Between 2018/19 and the review quarter, the average Ethiopian per capita debt burden has increased by close to 7 percent. In particular, the growth of the domestic per capita debt burden has been significant since 2021/22. The average per capita public debt burden during the review quarter that concluded in September 2023 was $588.5, although the nation's GDP per capita was $1,787. Average Ethiopians per capita debt for the quarter was around 33% of their GDP per capita (Figure 6). Even though it is rising, Ethiopia has a lesser per capita debt burden than Kenya. During the same period, Kenya's per capita debt burden was $1330.6[3].

[2] https://cytonn.com/topicals/kenyas-public-debt-5
[3] It is computed based on data from Kenya's National Treasury and Planning annual public debt management report.

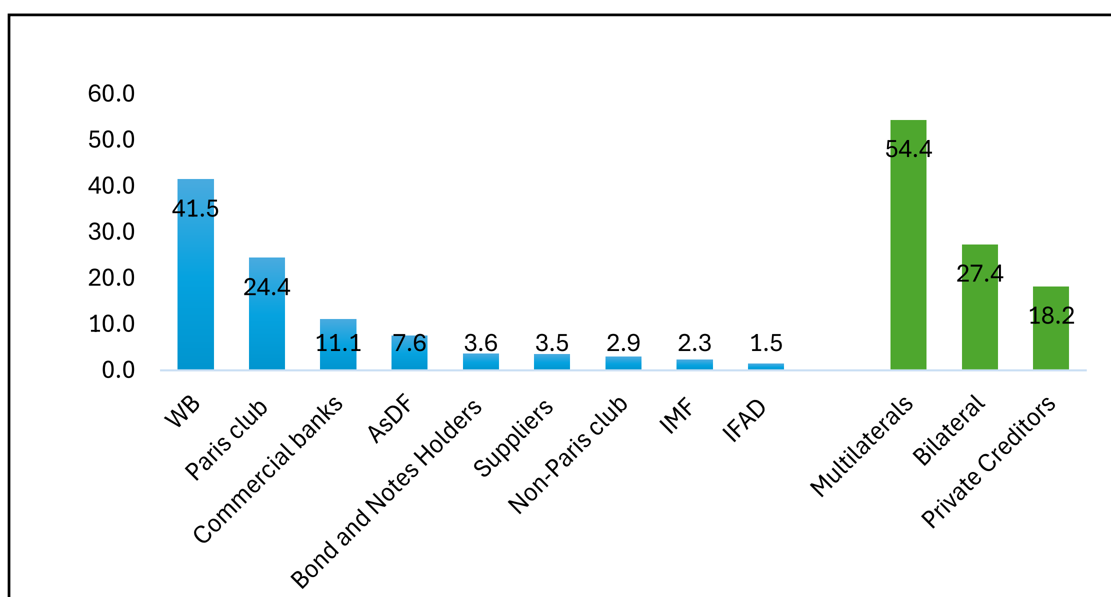
Figure 6: Per capita public debt burden and GDP per capita (current prices), 2018/19-2022/23 and 2023/24, QI



Source: Computation based on Ministry of Finance (MoF) and IMF data

Multilateral, bilateral, and private creditors were the sources of external financing for the government of Ethiopia. In the quarter's review, it was found that 41.5% of the total external debt is owed to the World Bank (IDA), followed by the Paris Club (24.2%) and commercial creditors (11%). When examining the outstanding debt categorized by the lending entities, it is observed that official creditors hold 82% of the total debt. Among them, multilateral donors account for 54.4% and bilateral donors account for 27.4% of the total external debt. The remaining 18% of the debt is owed to private creditors (Figure 7).

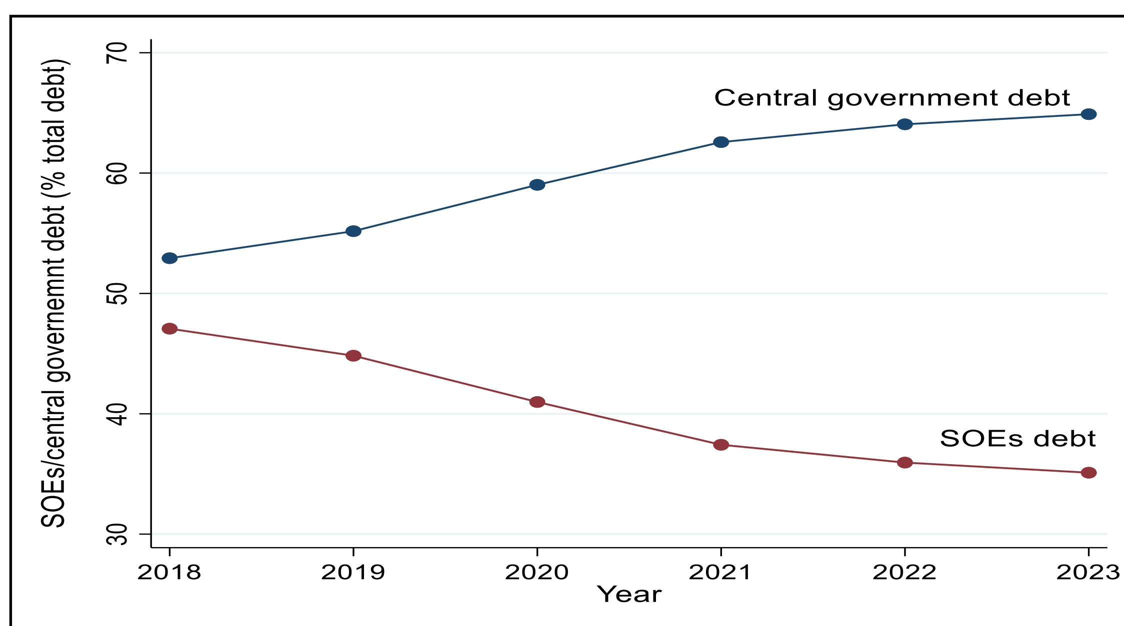
Figure 7: External debt outstanding ($27.7 billion) by lender category, QI, July-Sept 2023 (% of total external debt)



Source: Computation based on MoF data

Several factors have possibly contributed to the rise in the debt burden in the recent past. The government's significant borrowing for financing public infrastructure projects, military spending, and budget deficit has resulted in the mounting debt problem. One of the primary factors contributing to the rise in public debt is the public investment-driven growth model followed by the government that focused on higher public infrastructure investments and state-owned enterprises. Perhaps, the heavy investment projects in infrastructure such as Ethiopian Sugar Corporation, Ethiopian Railways Corporation, and Ethiopian Electric Authority as well as building industrial parks that were part of the growth and transformation plan (GTP) have immensely contributed to the debt burden of the nation. Evidence shows that state-owned enterprises (SOEs) were also the main borrowers both from domestic and external sources. During the review quarter, about 65% of the total debt stock was accounted for by the central government while SOEs accounted for the remaining 35% (Figure 8). In general, as the government has been persistently spending more than it mobilizes revenue, the attendant budget deficit must be financed through borrowing from domestic as well as external sources. Most importantly, the poor export performance, the growing foreign exchange needs, and the resulting export-import gap necessitate external borrowing.

Figure 8: Public debts of SOEs (% total debt), QI, (July - September 2023)



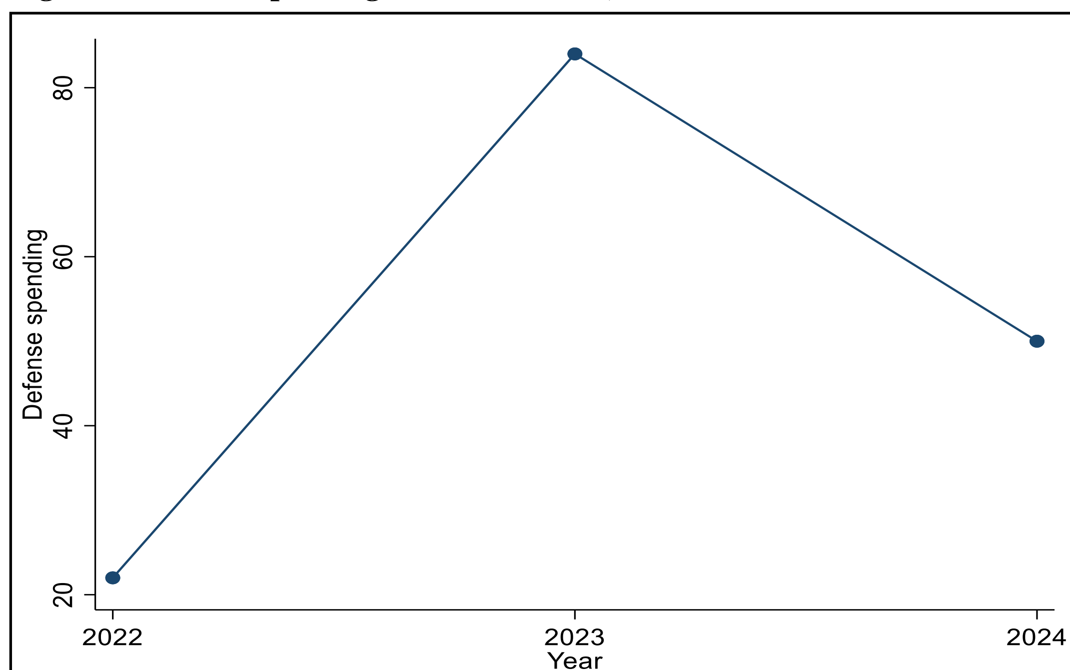
Source: Computation based on MoF data

Despite the heavy borrowing to fund SOEs, some of the large investment projects have not generated sufficient revenue to repay the debt. Even worse, some of the heavy public investment projects, such as the Sugar Corporation, have failed miserably due to inefficient project management systems and other factors. Aside from crowding out the private sector, evidence suggests that some SOEs, for instance, the Sugar Corporation are overburdened with

debt[4]. The failure of some SOEs in generating revenues and servicing their debts suggests the need for improving efficiency in project implementation.

Defense spending along with debt servicing continued to surpass social spending. The mounting debt stock is also the cumulative effect of recent conflicts that increases military spending significantly, putting a strain on the country's finances. Spending on defense has risen considerably during the past four years. Ethiopia spent 127.3 percent more on the military in 2023/24 than it did in 2021/22 (Figure 9). In the 2023/24 approved budget, the four budget lines with the highest allocation were debt servicing, roads, education, and defense. At close to one billion USD (ETB 50 billion), the budget allocated for defense takes fourth place, with an 8.7 percent share (UNICEF, 2023). On the other hand, the budget allocated for social services was only $682.4 million (ETB 37.24 billion) in the same budget year. It appears that part of the explanation for the rising debt burden of the country is due to a spending pattern that prioritizes military spending.

Figure 9: Defense spending (in Billion ETB), 2023



Source: Computation based on MoF data

The Ethiopian government is increasingly relying on domestic borrowing to finance the growing budget deficit. Domestic debt accounts for more than half of the country's public debt. Of the overall debt of the public sector, domestic debt made up 56.2 percent while external debt accounted for 43.8 percent. With external financing options severely constrained, the government is heavily relying on domestic sources and the deficit

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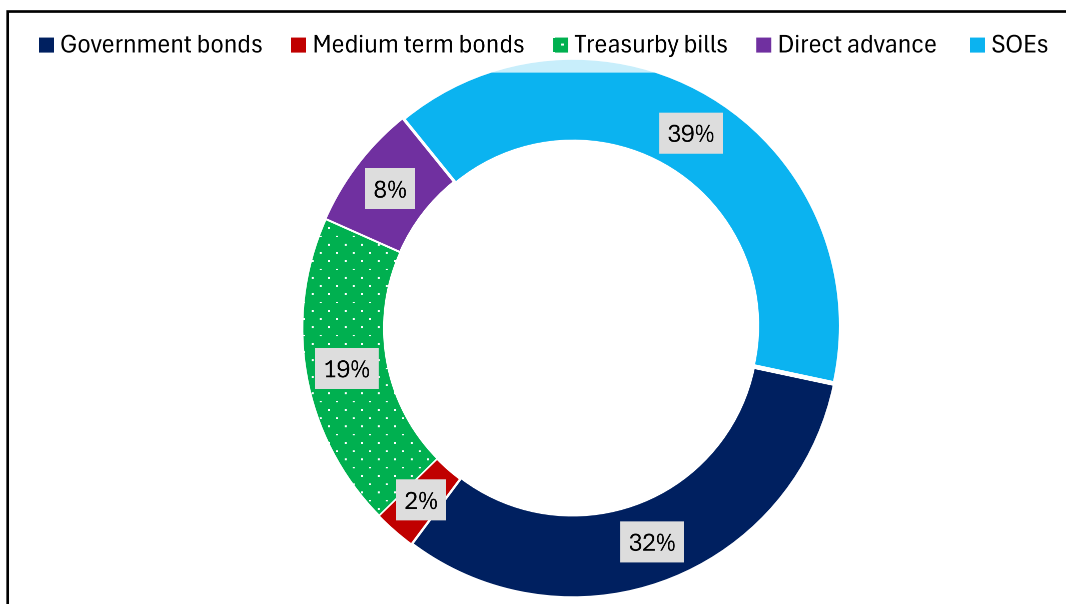
[4] The Commercial Bank of Ethiopia reportedly provided loans equivalent to more than $2 billion for expansion and modernization projects. The latest estimates refer to an additional $2 billion in outstanding external debt contracted by the corporation. Available at https://theconversation.com/why-ethiopias-showcase-sugar-projects-face-huge-challenges-122871

continues to be financed mainly through domestic borrowing. External financing disbursement has generally decreased in the past three years or so (Figure 18). Moreover, evidence from the Ministry of Finance shows that during the quarter (July 1, 2023-September 2023), there were no new loans signed. For this reason, reliance on domestic borrowing has increased during the review quarter. A large portion of the burden of funding the budget deficit was borne by domestic lenders. The government used a combination of Treasury Bills, mostly purchased by pension funds and state banks, Treasury Bonds, which private banks bought in the amount equivalent to 20% of their gross lending, and Direct Advances as the main domestic debt instruments.

Data from the Ministry of Finance shows that the total outstanding treasury bills increased by 8.75 percent to $2.66 billion [ETB 371,768.35 million] during the review quarter, up from $6.2 billion [ETB 341,869.53 million] in the earlier quarter. Borrowing from the central bank stood at $2.66 [ETB 147] billion in the review quarter (Figure 10). Since the stock of domestic debt is already high, it may leave little room for debt to serve as a key source of financing for deficit and development.

Figure 10: Composition of domestic debt outstanding by instrument type (% of the total public domestic debt), QI, (July - September 2023)



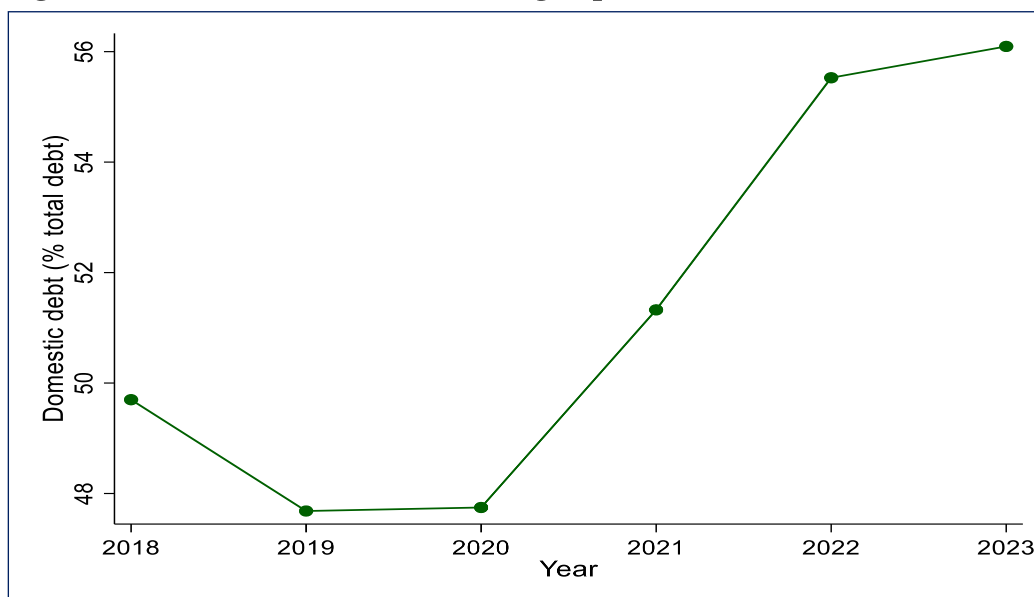
Source: Computation based on MoF data

The structure and size of Ethiopia's public debt appear to reflect its political and diplomatic ties with the West and affiliated international financial institutions. Soaring diplomatic relations with the West and multilateral development partners that intensified in 2020 on account of the conflict in Northern Ethiopia have contributed meaningfully to the decline in foreign financial flows[5] (Figure 18). For instance, according to Reuters, in January

[5] According to Adem's (2021) commentary on Foreign Policy magazine, the relationship between the West and Ethiopia's government is now low(https://foreignpolicy.com/2021/11/10/why-ethiopia-should-trust-the-west/)..

2021, the EU suspended its budgetary support after it accused the federal government of restricting the access of aid organizations to the Tigray region[6]. This has forced the government to rely heavily on domestic borrowing, including borrowing from the NBE with implications for inflation and local currency weakening. As a result, dependence on domestic borrowing has considerably increased in the post-2020 period. In 2020/21, domestic borrowing accounted for 47.7 percent of total public debt. This share has increased to 56.2 percent in the first quarter (July - September 2023), suggesting significant reliance on domestic borrowing (Figure 11).

Figure 11: Share of domestic borrowing in public debt (%), 2018/19-2023/24 (QI)

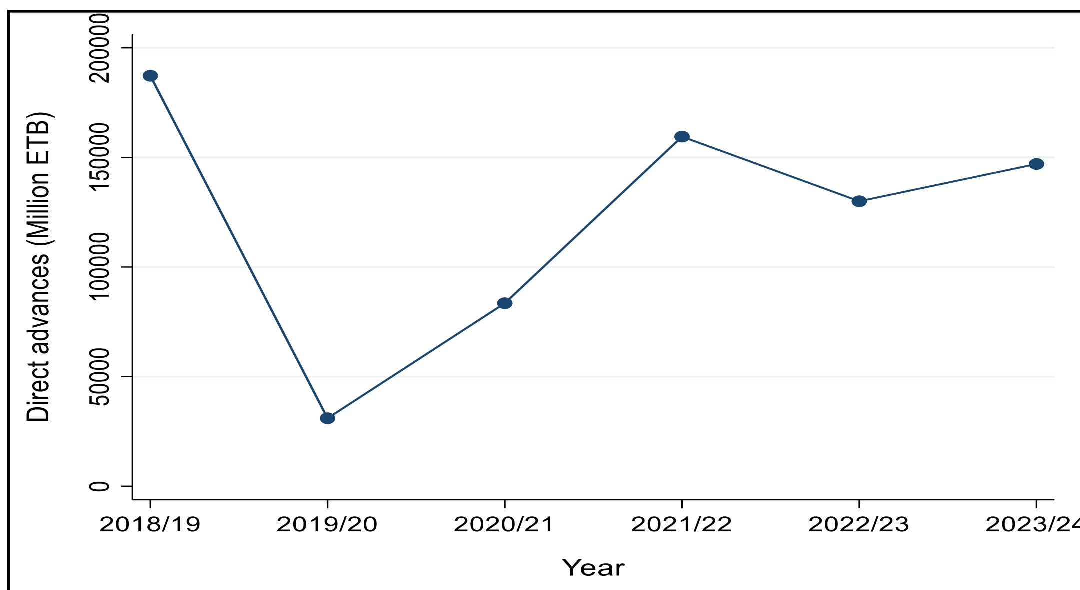


Source: Computation based on MoF data

The magnitude of direct advances (government's borrowing from the NBE) increased dramatically. The government's borrowing from the National Bank of Ethiopia (NBE) increased by 374.2% during the review quarter compared to the pre-war period in 2019/20. When looking at the quarterly change, direct advances increased by 13% from $2.3 billion on June 30, 2023, to $2.66 billion on September 30, 2023 (Figure 12).

[6] Available at: https://www.reuters.com/article/us-ethiopia-conflict-eu/eu-suspends-ethiopian-budget-support-over-tigray-crisis-idUSKBN29K1SS/

Figure 12: The trend of direct advances (Government borrowing from the NBE), million ETB



Source: Computation based on MoF data

To finance its military spending and handle the worsening fiscal position due to the decline in foreign financial flows following the conflict, the government resorted to substantial domestic borrowing. In fact, before slowing down in 2023/24, the amount of domestic debt owed by the central government increased significantly between 2020/21 and 2023/24. On average, the central government's debt grew by more than 19% annually during this period. Such borrowings may fuel inflationary pressure. To ease the inflationary effect of deficit financing through heavy domestic borrowing, it is advisable to mobilize higher domestic revenue and renew ties with development partners to increase foreign aid flows, at least, closer to the level attained in the pre-2020/21 period. This will also be critical in resorting to a non-inflationary means of financing deficit and expanding fiscal space.

Amid dented external official funding, there has been an overreliance on Bank advances and Treasury Bills to finance the budget deficit. Perhaps, the government has tried to manage the growing budget deficit with the domestic resources at its disposal. However, deficit financing through domestic borrowing, particularly direct advances, is often inflationary and may crowd out private investment. The rise in the amount of national debt that is accounted for by the central government correlates with inflation. In particular, the inflationary pressure was higher in 2021/22 and 2022/23 when the government's domestic debt growth peaked. Perhaps borrowing from the central bank is usually considered a last resort due to the potential inflationary risks in a country with limited growth of productive capacity. Moreover, monetization of the deficit through direct advance, which implies money printing by the NBE, contributed to currency depreciation and the rising domestic debt of the government. In contrast, deficit financing that relies more on Treasury Bills (bought mainly by the state bank and pension funds), and Treasury Bonds (purchased by private banks in amounts equal to 20% of their gross lending) would be key to reducing inflation.

b. Ethiopia's Debt Sustainability Analysis

Ethiopia is at high risk of debt distress. Concerns about long-term debt sustainability arise due to high debt levels, limited debt servicing capacity, and dwindling foreign exchange earnings. The current public debt to GDP ratio of 38.7% is lower than IMF's debt sustainability requirements for low-income countries, which are set at 40% for external debt and 55% for total public sector debt. There is debt liquidity rather than a solvency problem. Although Ethiopia's solvency is not at risk given the present ratio of its total debt stock to GDP, Ethiopia's risk rating is high in terms of external debt sustainability.

There is a risk embedded in the external debt service to export and debt service to revenue ratios. Given the problem of liquidity in the country, external debt levels are high, raising concerns about repayments. The present value of the external debt-to-export ratio of 199% is significantly higher than the 180% threshold. The external debt service to export ratio reached 36.8% during the review quarter. Though it decreased from 54.6% in the previous quarter, this is above the threshold requirement of 15%. Due to the decline in the stock of external debt disbursements related to the significant drop in external loans, according to UNDP (2022), the debt service to exports ratio has fallen in the past two years. Notwithstanding this, it is still above the required threshold to improve the classification to moderate or low-risk status.

Additionally, at 32.7%, the other key indicator of the country's liquidity, the external debt service to revenues ratio, is above the IMF recommended threshold of 18 percent (Table 3). This indicates that about 33 percent of the government's revenue is devoted to servicing debt, leaving limited fiscal space for other key activities, such as social protection programs, public investments, roads, etc. The existing liquidity indicators (debt service to export ratio and debt service to revenue ratio) breached the recommended threshold in the last IMF's debt sustainability analysis (DSA). Table 2 shows the debt sustainability thresholds used for assessing Ethiopia's external debt sustainability.

Table 2: Debt sustainability analysis indicators

Indicators	Ethiopia (%)	Thresholds (%)
Present value of total public debt to GDP	34.9	55
Present value of external debt to GDP	13.1	40
Present value of external debt to exports	199	180
External debt service to exports	36.8	15
External debt service to revenues*	32.7	18

Note: *Due to a lack of revenue data for the quarter, the external debt service to revenue ratio statistics is based on the available figure for 2022/23

Source: Computation based on MoF data and International Monetary Fund, Article IV 2019

The rising public debt has raised concerns over its sustainability and implications for fiscal and overall macroeconomic stability. Concerns have been raised over whether the government would be able to pay back the external debt as the nation failed a $33 million interest payment on its $1 billion Eurobond in December 2023 and the USD 1 billion Eurobond is due to mature on December 11, 2024. This is because the country's nearly $28 billion external debt must be paid in foreign currency, placing more pressure on the public debt situation, which is already worsening due to high fiscal deficits and the significant depreciation of the local currency over the past six years, which has decreased by roughly 58% relative to its value in 2019/20.

Government spending prioritized debt servicing over social spending with implications for investments in welfare and social protection programs. The 2023/24 budget proclamation prioritizes the repayment of public debt above all other expenditures. The analysis of the budget shows that the share of the government budget that goes toward financing debt climbed from 22.3 percent in 2022–2023 to 27.8 percent in 2023–2024. For instance, between 2019/20 and 2022/23, on average, Ethiopia has paid over $1.96 billion annually on external debt servicing. The budget needed to pay down debt is rising because of the growing budget deficit brought on by higher defense expenditures and emergency response/humanitarian assistance for population hit by shocks like drought and violence. This increasing expenditure burden has resulted in increased borrowing, pushing the economy into a high risk of debt distress (UNICEF, 2023).

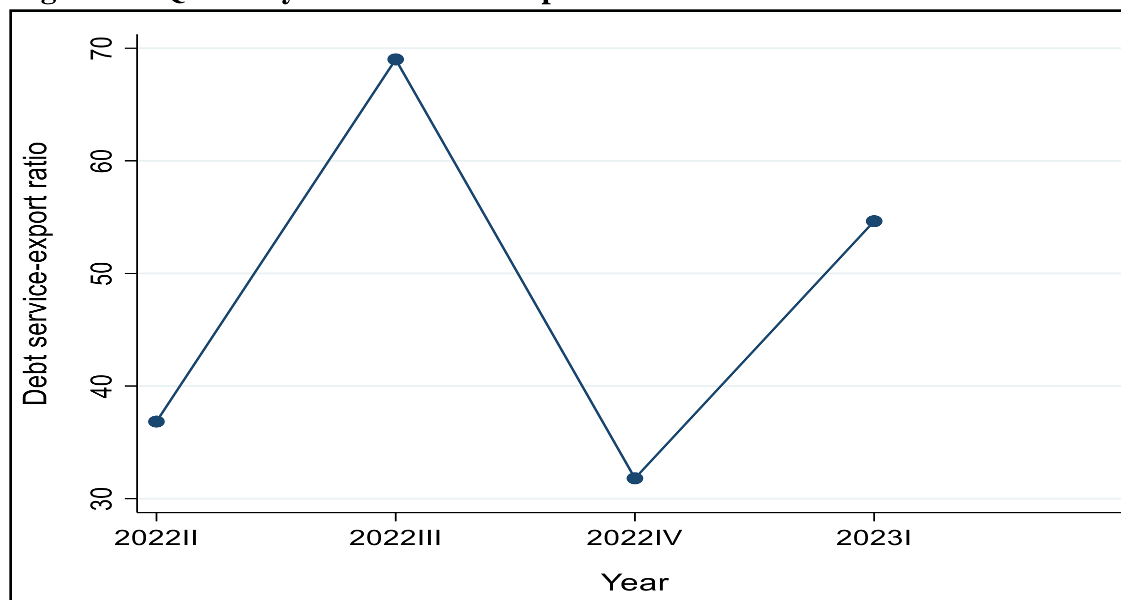
Table 3: Debt servicing by quarter (million USD)

	Principal	Interest	Total debt service
QII Oct-Dec 2022	296.95	97.51	394.46
QIII Jan-Mar 2023	206.40	71.42	277.82
QIV Apr-Jun 2023	415.79	125.12	540.91
QI Jul-Sep 2023	242.69	64.27	306.96

Source: Ministry of Finance

Looking at the debt servicing during the review quarter, the country has paid close to $307 million on external debt servicing. About 79% of the total amount was paid in principal while the remaining balance covered interest and fees associated with servicing the external debt. Around 54% of the debt was paid by state-owned enterprises, and the central government paid the remaining 47%. During the review quarter, the amount spent on debt servicing was $234 million lower than the amount spent in the previous quarter (Table 3). It is anticipated that there will be a further decrease in the upcoming quarters due to the decision made by the Official Creditor Committee (OCC) under the Paris Club to suspend the payment of government-guaranteed debt, including both the principal and interest, that is owed to OCC members. This suspension is slated to take place between January 2024 and December 2025.

Figure 13: Quarterly debt service to export ratio



Source: Computation based on MoF and Ethiopian Customs Commission data

The growing liquidity problem facing the country is portrayed by the high quarterly debt service to export ratio. This suggests that a larger proportion of the country's export earnings are going towards servicing external debt, which can limit resources available for import spending and improving the foreign exchange reserves. The debt service to export ratio has declined from 54.6% in the fourth quarter of the last Ethiopian fiscal year to 36.8% in the review quarter (Figure 13 / Table 4). Notwithstanding this, the ratio is considerably high and persistently remained above the IMF threshold level (15%) to consider the country's debt repayment status at moderate or low-risk status (Figure 13).

Table 4: Debt service to export ratio by quarter

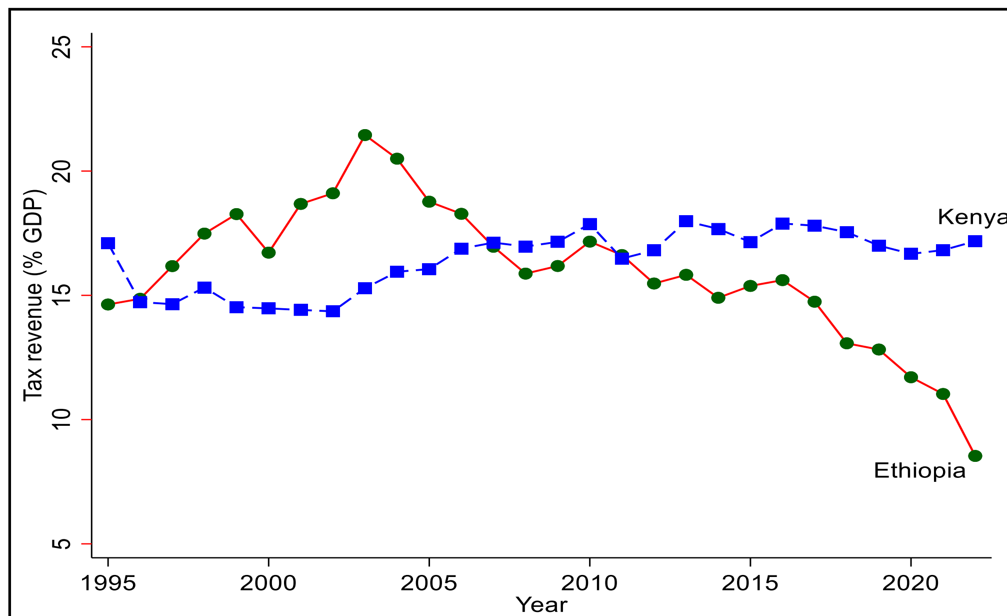
	Debt service (Million USD)	Exports (Million USD)	Debt service to export ratio (%)	IMF threshold (%)
Oct-Dec 2022	394.46	571.6	69	15
Jan-March, 2023	277.82	873.5	31.8	15
April-June, 23	540.91	990.0	54.6	15
July-Sep. 2023	306.96	833.1	36.8	15

Source: Computation based on MoF and NBE data

Ethiopia is facing difficulty paying off its external debts due to a growing liquidity problem. There is evidence that during different points in time, the inflow of foreign resources is significantly less than the outflow of external debt. For example, because the total debt service payment (principal and interest) exceeded the disbursement for the quarter, the net resource transfer was negative for the review quarter. In other words, a net resource transfer of USD -155.25 million was made by the country when the principal and interest payments were

deducted from the disbursements made by creditors of external sources (inflow). More recently, Ethiopia failed to make a $33 million interest payment on its $1 billion Eurobond in December 2023. It became the third African country following Zambia and Ghana to default on its international debts. Consequently, Ethiopia has been categorized as being at a high risk of debt distress. Fitch Ratings downgraded the country's credit rating to 'C' and the Eurobond to 'restricted default' after a grace period expired for a payment due on December 11, 2023, due to the high risk involved in external debt repayment. For this reason, the country must negotiate its external debt servicing obligations, create fiscal space for development, and reduce pressure on external accounts[7].

Figure 14: Tax revenue (% GDP)



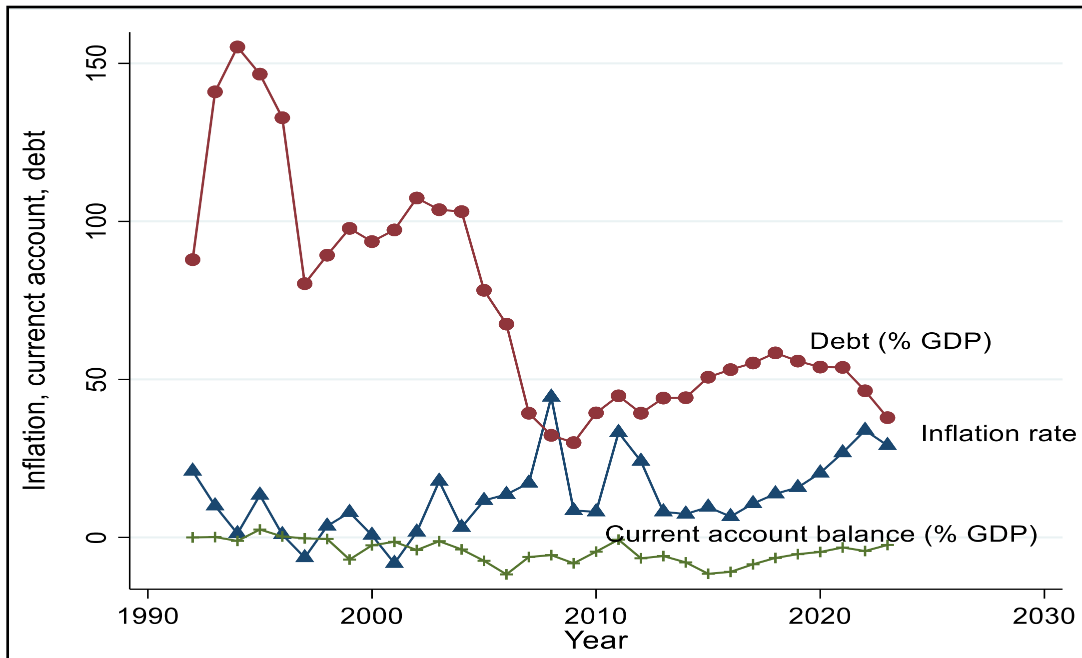
Source: Computation based on IMF data

In general, the country's rising debt problem is due to persistent current account deficits resulting from poor export performance and increased spending on imports (Figure 15). Moreover, it was due to a significant fiscal deficit. Ethiopia's fiscal deficit was 2.9% of GDP in 2023. Faced with the significant resource gaps [export-import and revenue-expenditure], the nation's (public) investment and growth have been financed mainly through domestic and external borrowing. Moreover, the tax-to-GDP ratio of the country is insufficient to support essential spending and fiscal sustainability, let alone finance growth-enhancing investments. At 8.53%, the tax revenue to GDP ratio is lower than its SSA peers such as Kenya (17.18%) (Figure 14). For this reason, during the current fiscal year, the government plans to cover 40%

[7] There have been discussions with the G20 on possible debt restructuring under the Common Framework to reduce debt vulnerabilities (UNDP, 2022). Moreover, since Ethiopia is a G20 DSSI eligible country that has signed a Memorandum of Understanding with the Paris Club Secretariat on DSSI related to Paris Club Countries and Non-Paris Club Countries, was not required to make any external debt service payments to its bilateral creditors of central governments following the G20 DSSI during the period (May 1, 2020 - June 30, 2021). It has suspended the central government's external debt service obligations to its bilateral creditors, which amount to USD 216.0 million, as a DSSI-eligible country (Ministry of Finance, 2023).

of its budget through domestic borrowing and 10% through external borrowing. The debt distress, which is one of the key macroeconomic challenges, may signal that the limit to the public debt-induced growth model followed by the country is already reached. Thus, there is a need to balance development financing and debt sustainability in Ethiopia, so that public debt shall be maintained at the right level.

Figure 15: Current account deficit, public debt, and inflation



Source: Computation based on IMF data

5. Exchange Rate Developments

Key facts and figures

The exchange rate of the birr against major currencies is weakening and highly misaligned.

The Birr has depreciated nearly by 58% between June 30, 2020, and September 30, 2023.

The local currency has depreciated by 19.3 percent annually over the past three years.

The gap between the official and parallel market exchange rates has persisted over the past several years and has gradually widened to over 100%.

The issue of foreign exchange shortages has recently worsened due to a significant decline in foreign financial flows such as official development assistance and remittances over the past few years.

The exchange rate of birr against major currencies is not only weakening but also highly misaligned. Ethiopia's currency continued to be weak against major currencies. Looking at the yearly evolution of the exchange rate, the birr has depreciated nearly by 58% between June 30, 2020, and September 30, 2023. This suggests that the local currency has been depreciating by 19.3 percent on an annual basis. The exchange rate has risen from ETB 53.6 to 55.2 per dollar between January and September 2023 (Figure 16). Moreover, the exchange rate remains misaligned as depicted by the large gap between the official and black-market exchange rates. Data from the review quarter shows the official market rate for the birr was 55.2 per dollar, while the parallel market traded, on average, at over 112 birr per dollar (Table 5). This gap discourages using official market channels for currency exchange in the country.

Table 5: Exchange rate in the official and parallel market

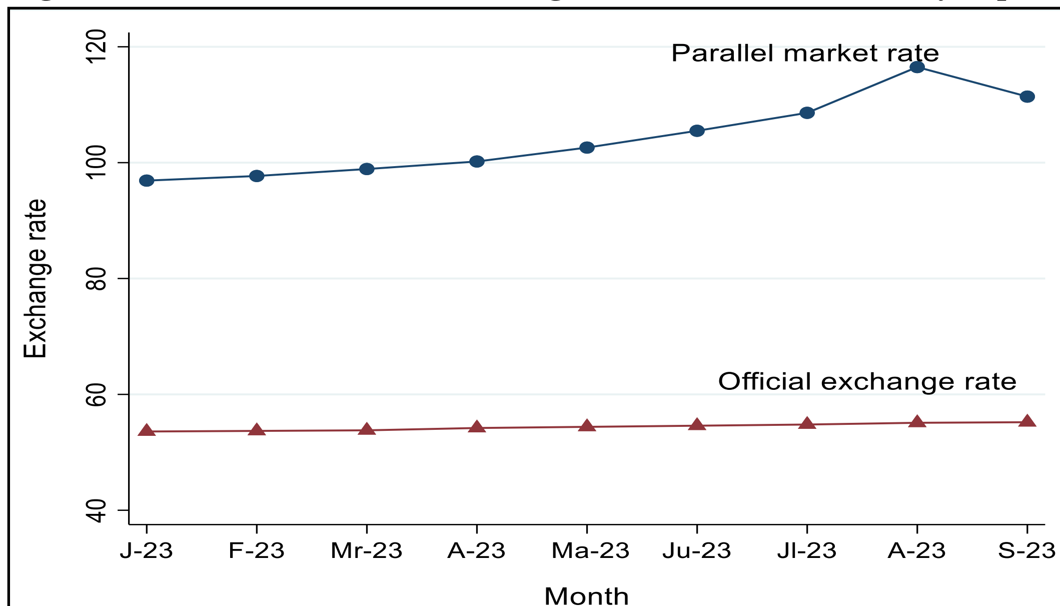
	June 30, 2020, QIV	30-Jun-2023 (QIV (A)	30-Sep-2024 (QI) (B)
Official Exchange rate	34.98	54.59	55.22
Parallel exchange rate	44.3	102.8	112.2
Black market premium	9.32	48.2	56.97

Source: Computation based on MoF, https://www.exchangerates.org.uk/USD-ETB-spot-exchange-rates-history-2023.html and https://ethioblackmarket.com

The high exchange rate misalignment is one of the biggest distortions harming the nation's economy. The exchange rates in Ethiopia's official and parallel foreign exchange markets are now significantly diverging. The gap between the official and parallel market exchange rates has persisted over the past several years and has gradually widened to over 100% in recent months. Table 5 indicates a rise in black market premium from ETB 9.32 only on June 30, 2020, to ETB 48 on June 30, 2023, to a staggering ETB 57 in the review quarter

(Table 5 and Figure 16). The main causes of the parallel premium are rising demand for foreign currency for import expenditures, the acute shortage of foreign exchange in the formal sector and critical depletion of foreign exchange reserves, prioritization of external debt servicing by the government, and declining confidence in Ethiopia's (formal) economy.

Figure 16: Official and Parallel Exchange Rates (Birr/USD), January-September 2023

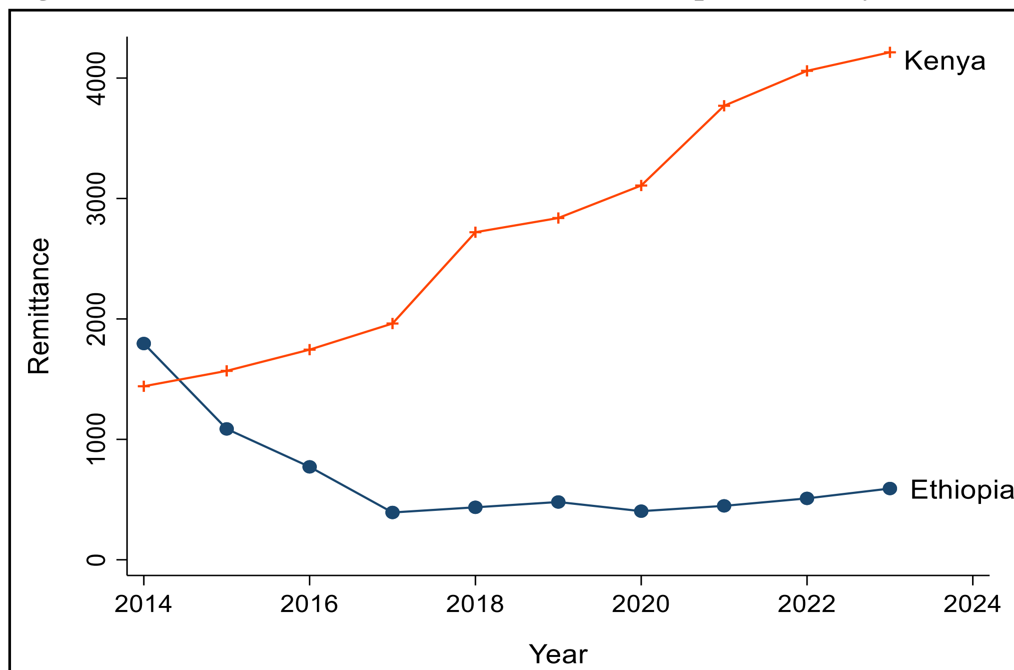


Source: Computation based on https://www.exchangerates.org.uk/USD-ETB-spot-exchange-rates-history-2023.html and https://ethioblackmarket.com

The Ethiopian birr has seen a significant depreciation against the US dollar and other major currencies in recent times. Studies identified several contributory factors to the ongoing depreciation of the local currency. The major ones include increased imports to the country, high and rising demand for foreign currency (US dollar) (Deloitte, 2023), acute shortage of foreign currency, depletion of foreign exchange reserves, loose monetary policy, and monetization of deficits (printing of money). All these have contributed to the weakening of the birr against major foreign currencies.

Although Ethiopia has been facing foreign exchange shortages for a long time, the issue has recently worsened due to a significant decline in foreign financial flows (remittances, foreign aid, export earnings) over the past few years. An important factor that adds a strain on foreign exchange availability has been the considerable drop in remittance inflow through official channels. Many remittance providers transfer foreign currency using channels outside the formal banking system. Ethiopians living abroad send foreign currency to intermediaries who pay their chosen recipient in Ethiopia with local currency at the black-market rate. Figure 17 shows the clear divergence in the magnitude and growth of remittance to Ethiopia and Kenya after 2016. In the post-2016 period, Ethiopia has experienced a significant decrease in the amount of remittance inflow through the banking system while Kenya's remittance has been growing rapidly.

Figure 17: Remittance flow (USD million) to Ethiopia and Kenya (2014-2023)

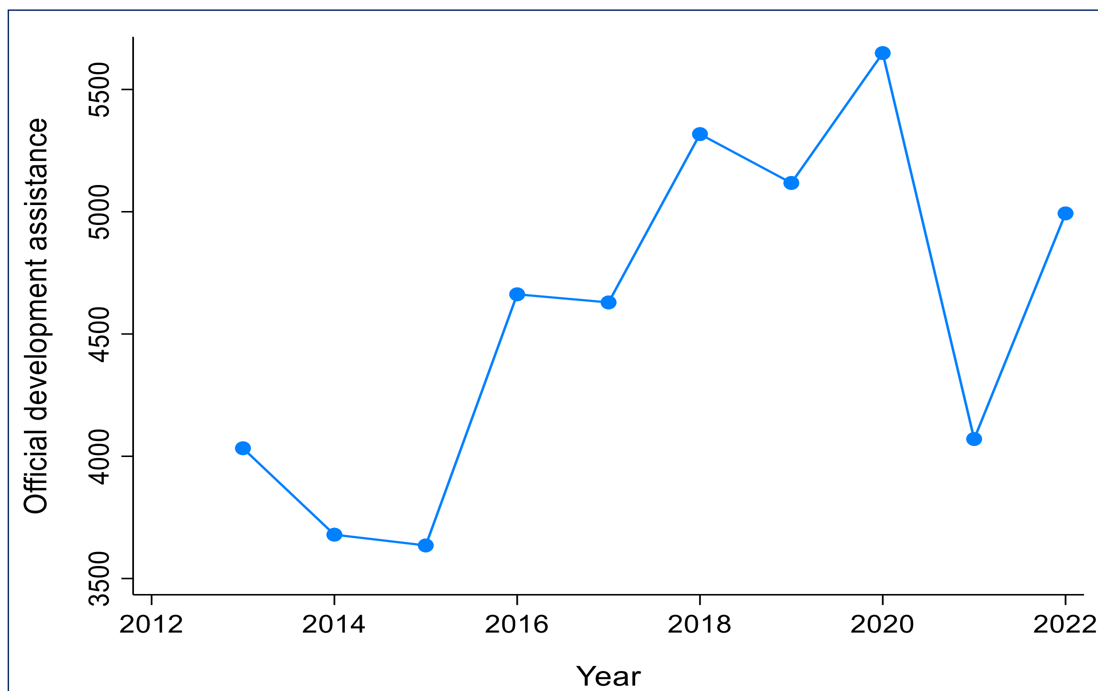


Source: Computation based on KNOMAD data

Some of the explanations for the foreign exchange shortage are also linked to the cumulative effect of the lower external financial flows. In particular, the conflict that broke out in northern Ethiopia in 2020 has led to a considerable reduction in the size of foreign aid and loans from bilateral and multilateral sources, foreign direct investment inflows, tourism, etc. For instance, official development assistance (ODA) inflows have declined significantly in recent years. In 2020, ODA received amounted to $5.6 billion, which decreased to $4 billion in 2021 and then increased again to $4.9 billion in 2022. However, this is still lower than the amount received in 2016/17 (Figure 18). FDI in Ethiopia has been declining in the last three years. For instance, it was estimated to decrease by 13% in 2023, from USD 4.2bn in 2021. The drop in FDI is possibly linked to internal conflicts and foreign exchange shortages considering the difficulty in convertibility of the Ethiopian birr (Deloitte, 2023).

The shortage of foreign exchange is also associated with the weakening export performance as indicated by the tiny size and sluggish growth of export earnings, the continuous increase in import expenditure, and the resultant growth of the trade deficit (Figure 19). The current account deficit widened from $4.5 billion in 2021 to an estimated $5.9 billion in 2023 (Deloitte, 2023). Data from the Ethiopian Customs Commission indicate that total export proceeds declined by about 16 percent from $990 million in the fourth quarter of 2022/23 to $833 million during the review quarter. Moreover, large government imports, including fuel, machinery, and food items are additional factors that further strain the depleting foreign exchange reserves.

Figure 18: Trend of official development assistance (ODA) disbursements (US dollars, millions)

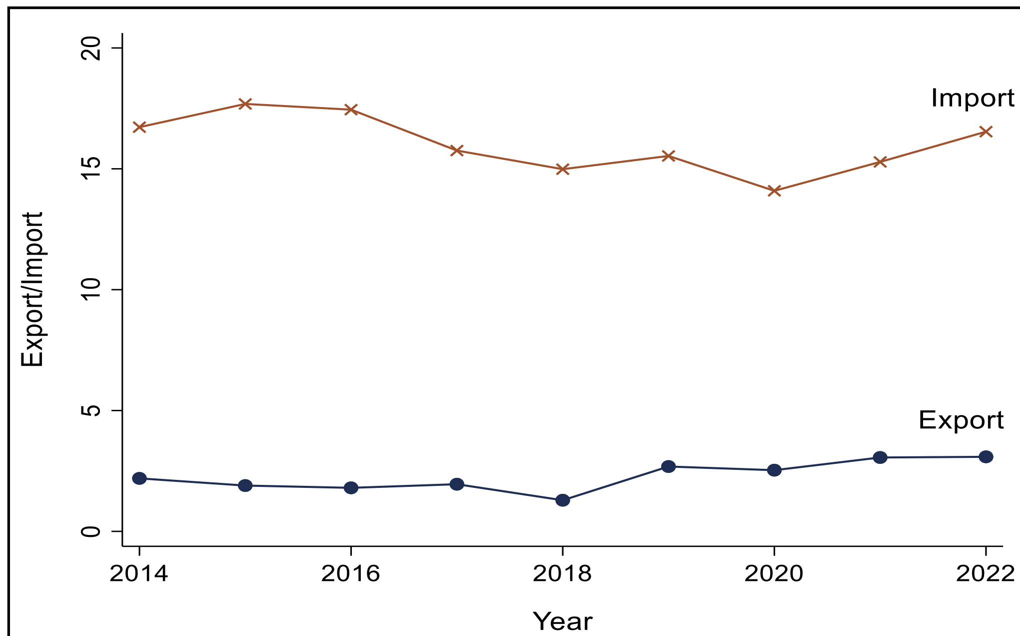


Source: Computation based on OECD data

World Bank's data show that Ethiopia's total reserves were sufficient for two months of imports in 2020. During the review quarter, however, anecdotal evidence suggests that the country's foreign currency reserves amount to approximately $0.9 billion, which is sufficient to cover only 0.7 months (21 days) of imports. This is significantly lower than the traditional rule of thumb for foreign exchange reserves, which are commonly set at 3 months of imports. On the other hand, Kenya's official foreign exchange reserves stood at $6.5 billion in May 2023, sufficient to cover 3.6 months' worth of import cover (Deloitte, 2023). The critically low foreign currency reserves are creating pressure in the foreign exchange market and widening the black-market premium. This may pressure the government to seek alternative funding and exchange rate mechanisms and regimes.

The continuous depreciation of the local currency against major currencies leads to higher inflation rates since the country heavily relies on imports of crucial items such as cooking oil, fuel, and other inputs (Deloitte, 2023). Moreover, the huge divergence in the official and black-market rates is contributing further to higher commodity prices. Since importers are using the black market to obtain foreign exchange, in most cases, imports are priced at the black-market/parallel exchange rate. Such traders who acquire foreign exchange from the parallel market at inflated costs raise prices to maintain their profit margins. The depreciation of the birr against major currencies and the huge black-market premium are contributing to the upward trend in prices across the market and remain important in fueling inflationary pressure. This suggests that the economy is distorted and needs to be addressed.

Figure 19: Trend of export revenue and import (billion USD), 2014-2022



Source: Computation based on World Bank's World Integrated Trade Solution

It appears that the depreciation of the local currency along with limited and falling foreign exchange reserves remain significant risks in fueling the inflationary pressure. One of the main issues is the misalignment of the exchange rate. However, simply devaluing the currency or letting the market force a depreciation may not solve the problem due to the complex and deep-rooted causes of the foreign exchange shortage and currency depreciation. Furthermore, devaluation or market-induced depreciation can lead to inflation and may cause more harm than good. Previous attempts to weaken the birr through policy or market forces have not been effective, leaving the government with limited options.

To address the foreign exchange shortage, in the short term, improving external assistance and grants, at least, to the level where it was between 2018-2020 is crucial. This can be realized through negotiations and building strong relationships with multilateral funding organizations and improving ties with development partners is vital to reverse the critical depletion of foreign exchange reserves. In the medium-to-long term, policy measures such as increasing the value and diversity of exports and improving local production capacity to reduce import dependency may be necessary to generate more foreign exchange revenue and improve the foreign exchange reserve of the country. Implementing devaluation or allowing free market-induced exchange rate depreciation and/or aligning the official rate with the black-market exchange rate may further worsen the problem, and hence should be avoided, at least, for the present.

6. Concluding Remarks

The Ethiopian economy is facing several challenges that are impacting its macroeconomic stability. Over the past few years, the economy has shown signs of vulnerability and an accumulation of risks that have recently worsened. High debt burden and external debt servicing, continued depreciation and misalignment of the exchange rate, shortage of and dwindling foreign exchange reserves, high and rising inflationary pressure, and limited fiscal space are a few of these.

Inflation in the country has remained persistently high, at 28.4% during the review quarter, reflecting the combined impact of the conflicts, currency depreciation, exchange rate misalignment, monetary financing of deficits, drought, and global developments. Non-food inflation remained high relative to food inflation due to the high inflation in housing and utilities, health, clothing and footwear, and hotels and restaurants, among others.

Most of the policy measures and initiatives aimed at reducing inflation have proven to be largely ineffective. Unless controlled, the high inflation, particularly for essential food and non-food items, will continue to worsen the poverty and food insecurity situation for consumers of food and vulnerable populations. Moreover, aside from its welfare consequences, it has implications for the fiscal position of the government. As the government is undertaking multiple investments in the country, inflation tends to affect public finances and may aggravate the fiscal imbalance.

Along with effectively implementing the recent monetary policy measure taken by the NBE, boosting domestic production and productive capacities, addressing internal conflicts, reducing domestic borrowing particularly direct borrowing from the NBE, cutting military spending, and correcting the exchange rate misalignment are some of the measures at the heart of addressing inflation and the overall macroeconomic problems facing the country. Since internal violence and conflicts have been observed to fuel inflation, the government and other concerned bodies need to resolve the problem.

Ethiopia faces serious problems with inflation and debt sustainability, and to maintain long-term financial stability and foster growth, the government needs to focus on lowering inflation and renegotiating debt. Since the country's ability to service its debt will largely depend on an increase in foreign exchange earnings, securing more foreign currency through ODA, and promoting remittances and exports is critical. As the foreign exchange inflows improve, the birr is expected to stabilize and thereby reduce the black market premium and the inflationary pressure. The widening black-market premium, which has led to the reduction of foreign financial flows such as remittances through official channels and elevated prices of imports, is also a cause for concern. Perhaps, the declining remittance flow through the banking system and channeling through the black market needs serious attention as it is draining the foreign exchange availability in the country.

The government is facing challenges in public debt management due to low tax revenue mobilization, a drop in foreign financial flows, high interest on loans from private creditors, and relaxed spending by the government in response to a series of internal and external shocks such as COVID-19, conflicts, etc. As one of the major culprits of the debt problem is military

spending, the government needs to reduce military spending (where possible) and focus on social services spending and investment in public infrastructure. Otherwise, the present high debt stocks will tend to limit government consumption and public investment in infrastructure, human capital, and social protection programs. In addition, the country must reduce its external debt servicing obligations through negotiations to create fiscal space for development endeavors and relieve the growing pressure on its external accounts.

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