



**Addis Ababa University  
School of Graduate Studies  
College of Business and Economics  
Department of Public Administration and Development Management**

**ASSESSMENT OF PUBLIC DEBT MANAGEMENT PRACTICE  
IN ETHIOPIA**

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## **Acronyms**

ADLI- Agricultural Development Led Industrialization

AFDB- African Development Bank

ADF- African Development Fund

AEO- African Economic Outlook

BADEA - Bank of Arab for economic Development in Africa

BDC-Bilateral Development Cooperation

BIS – Banks for international settlements

COMSEC- Common Wealth Secretariat

CS-DRMS- Software & Common Wealth Secretariat Debt Recording Management System Software

DBE- Development Bank of Ethiopia

DMD- Debt Management Directorates

DMO- Debt Management Office

DMFAS- Debt Management & Financial Analysis

DSA- Debt Sustainability Analysis

DSF - Debt Sustainability frame work

EBRD- European Bank for Reconstruction and Development

ECB- European Central Bank

EEPCO- Ethiopian Electric Power Cooperation

EIB - European Investment Bank

ERC- European research council

ETC- Ethiopian Telecommunication Corporation

GDP- Gross domestic product

GNP- Gross National Product

GTP- Growth Transformational Plan

HIPC- Heavily Indebted Poor Countries

IDA- International Development Association

IFAD - International Fund for Agricultural development

IFIs- International Financial Institutions

IIs- Implementing Institutions

IMF- International Monetary Fund

LIC- Low Income Countries

MDGS- Millennium Development Goals

MDRI- Multilateral Debt Relief Initiative

MEFMI- Macro Economic Financial Management Institute

MOF- Ministry of Finance

MOFED- Ministry of Finance and Economic Development

MTDS- Medium Term Debt Strategy

MTEF- Medium Term Expenditures Framework

NDF- Nordic Development Fund

OECD- organization for economic co-operation and development

OEDD- Oregon Economic Development Districts

OECE- Organization for European Economic Co-operation

OFID - OPEC Fund for International Development

PASDEP- Plan for Accelerated and Sustained Development to End Poverty

PBS-Public Basic Service

PVD-Present value of debt

SDPRP- Sustainable Development and Poverty Reduction Program

UN- United Nation

UNCTAD- United Conference on Trade & Development

UNITAR- United Nations Institute for Training and Research

WB- World Bank

## ABSTRACT

Ethiopia's external debt stock has risen rapidly and has almost quadrupled even if debt relief was granted under the Heavily Indebted Poor Countries /Multilateral Debt Relief Initiative (HIPC/MDRI) in 2006 and other problems being facilitated. The impact of this debt burden is enormous in economic and human development of Ethiopia which can be observed from the debt overhang. This entails a need for more comprehensive study which rigorously examines public debt management practices in Ethiopia.

Hence, the purpose of this study was to assess the debt management strategy and the precise debt management practice of Ethiopia starting from 2002 after Ethiopia restarts debt management practice from ground due to the debt relief and debt cancellation granted by various multilateral and bilateral creditors up to 2011.

The research employed a descriptive research analysis which involves both quantitative and qualitative tools to drive concrete findings. In order to extract the necessary information for the study, document review was considered as the major tool for secondary data gathering while primary data was gathered through key informant interview with directors and managers of debt management unit in the Ministry of Finance and Economic Development.

In visualizing the major components of Ethiopia's debt management strategy the main objective focuses on debt sustainability analysis and gives less attention to parts of debt management strategy such as, fiscal, legal, institutional and operational measures. Despite the efforts in debt management activities, it is still at nascent stage and not performing at its maximum potential. The major challenges faced by debt management practices includes; shortage of human labor force, minimum skills of negotiating teams as well as those who engaged in monitoring and evaluation process, lack of debt management strategy, inaccessibility of alternative creditors to make a choice, late disbursement made by creditors after loan agreement signing, the inability of the government to fund expenditures from treasury and non existence of past performance evaluation process. According to the debt management directorates study, even if Ethiopia's debt is affordable, the time to time plan of the government necessitating large amount of finance may put risk on future debt capacity.

## **Chapter One**

### **1. Introduction**

#### **1.1 Background of the Study**

Most third world countries usually rely on credits for financing their budgetary deficits and for managing their payment and liquidity problems. Expenditure was financed by short term commercial credits often at variable interests and further aggravated by the level of worldwide inflation and the rise in the value of United States dollar (USD). Many developing countries found that their dollar denominated loans gradually became unmanageable finally turned their payment problems in deep debt crisis. The grouping of debt service obligation ensured that the debt burden of most developing economies took on an unbearable character that reflected the serious debt management problem. Accordingly, Western Banks, International Monetary Fund (IMF) and World Bank (WB) support the third world countries by insisting them to emphasis on debt repayment package. However, the limited success of prevalent debt management approach in most third world government became more impossible which has brought a great deal of hardship for a majority of the people (Adebayo, 1990).

The stock of developing countries external debt rose from \$4.4 trillion in early 2010 to \$4.9 trillion at the end of 2011, the upward effect of time to time appreciation with the U.S. dollar, of foreign currencies dominated one-third of developing countries external debt. However, developing countries saw a significant improvement in external debt payment capacity over the past decade, that the average debt service to export ratio for all developing countries dropped to 8.8 percent, compared to 11.3 percent in 2009 in spite of further 11% rise in their joint external debt obligations. This was a consequence of effectiveness of debt management with increased export earnings but it is also a direct outcome of debt restructuring and outright debt relief from official and private creditors, in the context of the Heavily Indebted Poor Countries (HIPC) and Multilateral Debt Relief Initiatives (MDRI) and additional bilateral debt relief (Bertelsmann, 2012).

Ethiopia is also part of developing countries where years ago, external debt had shown not only increase in magnitude but also exhibited major change in its structure and composition. Under this situation it has become imperative to have in place a strategy aimed at medium and long term

solutions to the debt problem. Thus, based on already existing economic policy and development strategy, debt management strategy was launched since December 1993 aiming at reducing and cancelling of existing debt outstanding as well as improving of the country's debt management capacity including selection and negotiation of future loans and allocation of external finance for sound projects. However, Ethiopia debt service per capita increased as a result of increased finance needed for developmental activities. (MoFED, 1993).

In November 2001, Ethiopia declared eligible for HIPC debt relief and reached its HIPC decision point which necessitated conducting a debt strategy analysis to assess debt sustainability. Hence, Ministry of Finance and Economic Development (MoFED) in collaboration with HIPC capacity building program organized the Ethiopian debt and new financing strategy workshop from August 25- September 5, 2003. However, the results of the workshop showed that Ethiopia's debt sustainability had not been achieved then and key areas related to the capacity to develop and implement debt policies, priorities for strengthening capacity of institutions, debt recording, debt negotiation, and execution of debt policies, macroeconomic analysis, poverty reduction and simulation of new financing strategy were developed (MoFED, 2003).

In the same way, continuous and persistent global financial turbulences have called for formulating a more reliable and robust debt management strategy known as medium term debt management strategy (MTDS) within the framework of the country's development goals. This enables the government to plan and negotiate the best available borrowing options to fund economic development, growth and poverty reduction, keep debt servicing costs and risks as low and sustainable as possible in the short and long term, and assess potential risks arising from non-concessional loans (MTDS, 2012).

However, the total debt outstanding reached \$16,114 million in 2012/13 especially due to an increased disbursement from new external loans. Accordingly, the country's debt servicing payment increased from \$241.88 million in 2010/11 to \$2,550.59 million in 2012/13 (MoFED, 2012/13).

## **1.2 Statement of the Problem**

The loans received from the various bilateral and multilateral institutions in Ethiopia have focused on addressing multi-faceted development challenges like acute poverty, low economic

growth, and spread of HIV/AIDS, lack of infrastructure and low provision of social services ranging from education to health. Despite various benefits derived from external assistance these challenges remained sometime because of long-running and significant external burden that has been, and continued to be, a permanent feature of the country's history (Befekadu, 2001).

Iyoha, (1999) as cited in Arit Edet-Nkpubre (2013) mentions general causes of the external debt burden such as accumulating principal, corruption, interests, payment arrears, inefficient loan utilization, inappropriate domestic macroeconomic policies and political instability which puts huge impact in retarding the debtor nations ability to grow out of debt burden, creating uncertainty, which compounds the problem of business planning and production.

Though external debt has two conflicting purposes (both positive and negative) most governments have large financial needs as they seek to develop their countries and provide their citizens with the social services. It is also an effective tool for generating economic development and distributing the debt burden fairly between current and future generations of taxpayers. However, public debt entails significant risks like unsustainable debt, if they are not managed properly. Unsustainable public debt can impair the government's ability to reduce unemployment and poverty levels precisely when counter-cyclical budget actions are most needed, during an economic downturn or financial emergency. (INTOSAI, 2011)

According to the 2012 debt sustainability analysis of IMF and WB, despite the rise in the external debt burden, Ethiopia was at low risk of debt misery after factoring the inflow of capital which has increased appreciably in recent years. Accordingly, external debt to GNP fell from 83% before the Heavily Indebted Poor Countries (HIPC) initiative to 11% in 2008, but the ratio has since then doubled due to a surge in public enterprise borrowing, mainly for infrastructure development.

However, this large quantity budget financing needs of the GTP could cause a risk to debt sustainability in the future which underlines the importance close monitoring of non-concessional borrowings of public enterprises and careful viewing of public investments necessitating debt-management framework (African Economic Outlook, 2012).

High-quality public debt management plays a critical role in reducing developing countries' vulnerability to financial crises by meeting government financing needs, increasing debt capacity

repayment, encompassing sound risk and cash management, effective coordination with fiscal and monetary policy, good governance, and adequate institutional and staff capacity. Ethiopia's governments started implementing debt management activity in 1993 and currently also implementing a Medium-Term Debt Management Strategy. The World Bank (WB) and the International Monetary Fund (IMF) have taken steps to help countries improve their public debt management and domestic debt market development by disseminating sound practices in these areas, remarkably by publishing "Guidelines for Public Debt Management" and Developing Government Bond Markets (Adenike et.al, 2007).

However, the impact of debt burden is enormous in economic and human development of Ethiopia. This can be observed from the debt overhang which continued to have a devastating effect on macroeconomic stability and the credit worthiness of the country stunting growth, trade and development and exerting a huge pressure on public expenditures critical to the social sector development (Solomon and Tesfaye, 2013). Thus, the importance of effective debt management has assumed important for Ethiopia in its effort to restore stability and credit confidence in its economy.

The studies conducted so far, such as the study by Abha et.al, (2013) on small states performance on public debt management in Cyprus, the study by Constantinos and Dimitri (2007) on Public Debt Management and Debt Market Development as well as the study by Pål Borresen and Enrique Cosio-Pascal (2002) were some of the studies focusing on public debt management. In addition, the studies by Solomon and Tesfaye (2013) focus on the need for an effective debt management along with the overall macroeconomic management and the study by Carlos A. Primo Braga (2008) focus on the importance of strengthening debt management capacity, institutions and practices to address concerns about the growing risk of debt distress.

However, no attempt has been made to assess the practice of debt management in Ethiopia. Thus, there is apparent lack of empirical research that clearly shows the assessment of public debt management practice in Ethiopia. This study, therefore, intends to fill the identified gaps, by assessing public debt management practices in Ethiopia to find out the major challenges faced during the process.

### **1.3 Objective of the Study**

#### **1.3.1 General Objective of the Study**

The main objective of the study is to examine the debt management practices of Ethiopia and the challenges encountered on the execution of the process.

#### **1.3.2 Specific Objectives of the Study**

1. To assess the debt management strategy of Ethiopia
2. To evaluate the practices of debt approval and mobilization activities.
3. To examine the practices debt disbursement and debt service payment process.
4. To review the debt management directorates practice in the assessment of the country's debt repayment capacity.
5. To forward possible implications and recommendations based on the findings of the study.

### **1.4 Research Questions**

1. What are the components of Ethiopia's debt management strategy?
2. How is the practice of debt approval and mobilization look like in Ethiopia?
3. How is the practice of debt disbursement and debt service payment conducted in the country?
4. How the debt management directorates assess the debt repayment capacity of external debt?

### **1.5 Scope and Limitations of the Study**

#### **1.5.1 Scope of the Study**

Public debt general classification encompasses both domestic and external whereby the concept of public debt appears wider concept. In addition public debt management practice encompasses various activities like meeting government financing needs, debt approval and mobilization, debt disbursement, executing debt repayment. It also consists of transparency and accountability, coordination with macroeconomic policies, developing debt management strategy, developing efficient market for government securities, developing risk management framework, designing

appropriate legal and institutional frame work. Thus it would be difficult to deal with and assess all these issues within a single research.

Therefore, the scope of the study has been limited to external debt specifically on debt management strategy and the precise debt management practice of Ethiopia.

In doing so, the study has covered a period of ten years starting from 2002 after Ethiopia restarted debt management practice from ground due to the debt relief and debt cancellation by various multilateral and bilateral creditors up to the year 2011.

### **1.5.2 Limitations of the Study**

The major constraints of this study include: difficulty in having access to relevant documents pertaining to the study and time constraints on the respondents' side at the institution to provide relevant information during the interview conducted with them are factors that have proposed difficulty in progress of the study. Despite all these limitations the researcher is confident enough to state that the findings remain unbiased.

## **1.6 Research Methodology**

### **1.6.1 Research Design**

The primary objective of this research is to assess the practice of public debt management activities of Ethiopia and find out the challenges encountered in the process. In order to undertake these activities, explain and meet the research objective, descriptive research method has been employed. It was employed because the researcher aimed to describe the observable practice of Ethiopia's public debt management activities. In addition, descriptive researches inquires answers for questions such as "what" and "how" which have been assumed to be more appropriate to have detailed insights and understandings of the topic under study. Therefore, this method is selected as it has advantage in investigations of practices of public debt management activities in realistic settings in order to further scrutinize and predict the issue. In addition, qualitative research approach has been used in order to assess and understand various issues contributing to the practice and challenges of debt management practice under consideration.

### **1.6.2 Data Source**

The study considered two basic sources of data: primary and secondary data sources. In this study the primary data has been collected form specific target institution: the Ministry of Finance and Economic Development specifically from department of debt management, international

financial institutions (IFIs) and bilateral development cooperation directorates (BDD). In these institutions knowledgeable personalities on the subject, managers and directors of the debt management activities and others who are pertinent to the issues were considered as the primary source of information.

In addition to primary data, secondary data have been gathered from published and unpublished materials of the above mentioned departments as well as materials of World Bank, IMF and other institutions. Besides, different books, journals, research papers written on the issues and the internet have been considered for the study.

### **1.6.3 Data Collection Techniques**

In order to extract the necessary information for the study, document review has been considered as a major tool for data gathering. A series of document reviews that reflect the range of issues and objectives contained in the study have been made and summarized. In addition to this, the study has used key informant interviews. For the interview, experts at the target institutions who were thought to have had more knowledge and better understanding on the topic have purposefully selected.

Two kinds of interviews have been made. The first set has been used to elicit information from experts and officials of Ministry of finance and economic development specifically from the debt management directorate unit on the operational activities in the process of debt disbursements and its payment obligation. The second set has been used to collect information from the IFIs directorate and bilateral development cooperation directorate departments located at Ministry of Finance and Economic Development office with regards to practices in debt approval and mobilization of external debt.

### **1.6.4 Data Analysis**

In order to achieve the above objectives, the study has employed descriptive data analysis technique. The qualitative data collected through review of documents and key informant interviews were analyzed in parallel within the framework of the research objectives to make a concrete descriptive analysis of the situation. Then, all of the basic data have been analyzed using tables and descriptions. Based on the findings relevant conclusions, implications and recommendations have been drawn.

### **1.7 Significance of the Study**

Even though public debt has negative consequences most governments have large financial needs as they seek to develop their countries and provide for social needs of their citizens. However, public debt entails significant risks if they are not managed properly. An unsustainable public debt can impair the government's ability to reduce unemployment and poverty levels necessitating public debt management. Hence, the goal of this research is to provide updated and comprehensive current practices in debt management operations. The study has been planned to help improve the quality of public debt management through addressing the major challenges being identified in the practice and also to initiate programs for effective country development plans and policy. Even though the study is carried out for academic purposes and it is confined to a single department, it could be helpful to have a deeper knowledge about the complexity of debt management practiced in the country within the delaminated scope.

Furthermore, the result of the study is expected to generate important findings that can help as useful input for further research.

### **1.8 Organization of the Paper**

The study is divided into four chapters. The first chapter covers the background of the study, statement of the problem, objective, significance, methodology, scope and limitations of the study. Literatures by referring to various relevant books, publications and other related literatures concerning debt Management practices are reviewed in the second chapter. In addition the literature aims at covering historical background as well as the current status of Ethiopian debt management activities. In the third chapter, data gathered through document reviews and key informant interviews were presented and interpreted and finally based on the finding the conclusions, implications and recommendations were forwarded in forth chapter. A list of references follows the fourth chapter.

## **Chapter Two**

### **2. Literature Review**

#### **2.1 An Overview of Public Debt**

Many countries often follow various kinds of international guidelines for measuring public debt and failure to apply global standards can lead to misunderstandings because of the potentially large magnitudes involved. However, according to IMF Public Sector Debt Statistics Guide total gross debt defines as all liabilities that are debt instruments which require payments of interest and/or principal by the debtor to the creditor at a date, or dates in the future (IMF, 2012). Some other definitions than the above one may also exist due to specific legal institutional and practical arrangements. Public Debt can also be defined as an obligation of a government and is also sometimes referred to as government debt (Mohammad, 2010). It is a term for all of the money owed at any given time by any branch of the government. It encompasses public debt owed by the federal government, the state government, and even the municipal and local government. It is therefore, useful to always clearly identify the definition of debt according to the instruments included. In addition, the definition of debt does not necessarily imply that the timing of future payments of principal and/or interest is known. In many instances, the schedule of payments is known, such as on debt securities and loans. However, in other instances the exact schedule of payments may not be known (IMF, 2013).

Developing countries have a large demand for infrastructure projects, such as schools, hospitals, roads, water, electricity etc, however, in most cases the governments in the developing countries do not have sufficient revenues to fund such projects which are vital to ensure sustainable development. To meet this form of demand the utilization of debt transfer and its variants along with the developing countries structures is a better alternative to the conventional financing which is based on interest. This is because firstly they are expected to enhance the stability of the financial institutions and markets that ensures a stronger connection between the financial sector and the real sector of the economy and enable the system to be less prone to activities which are the cause of many crises. Secondly, such a policy consisting of financing government expenditure through developing countries instruments is expected to discipline public expenditure as availability of finance. As a result, greater prudence will be introduced in the

overall macroeconomic management as well as in the efficiency of microeconomic units operating in an economy (Abdou et.al , 2011).

Governments may borrow to meet temporary needs, when estimated revenue falls below or is exceeded by estimated expenditures, unwillingness to limit spending or increase taxes for fear of the political consequences, when widespread unemployment exists, to meet emergencies, such as war debts (Mohammad, 2010).

However, the problems of extraordinarily high public debt and very large external debt can be created as the consequence of large and persistent fiscal and current account balance of payments deficits, imprudent use of borrowed resources, such as wasteful government spending, resort to borrowing for non development expenditures, undertaking of low economic priority development projects, and poor implementation of foreign debt projects, weakening debt carrying capacity in terms of stagnation or decline in real government revenues and exports, and lastly rising real cost of government borrowing both domestic and foreign.(Masroor and Qureshi, 2009)

In addition, according to Iyoha (1999) cited in Oke and Sulaiman (2012) the external debt burden can be created because of accumulating principal, interests, payment arrears and penalties, corruption and inefficient loan utilization. Other general causes of the external debt problem in a country include inappropriate domestic macroeconomic policies and political instability that also play a major role in retarding the debtor nations' ability to grow out of debt burden, creating uncertainty, which compound the problem of business planning and production.

### **2.1.1 Types of Public Debt**

Government loans are of different kinds, they may differ in respect of time of repayment, the purpose, and conditions of repayment, method of covering liability and on other conditions. Accordingly, total public sector debt can cover public nonfinancial corporations, and public financial corporations. The public sector units may also guarantee the debt of private sector institutional units and other public sector units which can be further be classified in accordance with to the residence of the creditor as domestic or external (IMF, 2013).

Debt can also be classified based on the maturity of the loan as “original maturity” or “residual maturity”. The original maturity is a maturity measured from the date of signature of the loan till the date of the last payment paid in three time- spans; short, medium and long term. Short-term

are those loans where the original maturity is shorter than one year. Medium-term loans are those loans where the maturity is longer than one year but shorter than five. Long-term loans are those where the maturity is longer than five years. The residual or remaining maturity of a loan is the time length elapsed till the loan is fully repaid. However from all mentioned above the major differentiation as far as public debt classification is concerned whether the debt is contracted domestically or externally depending on, the type of creditors, the different types of risks and the residence of the creditor not the currency of the loan that involves (Enrique, 2010).

#### **a. Domestic Debt**

Most people and institutions define debt as “internal” or, more commonly, “domestic” debt when the debt is owed to creditors that are resident in the same economy as the debtor.

According to Mohammad, (2010) Domestic debts can also be defined as debts raised by governments with strong economies, which are well trusted in the world, are able to raise funds by issuing their own securities, usually called government bonds. Individuals, other nations, and groups buy these bonds, and the government promises to pay them back at a certain, usually fairly good interest rate.

#### **b. External Debt**

External debt of public sector includes the external debt of the public sector and the private sector of an economy being a subset of total external debt (IMF, 2013).

“External debt, at any given time, is the outstanding amount of those actual current, and not contingent, liabilities that require payments of principal and/or interest by the debtor at some point in the future and that are owed to non-residents by residents of an economy”. This definition focuses on the transfer of resources between residents and non-residents, allows to evaluate the political cost of a default on public debt and measure the amount of international risk sharing and the income effects of variations in the stock of debt (UNCTAD, 2008).

Due to low share of domestic savings and the relative weaknesses of domestic financial markets often linked to major macroeconomic imbalances developing countries have historically favored external indebtedness in order to finance economic development. However, the governments of developing countries have made an effort to control macroeconomic balances and to develop domestic financial markets which has been possible because domestic saving have increased in these countries, and because the development of domestic financial markets helps domestic

enterprises to find financing domestically. Moreover, domestic indebtedness is appealing for governments because it presents a series of advantages compared with external debt through eliminating exchange rate risk from market risk, eliminating the complexity of taking loans under foreign laws and regulations, fixing the paying back algorithm only by the debtor, issuing the debt by the central government which provides financial instruments in the local market that are used by the Central Bank for the implementation of monetary policy and lastly, the yield curve of public domestic issues may be used as a benchmark for domestic private issuers (Enrique, 2010).

However, Masroor and Qureshi (2009) support that all the developing economies domestic debt capital markets are under developed and lack liquidity therefore governments are forced to raise external debt to fund the development needs of the country. Furthermore, domestic borrowing is expensive and short term and provides incentive to governments to borrow from external sources to fund the long term development needs due to the fact that external debt is comparatively cheaper and has longer tenor.

## **2.2 Public Debt Management**

### **2.2.1 Meaning and Objective of Public Debt Management**

Public debt management has been defined by different institutions and peoples depending on the objective that the debt management needs to fulfill. Accordingly, IMF and World Bank Public Debt Management Guideline (2001), Graeme (2004) and Mohammad (2010) defined public debt management as the process of establishing and executing a strategy for managing the government's debt in order to raise the required amount of funding, achieve its risk and cost objectives and to meet any other debt management goals the government may have set, such as developing and maintaining an efficient market for government securities.

Public debt management is generally associated with fiscal policy (budget execution) cash management, monetary policy and operations, market development and infrastructure, financial stability, legal framework and institutional arrangements (Mohammad, 2010).

The primary objectives of government debt management are to minimize over the long term the cost of meeting the Government's financing needs, taking account of risk, whilst ensuring that debt management policy is consistent with monetary policy. Governments may also have secondary objectives of maximizing the overall wealth of bondholders and taxpayers, such as maintaining the liquidity of government issues in order to reduce liquidity and provide a pricing

scale for private issuers. Debt management also seeks to promote the development of the domestic debt market through a gradual extension of the maturities of government debt and the introduction of new debt instruments (Donna, 1999).

In order to achieve the above stated objectives the process of government debt management mainly necessitates the following activities; establishing clear debt management objectives and supporting them with a sound governance framework, a prudent cost and risk management strategy and accompanying portfolio management policies, an efficient organizational structure, appropriate management information systems, a strong in-house risk management culture, ensuring that all portfolio-related transactions are consistent with the government's debt management strategy are executed as efficiently as possible and finally establishing reporting procedures to ensure that the government's debt managers are accountable for implementing the debt management responsibilities delegated to them (Graeme, 2004).

Good public debt management can help reduce borrowing cost in many ways. A well designed and implemented borrowing program can give confidence to investors and thus reduce the lending spread. Good public debt management can also help develop the domestic financial market which makes them to benefit from having available public debt instruments in which to invest and which can provide benchmarks for the pricing of other instruments. In turn, a well-developed domestic financial market can facilitate economic development, and make the economy more resilient to external shocks, such as capital outflows (Tomas and Sundararajan, 2008).

### **2.2.2 Evolution of Debt Management**

Government debt management has a long tradition. More than three centuries ago, the Bank of England was managing government debt, and the origins of Sweden's National Debt Office go back to 1789. There was also a move toward building the professionalism of government debt management, beginning with the establishment of the New Zealand Debt Management Office in 1988 and Ireland's National Treasury Management Agency in 1990. It was no accidental that the countries that were the first to substantially upgrade their government debt management in the late 1980s and early 1990s were those with histories of fiscal problems, high ratios of public sector debt to gross domestic product (GDP), and a large proportion of foreign currency debt in their government debt portfolios. Prior to the introduction of comprehensive government debt

management reforms in the late 1980s and the 1990s, government debt was regularly managed without clear objectives or a supporting policy framework. Financing decisions were often politically motivated or were based on achieving the lowest annual debt-servicing cost regardless of risk portfolio (Graeme, 2004).

Since the late 1980s, several factors have stimulated efforts to take a more professional approach toward management of government debt. One was the growing recognition among early reformers such as Ireland, New Zealand, and Sweden that poor-quality decisions on government debt management added to the overall riskiness of the government's balance sheet. Another was the increased understanding that a prudent debt management strategy, along with sound macroeconomic and structural adjustment policies, is essential for containing the impact of financial market shocks. Furthermore assignment of a high priority to the strengthening of the quality of government debt management was a key element of the policy reform packages in Korea and Thailand. Deregulation of the financial sector and innovations in financial products also played an important role. In Brazil, China, Colombia, India, the Republic of Korea, Mexico, South Africa, and Thailand concern over rising government indebtedness was a factor behind debt management reforms, and it helps explain why several other governments, including those of Jordan, Lebanon, and Peru, considered extensive reforms in government debt management. Latin America and few countries such as the Ottoman Empire also came to existence with huge debt resulting debt servicing problems characterized by high effective interest rates and frequent defaults necessitating debt management (Kunibert, 2010).

The debt crisis of the 1980's prompted interest of governments in developing countries and international organizations to develop capacity in debt management. Developing countries failed to honor their obligations to pay their creditors and this necessitated debt restructuring including rescheduling mainly through Paris Club, and other debt relief mechanisms. These debt reorganization operations required accurate and complete debt data. It was because of this need that United Conference on Trade and development (UNCTAD) and the Commonwealth Secretariat (COMSEC) started their technical cooperation activities by developing and making available the Debt Management and Financial Analysis (DMFAS) software and Commonwealth Secretariat Debt Recording Management System software (CS-DRMS) respectively. The two

institutions also started training staffs of developing debtor countries in debt management (MEFMI, 2013).

The 1980s debt crisis was also witnessed as a special historical situation that led to major external debt payment problems for a large number of developing countries and all types of debt at the same time. On the creditors' side, banks were devoted to lend to developing countries because of the shortage of alternative customers and in order to earn substantial profits in a relatively short period of time on loans associated with high country risks. On the debtor's side, neglected basic elements of debt management like having an overall public indebtedness strategy that was consistent with macroeconomic priorities, having accurate and up-to-date records of all public and publicly guaranteed external loans, being fully aware of both the timing and the amounts of debt servicing obligations including contingent liabilities, being able to project the impact of the borrowing decisions on the country's overall debt profile, national budget and balance-of-payments and being able to benefit from innovations and instruments available in the financial markets to reduce the costs and the risks to the debtor. This showed the importance of a sound public debt management in debtor countries. However, the resources allocated to this activity were small compared to the size of the needs (OECE & BIS, 1988).

In addition to 1980 debt crisis other reason that stimulated the interest in public debt management was the permanent budget deficits in many countries during the last two decades which had led to a rapid growth in public debt. To finance these deficits many governments were forced to introduce new types of debt instruments and to deregulate financial markets. The growth in debt and the richer menu of debt instruments increased the scope for using public debt management as a tool of economic policy making. Mostly, the objectives of public debt management obviously depended on the government's economic objectives that included maximization of the representative firm's investment and social objectives such that, maximization of the representative agent's welfare, maximization of end-of-period private wealth, and minimization of the cost of public debt (Andres, 1992).

### **2.2.3 Debt Management Strategy**

According to the Ministry of Finance and Treasury of Solomon Island Government (2012) the four components to the Debt strategy includes, maintaining debt at sustainable and affordable levels, ensuring that any new borrowing follows fiscal responsibility guidelines such as for a fit purpose; from an allowable source; and with acceptable terms and conditions, developing the domestic debt market and finally introducing legal, institutional and operational measures that ensure that the above three objectives are met.

#### **a. Maintain Debt at Sustainable and Affordable Levels**

For maintaining debt at sustainable and affordable level the following preconditions are the major ones;

- Pursuing grant funding and budget support; where grants are unavailable, or where a loan element of grant funding for priority development projects is obligatory,
- Borrowing must be limited to concessional loans with grant element of 35% or more from multi- or bilateral donors or development partners,
- Concessional debt terms and conditions must be appropriate for the project being financed
- Debt servicing shall be sequenced to avoid large peaks in repayment expenses at certain times of year.
- To maintain debt at its current (affordable and sustainable) levels or below, the cumulative new issuance should not exceed the cumulative principal repayments made
- As part of the budget process, an annual borrowing limit will be set such that debt levels will not cause thresholds to be exceeded in the Joint World Bank/IMF Debt Sustainability Framework for Low-Income Countries

#### **b. Follows Legal and Fiscal Responsibility Guidelines**

New borrowing must comply with legislative requirements and must be: for a fit purpose; from an acceptable source; and with favorable terms and conditions. To ensure that any new borrowing is for a fit purpose, borrowing must be for investing in the productive capacity of the country, for funding priority core infrastructure and development initiatives and for Specific purposes (projects) identified as a high priority in countries National Development Plan. In addition with investment projects cash flows need to be clearly identified as sufficient to make debt repayments. But borrowing must not be used for funding shortfalls in recurrent expenditure.

The new borrowing from acceptable sources such as concessional sources of finance from multilateral or bilateral donors need to be ensured than from unacceptable funding sources such as from central bank or commercial banks which are expensive.

The terms and conditions such as grant element, debt sustainability and affordability, interest rate, tenor, legal risk, repayment risk, concentration risk, grace period, currency and exchange rate risk associated with any debt proposals must be examined carefully.

**c. Develop Domestic Market**

The major task is strengthening and extending the market through improving investor confidence through maintaining accountability and transparency which in turn be achieved by encouraging participation through market liaison meetings held at least quarterly and by making early part repayments of principal to domestic bond holders.

**d. Legal, Institutional and Operational Measures**

Ensuring legal, institutional and operational measures are needed to meet the above three objectives, to strengthen debt management and establish a borrowing framework. Essential aspects of legal measures of debt management contain, definition of debt, clear authorization by parliament to the Minister of Finance to approve borrowings, clear debt management objectives, a requirement that all borrowing proposals (including guarantees) are reviewed by a Debt Management Advisory Committee and recommendations submitted to the Minister of Finance before borrowing and loan guarantees can be approved on behalf of the government; a requirement to review and update the Debt Strategy annually and mandatory reporting on progress covering an evaluation of outcomes against stated objectives since the last review. The major part in institutional framework includes functions and responsibilities of debt management units such as making debt payments on time, keeping timely, comprehensive and accurate records of government debt, publishing reports, prepare, reviewing and updating the debt strategy and others. Finally, the operational measure takes in to account the necessities of accurate records and reports for maintaining and building debt management office accountability and transparency, and thus credibility.

**2.2.4 Debt Management Office**

Following the debt crises that have affected several emerging market countries there were growing awareness of the need to reduce the country's vulnerability to international financial shocks. An issue which is raised in this context is the physical location of the debt management

office, and whether it is necessary to create a separate debt management office. Experience suggests that there is a range of institutional alternatives for locating the sovereign debt management functions across one or more agencies, including in one or more of the following: the ministry of finance, central bank, autonomous debt management agency, and central depository. (Elizabeth, Jean and Eriko, 2003)

According to Nikhil (2010) wherever the debt office is located, consensus seems to have evolved stipulating that there is need to manage debt in a functional framework i.e Front office, Middle office and Back office as the subsequent specific functions.

### **Front Office**

Some of the main responsibilities undertaken by the Front Office include: implementing the borrowing plan based on the strategy approved by the government, mobilizing resources from external and domestic sources based on the country's borrowing strategy, being a clearing house for requests for information from/to donors/creditors, international financial institutions, commercial banks, implementing strategies that minimize costs and risks of debt management including hedging and derivative, processing applications for government guarantees, issue guarantees and conclude agreements with borrowers and creditors. These should be done in an efficient and effective manner to minimize government's cost of borrowing taking into account the risk parameters established by the authorities.

### **Middle Office**

Some of the middle office functions include formulating of debt strategy, monitoring unplanned debt requirements, making recommendations for debt restructuring as and when necessary, monitoring and supervising performance against set benchmarks, recommending policy changes in debt management, preparing debt sustainability analysis to assess the long-term sustainability of projected borrowing levels; assessing external vulnerability using debt and reserves adequacy indicators, determining borrowing ceilings for government consistent with fiscal and monetary policy requirements, providing reliable medium and long-term forecasts of debt servicing and interest income that feed into fiscal forecast.

### **Back Office**

Specifically some functions Back Office includes; reconciling all debt transactions with stakeholders, ensuring timely and accurate debt service for public and publicly guaranteed debt,

monitoring disbursements and repayments of loan guarantees as well as on-lending agreements, authorizing debt data regularly, preparing statistical and management reports and coordinate with the front Office so that the recording and monitoring of new financing is done in a timely manner

Noor and Fauzia (1857) also generalize the function of the three office as follows: Front Office has the general responsibility of mobilizing funding for Government within the legal and policy frameworks which involves contracting loans, issuing guarantees and issuing government securities. The middle office of a country's debt unit undertakes analytical functions that enable government to meet its financing needs and its debt service obligations at the lowest possible cost with a prudent degree of risk exposure. It also monitors the front office's performance in terms of compliance with the chosen strategy and risk and cost limits. The Back Office has general responsibility, to maintain a complete, accurate and consistent database of the debt Portfolio. It also confirms debt Settlements and payments and report on debt.

## **2.2.5 Loan Mobilization, Approval, Disbursement and Repayment Procedures**

### **2.2.5.1 Loan Mobilization and Approval Procedures**

The process of loan mobilization and approval according to MIEFMI public debt management procedures manual (ND) involves several steps in designing the funding program which is undertaken by the front part of debt management office. These include the process of identification of potential creditors, selection of negotiating team, collection of creditor's information, process of authorization, actual negotiation signing of loan agreement and effecting the loan.

#### **1. Identification of Potential Creditors**

Depending on the country's scoring procedures under each criterion, the Front office should then choose the preferred creditors which have obtained the highest average scores as the possible sources of financing for Government. The Front Office is then required to sell the project proposals to the chosen potential creditor after which negotiations are conducted with the creditor. Potential financiers will normally undertake their own appraisal in order to justify their involvement in the project. If the potential creditor gets interested in funding the project, the Front Office prepares to start negotiations. Negotiations may involve selection of the negotiating team, identifying creditor Information and other details about the creditor. Before actual negotiations begin, necessary pre-negotiation authorizations and approvals must be obtained.

## **2. Selection of Negotiating Team**

Selecting the loan negotiating team is conducted based on the role played by individual institutions in the debt management cycle as well as who can meaningfully engage the experienced negotiating teams of creditor institutions/countries in order to develop the guiding principles. There must be representation from the sector involved, the parent Ministry, Ministry of Finance, the debt office and the government legal office (Attorney General). However, the borrower's team should not be too large.

## **3. Creditor Information and other Details**

This involves the evaluation of all the creditors' policies, procedures and lending instruments in order to find the preferred creditors. Some of these activities include identification of the type of support traditionally provided by a creditor, channels through which the resources will be delivered to the country, flexibility of the creditor in accommodating the Government's funding requirements and other activities.

## **4. Authorizations / Approvals**

Generally the terms to be negotiated must be in line with the National Debt Strategy provisions and the detailed funding requirements as contained in the budget documents. The above documents should be sufficient to enable the Minister of Finance and the Debt office to initiate the negotiation process. The team must obtain a legal, technical and financial opinion on the draft documents before proceeding for negotiations. The final or actual approval of the loan will be obtained from Cabinet or Parliament depending on the institutional arrangement after the negotiations.

## **5. Negotiation Process**

Loan negotiations involve three main stages:

### **i. Pre- negotiations**

The pre-negotiations stage involves a negotiating team to review the project documents (e.g. appraisal documents, draft agreements, disbursement and procurement procedures etc) including the legal obligations. Importantly, this review helps to ensure that the proposed obligation's clauses are not in conflict with the objectives and laws of the state.

### **ii. Negotiations**

During actual negotiations, the Government negotiating team takes into account points of consensus and divergence and they need to take particular note of non-verbal communications.

Non-verbal communications is deemed to be very crucial during the negotiation process. Such will include the appearance, the punctuality, the conduct and the composition of the negotiating team which reflects the preparedness, confidence and credibility of the team.

**iii. Post-negotiations**

Before putting together the final loan documents both parties must go through the entire document to satisfy themselves that everything in it and other negotiated documents is accurate in order to avoid any later confusion or disputes.

**iv. Renegotiations**

There are instances where there is the need to re-negotiating terms of existing debts by either rescheduling or refinancing arises. In such instances, the practice is to go through the whole process as if dealing with a new loan. Renegotiations should attempt to explain the nature and the structure of transactions in simple and clear terms and provide basis for understanding the restructured debt.

**5.1 Legal Aspects of Negotiation**

External commercial borrowing is a complicated process. It is not the loan agreement alone that is sufficient. It involves a number of other documents. The exact kind and number of documents to be executed in an external commercial borrowing depends on various factors including the nature of the lenders, that is, whether it is an international financial institution, a local financial institution, an export import bank, a commercial bank or a group of such banks. Some International financial institutions have adopted the practice of dividing the documents of loan into two parts. The first part consists of the General Conditions and the other part consists of the main loan agreement and other documents. These General Conditions are made applicable, through a condition in the loan agreement, to every loan agreement entered into by these financial institutions. Standardization also saves time and energy. It helps to achieve uniformity in lending and borrowings. The disadvantage to the borrower is that once the terms and conditions are standardized, they become non-negotiable (UNITAR,2000).

**6. Signing and Effectiveness of the Loan Agreement**

After all stages of negotiations are completed and when the process is proved to be successful, Cabinet /Parliamentary approval is obtained before the Minister of Finance signs the loan agreement. But, the loan becomes effective only after the debtor country has provided the legal

opinion by the Attorney General to the creditor. The opinion confirms that the laws, relevant statutes and due process of the debtor country have been followed in entering this commitment.

### **2.2.5.2 Loan Disbursements Procedures**

Disbursements refer to the release of funds by the creditor. Back office receives details of disbursements irrespective of the method used. Timely data on loan disbursements is needed for several reasons; firstly, the Back Office must keep track of available loan balances. Secondly, amounts of disbursed debt are also needed to estimate interest due to lenders. Lastly all records of external financing must be consistent with records maintained elsewhere on public sector borrowing. There are three methods of disbursement namely: direct, reimbursement and replenishment:

**Direct disbursements:** refer to the release of funds by the creditor directly to the beneficiary through reporting to the Ministry of Finance and to the Debt Office as well as to the implementing agency on the type and value of all direct disbursements to the project.

**Reimbursement method:** In this case, the government undertakes expenditure from whatever source and then submits evidence of such expenditures to the creditor for reimbursement. The funds have to be warranted from Ministry of Finance to the implementing agency before expenditure can take place.

**Replenishment method (or advance/special account disbursements method):** On receipt of a signed copy of a loan agreement and a disbursement letter, the Back Office writes to the treasury to open special accounts in accordance with the loan agreement. The Creditor advances funds, usually on installment basis to the project account. The implementing agency undertakes the expenditure by drawing down the project account. When funds in the project account reach a minimum level, the implementing agency, through Government, initiates the reimbursement process by applying to the creditor as per the terms of the loan (Nordic Development Fund, 2014).

### **Conditions Precedent to Disbursements**

The fact that a loan is effective does not mean that the funds will be released. The debtor has to make a formal application for the requisite funds. Some creditors provide standard application forms. Withdrawal applications are prepared by the project implementing agencies and are submitted to the Back Office for processing and approval in line with the institutional

arrangements of the debtor country. The approved forms are then submitted to the creditor for disbursements. The Back Office pre-screens or reviews the withdrawal applications and the supporting documents to ensure that all documents meet the loan agreement conditions and have no errors. In order to confirm the disbursement the back office should receive information on disbursements from reserve/Central Bank, the creditor - Disbursement advices (creditor notes), Suppliers and through down loading disbursement details from creditor website (Enrique, 2010).

In addition general conditions which need to be met prior to disbursement include, continuing validity of all documents received pursuant to the first disbursement, statements from the borrower which confirm that all the requirements of the Loan Agreement are met, and no material adverse change shall have occurred and payment of all amounts due under the loan shall have been received (EBRD, 2013).

### **2.2.5.3 Debt Service Payment Procedures**

The Back Office prepares debt payments falling due in a financial year for inclusion in a government budget for both government direct and guaranteed debt. After being verified with creditor bills, the creditors should be requested to send a bill to the Debt Office for any principal, interest or commitment fees due before the actual due date of the payment. Depending on the correctness of the bill as per the Loan Agreement the Debt Office request the Treasury Department or Accountant General' Office to authorize payment and the prepared debt service payment advice. After receiving the documents from the debt office, the Accountant General prepares the necessary documents for authorization with the Auditor General that the debt service to be paid in terms of foreign currency to avoid effects of exchange rates movements.

Finally the Debt Office should instruct the Central Bank to effect payment. After effecting payment, the Central Bank should confirm by effecting the remittance to the Debt Office and other copies sent to Treasury/Accountant General (MIEFMI, ND).

## **2.2.6 Major Issues in Public Debt Management**

### **2.2.6.1 Debt Sustainability Framework**

The DSF was originally developed in 2004 by the International Development Association (IDA) and the International Monetary Fund (IMF) in extensive consultation with other multilateral development banks, including the African Development Bank (ADB). It was designed as a complement to the Heavily Indebted Poor Country Initiative (HIPCI) and the Multilateral Debt

Relief Initiative (MDRI) to help low-income countries (LICs) address the balance between their financing needs and the sustainability of their debt. The DSF is guided by an objective of addressing the challenges of debt distress and the re-accumulation of non-concessional debt by HIPCs (African Development Fund, 2009).

The main objectives of debt sustainability frame work includes firstly, guiding low income countries borrowing practices in order to match their financing decisions to their current and prospective repayment abilities. Secondly, to inform creditors' lending and grant-allocation that their decisions to provide resources to LICs must be on terms that are consistent both with progress towards those countries' development goals and with their long term debt sustainability. Thirdly, to improve World Bank and IMF assessments, policy advice, and program design. In addition it can also help to identify potential crises in order to take preventive actions (IMF&WB, 2012).

Since the DSF was adopted in 2005 as analytical tool designed to analyze countries debt sustainability, accordingly, there has been an increasing focus on forward-looking debt sustainability analysis (DSA) as a means of better capturing individual country needs and vulnerabilities to various sensitivity tests (African Development Fund, 2009).

### **Debt Sustainability**

Debt sustainability condition requires transversality condition that the present discounted value of debt must tend towards zero in the long run. This condition equivalently requires that the growth rate of debt be less than the rate of interest in the long run, which prevents the borrower's debt from growing exponentially (Fernando and Carlos, 2005).

A country's public debt is considered sustainable when government budget constraints can be met without disrupting its monetary and fiscal policies. This implies that the amount of the public debt should not exceed the present value of all future primary surpluses. The concept of maintaining stable monetary and fiscal policy is crucial (Carlos and Dorte, 2009).

Both domestic and external debt sustainability is an integral element of macroeconomic stability. Interactions between different policy variables such as debt, fiscal and interest rate policies, and outcome variables such as GDP and export growth, as well as international economic conditions such as international interest rates jointly define weather the country is on a sustainable debt path or not (Ejaz and Hyungsoo, 1995).

The sustainability of government debt also means that the accumulated government debt has to be serviced at any point in time which requires the governments to be both solvent and liquid. Solvency implies a medium to long-term concept and requires that the government's net present value budget constraint is fulfilled, stipulating that the net present value of the government's future primary balances must be at least as high as the net present value of outstanding government debt. On the other hand Liquidity refers to a government's ability to maintain access to financial markets, ensuring its ability to service all upcoming obligations in the short term. In addition debt sustainability assessment needs to account for a country's ability to maintain market access in the short term for the purposes of refinancing maturing debt otherwise, higher bond yields will gradually increase the cost of servicing debt. Furthermore, government debt can only be considered sustainable if the fiscal policies required to ensure sustainable debt levels are feasible and realistic in both political and economic terms (ECB, 2012).

There is no simple rule that can help us determine whether foreign debt accumulation is sustainable or not through assessing whether a country suffers of a solvency or liquidity problem. One of the criteria is Solvency criterion, implies that the stock of foreign debt of the country can increase without limit as long as it does not increase faster than the real interest rate. Adjustment on resource gap is also necessary to stabilize the debt ratio being as one of sustainability criterion. This shows that a non-increasing foreign debt to GDP ratio is seen as a practical sufficient condition for sustainability: a country is likely to remain solvent as long as the ratio is not growing. In a country where the debt to GDP ratio is growing, the gap is the difference between the current trade balance and the trade surplus required to stabilize the debt to GDP ratio. Such a required trade surplus will be larger when the bigger are the debt to GDP ratio and the differential between the real interest rate and the growth rate of the economy. However, resource gap analysis does not provide a direct measure of whether the debt ratio is unsustainable. For foreign and public debt sustainability a measure of the primary gap and the trade balance gaps provides as useful benchmark but it does not directly provide a tool to assess whether a certain stock of debt is sustainable or not. As long as the debt ratio to GDP is stabilized over the medium term, it is considered as sustainable regardless of its level. While the practical criterion provides a normative rule that, how much a trade surplus or primary surplus is required to close the resource gap, such debt stabilization goal may not be realistically achievable if the initial level of the debt is too high. (Nouriel, 2001)

### **2.2.6.2 Debt Overhang**

The analysis of debt overhang was found by Myers in 1977. He observed that since the shareholders of a leveraged firm may refuse to fund a new project even though its net present value is positive debt overhang can lead to underinvestment. His argument of underinvestment relied critically on the assumption that equity is a base in funding the new investment which is useful in reducing leverage. Consequently, this context involves an interaction between investment and funding considerations that shows the effect of debt overhang on investment somewhat coincidental (Anat et.al, 2012).

Later writers like Paul (1998) and others observed debt overhang as the debt situation of a country and its ability to meet debt servicing obligations and explained the use of debt relief for the creditor in making some payment. They stated that debt overhang exists when the country's debt service burden is so heavy that a large portion of the current output accrues to foreign lenders and consequently creates hindrance to invest. This shows us that debt service will discourage investment and stifle economic growth which makes it virtually impossible for highly indebted countries to escape poverty.

However, debt relief is expected to stimulate growth by releasing resources from debt service to investments in infrastructure and institutions. Such investments in turn enhance domestic investment as well as attract private foreign investment. These give rise to the beginning and the birth of initiatives of debt relief like HIPC (Heavily Indebted Poor Countries) and Multilateral Debt Relief Initiative (MDRI) (Musebu, 2012).

According to Borenzstein (2000) as cited in Osuji and Ozurumba (2012) debt overhang defined as a situation in which the debtor country benefits very little from the return to any additional investment because of debt service obligations. Negotiation process between the debtor country and its creditors are useful to determine the actual debt payment if debt service obligations cannot be fully met with the existing resources. In order to devote the return from any increase in production and investment to debt servicing the amount of payments may become linked to the economic performance of the debtor country which intern creates a disincentive to investment in viewing from global interest point of view. This is further supported by the hypothesis of Pattillio (2002) as cited in Musebu, (2012) which suggests that if there is some likelihood in the future that external debt will be larger than the country's repayment ability, the expected debt-

service costs would discourage further domestic and foreign investment and harm economic growth.

According to Frimpong and Oteng- (2006) debt overhang also occurs as a condition where outstanding debt is so large that investment will be inefficiently low without sizeable debt reduction. This implies that debt reduction will lead to increased investment and debt service capacity and the prospect that the amount of the debt outstanding would be repaid. However, Cohen 1993 arguing that in debt overhang effect that the important debt problem is the crowding out of investment caused by debt servicing.

Most of writers define debt overhang as a major and significant factor responsible for slowing down investment. The Debt overhang theory is based on the premise that if the country's repayment ability is less than the amount of debt, with some probability in the future, expected debt servicing is likely to be an increasing function of the country's output level. This implies existing foreign creditors effectively tax some of the returns from investing in the domestic economy and investment by domestic and new foreign investor is discouraged (Osuji and Ozurumba,2012).

Debt overhang creates distorted incentives and conflicts of interests with respect to reductions in leverage. Specifically the harmful effects of debt overhang, include reduction in lending when banks are distressed, are created by high leverage. The inefficiencies can be reduced if banks are funded with significantly more equity on a regular basis. This calls for much higher equity requirements (Anat et.al 2012).

### **2.2.6.3 Debt Capacity and Debt Limits Theory**

As the country issues more debt there is a growing awareness among creditors, country policy makers and citizens of the potential impact of increased debt on a country's credit worthiness. The ability of a state to meet future debt obligations is limited by the availability of future funds to meet required debt service payments. This will lead to realizing the importance of managing their country's debt position, specifically establishing debt limits to manage their debt issuance and stabilize their credit position. The tendency for country to issue guaranteed debt and/or non guaranteed debt is important reason in setting debt limits specifically in deciding whether to set a single debt limit or multiple debt limits based on debt service funding source and type of credit backing. The country issue Debt limitation policy as they attempt to meet their infrastructure

investment needs by increasing their dependence on debt funding. The issues of policy limits includes; establishing formal debt limits, establishing multiple or single limits and if multiple limits are established, what categories of debt should have higher or lower limits (Howard, 2006).

According to Ramsey and Merl (1996) Debt capacity can be defined as the level of debt and debt service relative to current revenues that an issuing entity could support without creating undue budgetary constraints that might impair the ability of the issuer to repay bonds outstanding or make timely debt service payments. As long as debt outstanding and debt service payment commitments expand in proportion to a state's economy and wealth the rating agencies concerns about the collapse of an issuing entities debt capacity should be mitigated and the state's debt rating should be maintained. Debt capacity set ceiling on debt service payments as a percentage of state government expenditures, total debt per capita or debt service ratios which may or may not be statistically based in order to analyze and manage the state debt levels

The study by Xiaohu (1962) on Debt capacity analysis answers three specific questions: is your current debt level affordable? Can you borrow more? How much more can you borrow? In order to answer these questions debt capacity analysis involves the following steps which are preferred to be used in this paper to answer basic research questions.

#### I. Assessing the current debt level

This step involves calculation of both the debt outstanding and debt service payments amounts in the country's government. In calculating debt outstanding there is a need to identify and present the debt outstanding for all types of debt including general obligation bonds and revenue bonds and their proportion in the total debt and the need to specify the service areas funded by the debt. This step also involves identifying the maturity of the debt, distinguishing the long-term debt from short term borrowing.

#### II. Determining the debt capacity

A government has a higher level of debt capacity if it can borrow more without causing difficulty in repaying the debt. List of possible measures of debt capacity includes:

- Debt outstanding as a percentage of taxable property values is a proper measure for many local governments that use property taxes as a major source to pay off the debt. It assesses

whether the community has sufficient financial resources to support the debt. On the other hand debt outstanding can be measured as a percentage of total personal income in the community in order to measure the ability of community to pay off the debt.

- Debt outstanding as a percentage of population or debt outstanding per capita assesses the debt level per resident. It also measures the community financial resource to support the debt.
- Debt outstanding as a percentage of total level of export assesses the debt level per export. It also measures the amount of export to support the debt
- Debt outstanding as a percentage of GDP assesses the debt level per Gross Domestic product.
- Debt service as a percentage of revenues or debt service ratio measures the government's debt capacity through the revenue source available for financing debt service. This measure assesses whether the government can generate sufficient resources to pay for the debt.

The debt service ratio is the most popular measure of debt capacity due to the fact that the capacity to pay off the debt is more accurately measured by the debt service ratio and the government has a little more control over the debt service ration than other measures.

The next step after measuring debt capacity will be determining benchmark debt ratio based on several methods to gauge the maximum amount of debt for the government. First you may want to examine the debt ratios of your government in the past which will be evidence about how much debt a government can carry. Second you can find a group of government similar to yours in socioeconomic characteristic and their average debt ratio as the benchmark. Third you can consult a bond rating agency or an experienced analyst of government bonds. Finally, some governments have legal limitations on the debt level, which should serve as the basis for a proper benchmark debt ratio. Bench marks can be developed for both debt outstanding rations and the debt service ratio which may be different for different types of debt.

### III. Determining the additional debt capacity

Additional debt capacity is available if the current debt level of a government does not exceed its benchmark debt ratio implying the government can make additional borrowing.

#### IV. Determining the future debt capacity

This involves estimation (forecasting) of the debt ratios for future years in order for the governments to detect any change in the debt capacity overtime and what should be done to avoid the decline. The forecast should estimate any additional debt capacity in the future so financial planners or budgeters are aware of the availability of this additional revenue resource in budgeting.

According to Howard (2006), once the country has defined its debt capacity by any national state standards the next debt management challenge is to design and implement debt management policies and debt financing decisions that will limit debt issuance. These lead to the beginning of techniques for estimating a state's debt affordability. If a county debt policy and bond financing record indicates prudent judgment regarding the use of debt financing including affordability it is likely that the country debt will be sustained when additional debt is issued. Additional challenge for the country is to establish debt financing policies and procedures which ensure that current and future debt issues are affordable. The main issue of state government debt affordability has been on assessing the ability of the countries to make required debt service payments and to manage debt issuance within the country debt capacity.

##### **2.2.7 Empirical Literature Review**

Despite numerous empirical literatures on the arguments of public debt management with various social and economic variables; there also exist case studies that focus on the experience of countries on procedures of debt approval, mobilization, disbursement, repayment and other debt management practices.

The study by Constantinos and Dimitri (2007) on Public Debt Management and Debt Market Development describes the evolution and current challenges of public debt management and debt market development in Cyprus in order to identify relevant policy options for the authorities. Although significant progress had been made in terms of using market-based mechanisms and adopting a more sound public debt composition, there remain weaknesses that need to be addressed. These were institutional arrangements for public debt management, modernization of the government debt market, and upgrading investment management skills of domestic institutional investors. The proposed reform agenda was fairly ambitious and called for an

integrated approach gave the inter-linkages between reforms. The importance for the authorities was to promptly resolve outstanding issues and prepare the groundwork for the introduction of reforms via a carefully sequenced roadmap.

According to the study by Abha et.al, (2013) on small states performance in public debt management showed that the higher the quality of a country's policies and institutions, the better was the capacity to carry debt and withstand exogenous shocks. Borrowing for productive purposes could be an important element in boosting growth of gross domestic product but, conversely, excessive borrowing or poorly structured debt in terms of maturity, currency, or interest rate composition could quickly offset the positive impact, exacerbated the challenge of meeting debt service obligations, and may propagate economic crises. Arguments in favor of sound debt management were especially compelling for small states that must mitigate the particular risks to which their economies are exposed. Against this backdrop, the study identified aspects of debt management where small states did relatively well and those where they performed poorly, relative to other developing countries, and examines the underlying factors. It elaborated on some of the successful measures taken by small states to enhance debt management performance and considers how these applied more broadly in other small states.

The study by MEFMI of South African Debt Office (2001) on Sovereign Debt Management, Cash Management, & Domestic Market Development in Malawi focused on major activities of debt management. This department was the focal point within the Ministry and the government as a whole for co-ordination and mobilization of external debt. At that time, due to lack of staff, only two divisions were fully operational. Firstly, resource mobilization divisions, undertaken by the front office, were responsible for coordinating external borrowing and aid, and liaising with the multilateral and bilateral institutions. Secondly disbursement and debt servicing division, undertaken by the back office, responsible for coordinating all claims submitted from line ministries, preparing for disbursement, preparing repayment schedules for all loans, as well as maintaining all records of outstanding loan through CSDRMS (Commonwealth Secretariat Debt Recording and Management System). Government and parastatal external debt has been captured into the system and validation was done periodically to ensure that the database was always accurate and consistent. The Reserve Bank of Malawi, which was also responsible for debt

service payments, also maintains a parallel debt recording system in a spreadsheet for regular updates of both disbursements and debt service.

According to the study by Pål Borresen and Enrique Cosio-Pascal (2002) on the role and organization of debt office, the operating function of a debt office was divided into three different phases negotiating, utilization of loan proceeds and servicing. The activities or actions involved in each phase differ depending on the type of borrowing involved, but these activities could also be different in nature. Utilization of loan proceeds and servicing were closer to the monitoring of projects and budget execution which were performed by the Loan Management and Utilization Unit being the activities of back office. Negotiations over external financing included new borrowing and eventual rescheduling of operations. Specifically the negotiating activity performed by the front office decided on micro financial strategic issues and fixed benchmarks based on the output of the analytical function.

According to case study by MFMI of Eastern and South Africa (2001) on Public Debt Management, Cash Management and Domestic Market Development in Tanzania, all external borrowing and negotiations were guided by the document of Tanzania's National External Debt Strategy of March 1999. The Attorney General's Department handled the legal aspects as well as any legal disputes that may arise in relation to government loans and guarantees. The EFD (External Finance Department) had the mandate to interact with Tanzania's development partners and coordinate donor support. However, sector ministries may also contact and negotiate directly with identified financiers for projects that were additional to those already approved and incorporated in the budget framework. The EFD, in consultation with the PAD (Policy Analysis Department) and the BoT's (Bank of Tanzania's) Debt Department, would conduct the financial analysis of the terms and conditions of loan proposals including feasibility studies for donor-funded projects before they were signed. The EFD was also in charge of negotiations with external donors at both bilateral and multilateral levels. Finally the BoT would obtain copies of loan agreements from the MoF as the primary source of information for recording debt and also would use disbursement notices that were copied to the BoT at times, information was requested directly from creditors. External loan disbursements were recorded by both the Debt Department of the BoT and the AGD (Accountant General's Department). When multilateral institutions involved, the BoT would obtain disbursement data directly from creditors; for other creditors, the

information was sourced from the MoF (Ministry of Finance). Regarding the debt servicing payment the foreign markets department of the BoT was responsible for externalizing payments on due dates once it has received payment instructions from the AGD, based on the latter's debt service projections. Payments were used to be made after both the BoT and the AGD were satisfied that the payment was genuine and in conformity with priorities agreed upon at the beginning of the fiscal year. When there was doubt, payment was used to be delayed until all verification methods have been exhausted.

## **2.2.8 Brief Review of Ethiopian Public Debt Management**

### **2.2.8.1 Historical Evolution of Public Debt Management in Ethiopia**

In Ethiopia the first debt management office was established in 1958s in order to manage the loan signed between government of Ethiopia and USAID with an amount of \$10 million. During that time the office was managed with single person under the then Ministry of Finance. To successfully realize the government's five-year development plan during that period external debt amount got to increase from time to time, this resulted in the establishment of debt and investment office within the Ministry of Finance. Main responsibilities of the debt and investment office include, selecting the potential projects, mobilizing debt for selected projects and accordingly to manage the mobilized funds as well as government finance agencies. Until the middle of 1978s the responsibilities of debt and investment office were fully undertaken as the amount of debt, which was secured then, was at minimum level. However, after the middle of 1978s due to the rapid and ever increment of external debt, carrying out the debt management activities under a single department became difficult, and this necessitated the formation of an independent body which was in charge of carrying out the activities of selecting projects and fund mobilization. Accordingly, after 1988s office for state committee for foreign economic relations was established to undertake the debt mobilization and project selection activities. Consequently, the debt management activities started to be executed under the debt office. The debt office ended up in 1992s and after 1992s there came the merge of the previous development finance agencies office which was under the Ministry of Finance, and the debt office was renamed as debt and investment office. However, at the end of 2002s following the merging of the ministry of finance and ministry of economy development, the investment group moved to the treasury office being renamed again to the debt management office (MoFED, ND).

Ethiopia is one of the least developed countries in the world which necessitates foreign assistance and loans to fiancé food deficiency and other development expenditures. Accordingly, Ethiopia is highly indebted countries, despite slight decrease being witnessed due to cancellation and rescheduling, the remaining balance is still high relative to GDP. During the imperial regime the size of debt was modest and its magnitude was only \$371 million. But, at the end of 1991 it reached to \$8,790 million. The debt that was contracted until the 1990 was largely used for defense purpose and helped neither in improving the productive capacity of the economy nor in alleviating poverty which was reflected from negative growth rate in GDP. Since 1992 Ethiopia to cope with its unsustainable debt has been engaged in negotiation with creditors and accordingly a total of \$101.6 million was agreed to be either cancelled or rescheduled. Second round negotiation with Paris club creditors also resulted debt reduction for debt contracted before 1989 which resulted in a total debt relief of \$164.8million (Befekadu Degefe, 1992).

Under this situation it has become imperative to have in place a strategy aimed at seeking medium and long term solutions to debt problem. Thus based on the economic policy during that time the first debt management strategy was launched in 1993 aiming at reduction and cancellation of existing debt outstanding and debt service as well as improvements of the country's debt management capacity including selection and negotiation of future loans and allocation of external finance for sound projects which entails strengthening of debt management capacity and concerned institutions. The main objective of debt strategy includes; clear the bulk of the accumulated principal and interest arrears, half the increase in outstanding debt resulting from the accumulation of penalty and late interest charges, reduce contractual debt service immediately to a manageable level, create a conducive environment for inflow of external resource, seek reduction of the outstanding debt stock, avoid non concessionary borrowing by the government including government guaranteed loans, control and minimize suppliers credits, ensure that debt service ratio is contained within sustainable debt servicing capacity and strengthen debt management capacity. However, effective and smooth implementation of the strategy depends on the full cooperation of donors within the government of Ethiopia (MoFED, 1993).

In November 2001 Ethiopia was declared eligible for HIPC debt relief and reached its HIPC decision point. Accordingly, Ethiopia received debt relief from multilateral creditors. Hence

MoFED in collaboration with HIPC capacity building program organized the Ethiopian debt and new financing strategy workshop from August 25- September 5, 2003 in order to design the debt strategy with the main objective of testing sustainability of Ethiopian both domestic and external debt at its HIPC completion point. However, the result showed that Ethiopia's debt sustainability was not achieved. Accordingly, key areas related to the capacity to develop and implement external and domestic debt policies, priorities for strengthening capacity of institutions, debt recording, debt negotiation, execution of debt policies and macroeconomic analysis was made then (MoFED, 2003).

Since Ethiopia is not a post MDRI country it has become necessary to look in to the future borrowings and to ensure that the country would not face a renewed debt crisis and at the same time generate enough resource to finance PASDEP (Plan for Accelerated and Sustained Development to End Poverty) and attain the MDGS (Millennium Development Goals) as much as possible. In view of this it has become necessary to revisit the previously designed debt strategy and update it according to the financing needs visa vis debt sustainability issues in post MDRI era. To update the existing debt strategy a debt sustainability analysis was carried out which considered a base case scenario which is consistent with the assumptions and projections of the IMF article. Ethiopia's external debt sustainability was assessed on the basis of new Debt sustainability frame work for low income countries which was adopted by BWI'S boards in 2005. The result indicates that external debt under (2007/08-2015/16) would be sustainable since all the ratios are well below their respective threshold (MoFED, 2007).

### **2.2.8.2 Recent overview of Public Debt Management in Ethiopia**

#### **c. Medium-Term Debt Management Strategy**

The first external activity during this period was a joint MEFMI/World Bank MTDS training mission in Ethiopia that took place from 9th – 19th October 2012. A total of 25 participants comprising senior, middle-level and junior officials were involved directly in developing and reviewing the MTDS from various directorates in the Ministry of Finance and Economic Development as well as from the National Bank of Ethiopia attended the training with active participation throughout the training period. It sought to assist the Ministry of Finance and Economic Development of the Federal Republic of Ethiopia to impart skills in the development of a debt strategy using the MTDS analytical tool; and prepare an MTDS for the government to

implement a formal debt management strategy containing analysis of cost and risk tradeoffs of alternative strategies in order to avoid macroeconomic instability and debt hangover while accessing finances prudently to meet the development agenda of the country that is owned by the Ethiopian Authorities (MEFMI, 2013).

The medium-term debt management strategy should be embedded in an overall framework that includes debt sustainability analysis, considerations of the wider economic framework, a cost-risk analysis of the various financing strategies available, an annual borrowing plan to operationalize the strategy in the immediate budgetary period and domestic market development plans ideally. The Government of Ethiopia has taken the right and timely decision to design this medium term debt management strategy and to follow and stick the future domestic as well as external borrowing to finance the developmental endeavors (MTDS, 2012).

#### **b. Objectives of the MTDS and Its Coverage**

The time horizon of the MTDS analysis is five years, starting from fiscal year 2012/13 through 2016/17. This is in line with the country's Macroeconomic Fiscal Framework (MEEF) and Medium-Term Expenditure Framework (MTEF). The primary objective of MTDS is to diversify alternatives and possibilities to ensure the Ethiopian Government's financing needs are met to accomplish the GTP within sustainable debt levels, and by minimizing costs and risks of the existing and future portfolio. The secondary objective of the new MTDS is to enhance the Domestic Debt Market, by enhancing and developing efficient local primary and secondary debt markets for government securities, gradually minimizing dependence on foreign sources and increasing transparency in the country. Developing an MTDS was a new phenomenon and this action was considered as the first step for the country to manage the debt volume and borrowing process in the country so as to avoid any unforeseen debt hangover and macroeconomic instability. (MTDS, 2012)

## **Chapter Three**

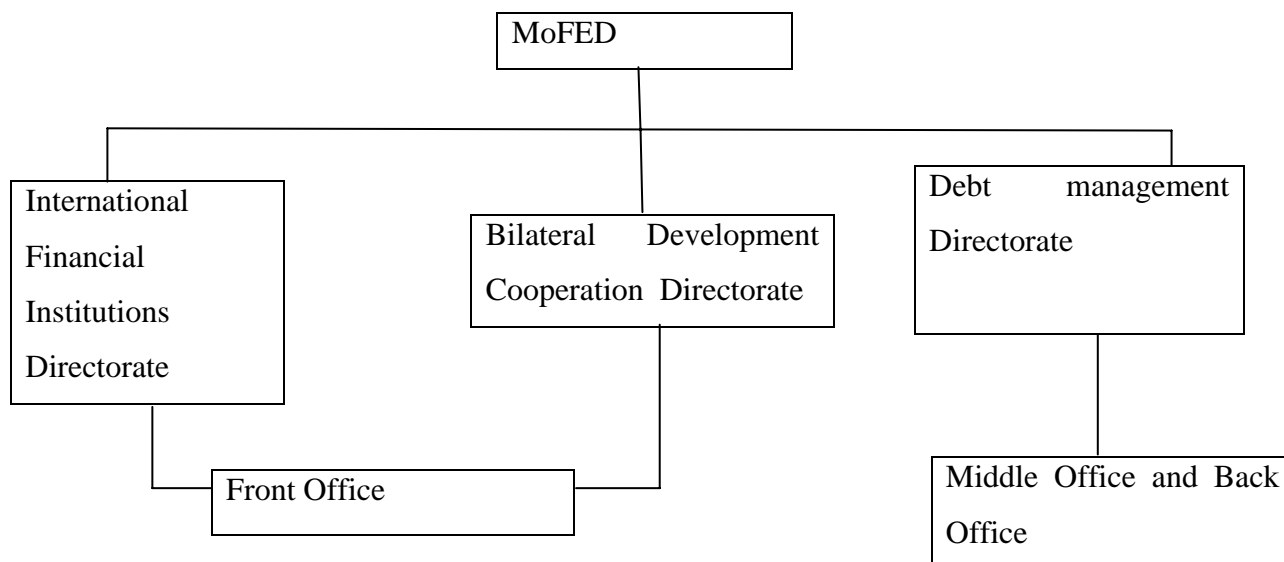
### **3. Data Presentation and Interpretation**

#### **3.1 Structure of Debt Management Directorates**

According to the document review conducted, the major activities conducted by the debt management directorate include ensuring of the relevance and importance of loans to be borrowed through participation in debt negotiations with creditors; appropriately registering of loans obtained from bilateral and multilateral institutions, preparing of detailed budgets of annual principal and interest debt service on external loans, arranging of payment schedule on amounts due and effecting of monthly payments to each creditor as per the approved budget, preparing and sending statements for due collection of proceeds based on loan agreements, keeping collectables and the remaining loan balance documents.

However, it has been observed that the debt management office is not structurally organized to form front, middle and back office but it is divided in to two parts. The first part includes the International Financial Institutions (IFIs) and bilateral development cooperation (BDC) directorates which perform the functions of front office debt management such as process of loan mobilization and approval. On the other hand, the second division consists of debt management directorate which involves the process of conducting the functions of both the middle office such as DSA and the back office functions of debt management which incorporates recording amount of new loans, disbursements and debt repayments. In addition, to the observation over the existing structure, it has also been confirmed by the information obtained from the interview conducted with IFIs directorate, bilateral development cooperation directorate, the DMD as well as through reviewing the manual used by each directorate.

Fig 3.1 Structure of Debt Management Office



The above structure reveals that these two divisions are not organized together to form one debt management unit rather they do their own activities independently. Even though both of them are responsible for MoFED in order to meet general objective and have some intersection points where one needs the other such as in the process of loan agreement, there exists a gap in performing specific tasks. For instance, according to the study by Fernando and Carlos, (2005), DSA requires that the growth rate of debt be less than the rate of interest in the long run, which prevents the borrower's debt from growing exponentially. In this case both directorates involved in implementing the activities of the front office debt management do not have information on how the growth rate of debt and the interest rate are related to contribute to DSA. In addition, the IFIs and BDC directorates need not only to observe the amount of government debt service payment based on the allotted maturity date but also the government's ability in debt repayment capacity and its source in order to issue the new loan agreement so that burden in making payments will be reduced in the future.

### 3.2 Ethiopia's Debt Management Strategy

Ethiopia has prepared different kinds of debt management strategy documents in 2003, 2005 and 2007. In 2003 Post HIPC debt and new financing strategy was prepared where Ethiopia's external debt was unsustainable necessitating top up due to change in exchange rates, a decline in international discount rates, reduced value of coffee exports and severe drought. The strategy was revised in 2005 to evaluate Ethiopia's debt sustainability with HIPC relief including top up.

Accordingly the NPV/export ratio in 2004/05 was reduced to 166.1% from 220.8% in 2002/03 even though it is above the threshold level. Finally, Post MDRI Debt and New financing strategy has been prepared to examine the debt sustainability of Ethiopia after the implementation of MDRI. As a result the total debt stock reduced to sufficiently sustainable level enabling additional room for new borrowing.

The above discussion shows that the main objective of Ethiopia's debt management strategy was on debt sustainability analysis and less on attention to parts of debt management strategy such as, fiscal, legal, institutional and operational measures.

For the achievement of debt sustainability the debt management strategies made external finance to be more of grants or loans with the grant element of 35% and more. Both bilateral and multilateral donors offer concessional financing with an average grant element of between 70% and 55% respectively which is greater than 35% as defined by the IMF. The higher grant element was preferable in all types and forms of financing. However, there are no conditions to check concessional debt terms and conditions to make them appropriate for the project being financed. This means the debt management strategies do not include divisions of projects based on project life time in order to assign appropriate maturity date and grace period which in turn creates problem in debt servicing activities. In addition, the strategies do not inform the source of any additional fiscal surplus arising from buoyant revenues indicating the difficulty in measuring the amount of return from specific program/project.

The fiscal measures include ensuring borrowing for a fit purpose and borrowing from an acceptable source with acceptable terms and conditions. Ethiopia's debt management strategies seek borrowings to finance the main priority and preferred country development programs such as SDPRP, PASDEP and to attain the MDGs. It is vital to maintain the MDGs as minimum long term government objectives and fulfill the targets of the SDPRP and PASDEP to respond to popular expectations. However, the focus of borrowing on investing on projects with high rates of return was low due to concentration on SDPRP and PASDEP which focused on poverty reduction program. In addition, cash flows from investment projects was not clearly identified as sufficient to make debt repayments. The debt management strategies show that there are no cases where borrowings were used for funding shortfalls in recurrent expenditure.

The debt management strategies also show that borrowings were from acceptable sources especially maximum IDA financing (grants and loans) restricted to concessional sources of finance as well as from other multilateral or bilateral donors. Concessional lending was available through multilateral agencies like the ADB and World Bank and bilateral donors like China and others. Even though there are limited or no borrowing from unacceptable sources such as central bank, commercial lenders or any other private sources, the debt management strategies were not proposed that borrowing from such sources were prohibited.

The debt management strategies ensured that borrowing was based on acceptable terms and conditions such as grant/concessional element, debt sustainability and affordability issues. The debt strategy also took concentration risk in a way that it became necessary to look into the future borrowings and ensure that the country would not resort to debt crisis and at the same time generate enough resources to finance the SDPRP, PASDEP and attain the MDGs. However, the kind of interest rate (fixed or variable) further to the amount was not visualized even though it has a decisive role in predicting future cost of debt. In the case of maturity date the strategy also fails to closely align it with the cash of the project, its duration, inter-generational equity and time value of money. As a result the advantage of very long term loans would be outweighed by accumulating large amount of debt over many generations.

In addition, the strategy papers did not take into account repayment risk where the government must be able to afford the debt repayment over the life of the loan and repayments must be timed for months with lower repayment volumes or where the government had peaks in cash collection. The debt management strategies were also unsuccessful to consider exchange rate risk faced even if there were low interest rates because the benefit of very low interest rates could be negated by depreciation of government currency against the loan currencies.

The Ethiopia debt management strategies did not focus on the development of domestic debt market at all indicating the country's plan to continue with increased external financing rather to reduce external debt burden in the future. However, this has been improved in the existing debt management strategy giving attention to the development of domestic debt market.

In order to ensure that the above mentioned objectives are met, legal, institutional and operational measures were needed to be considered in the debt management strategy. Accordingly, the Ethiopian debt management strategy put the legal framework without detail lists to be

accomplished. But, it has been with the major task of negotiating the legal issues to reduce conditions precedent to legal opinion through clearing all loan contracts with the Attorneys General Office before signing the loan agreement.

However, the debt management strategies failed to include the institutional framework which takes in to account the functions and responsibilities of each debt management unit. This may result in intricacy to make a plan for undertaking functions of debt management as well as in properly executing the functions and responsibilities. This in turn results in difficult situation to make past performance evaluation that may be a help not to replicate problems encountered earlier.

Regarding the operational frame work, the debt management strategy of Ethiopia in maintaining and building government's accountability and transparency, it established a comprehensive grants database called DEMFAS in MoFED for recording and monitoring all grant flows. This is important for establishing more effective procedures to monitor all disbursements and reports; for conducting semiannual survey of donors on commitments and disbursements to government agencies; and for obtaining information on all disbursements from all donors.

### **3.3 Sources of Debt Finance**

As discussed earlier, the International Financial Institutions (IFIs) Directorate and Bilateral Development Cooperation (BDC) Directorate are part of debt management office responsible in carrying out the activities of front office debt management unit. Based on the document review conducted, the IFIs directorate works with the International Financial Institutions like the World Bank and African Development Bank whereas the BDC directorate works with various countries which has been confirmed from the separate interviews conducted with the two directorates.

The interview conducted with the international financial institutions (IFIs) directorate shows that the IFIs are categorized into two based on the nature of relations with various countries. On the one side there are IFIs that work with country strategic papers or frameworks which stay for a period of 3-5 years where commitments are made from the framework; these are the International Development Association/IDA, The African Development Bank/AfDB and International Fund for Agricultural development/IFAD. On the other side the Bank of Arab for Economic Development in Africa (BADEA), Opec Fund for International Development (OFID), European Investment Bank (EIB) and Nordic Development Fund (NDF) are IFIs that the government

requests them to support projects/programs whenever necessary. In addition, to the interview conducted, the existence of various creditors as mentioned above are existed with the amount they have been given as per table3.1

Table 3.1 The Amount External Debt by Lender Category, Creditor Type and Creditor (Million USD)

	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
Total	6,240	551.70	497.98	423.16	357.79	394.10	1,750.20	1,564.49	2,081.47	1,650.40
Official creditors	3,840.14	339.52	372.70	381.94	357.79	394.10	882.96	1,115.07	1,079.58	1,175.98
Multilaterals	3,827.25	338.38	370.04	242.19	277.77	280.25	595.51	857.30	674.09	661.33
AFDF	499.02	44.12	133.21	48.05	46.45	76.52	130.62	118.62	181.20	79.39
BADEA	3.85	0.34	0.09	1.92	11.51	8.55	7.79	8.64	6.52	6.91
EIB	-	-	13.24	19.24	30.05	27.89	31.88	12.94	7.01	5.66
IDA	2,760.89	244.10	178.29	145.75	158.18	144.39	358.27	525.52	394.32	551.19
IFAD	136.86	12.10	12.54	17.26	20.20	6.68	3.40	5.24	12.24	11.50
IMF	340.79	30.13	15.25	-	-	-	50	175.66	62.11	-
NDF	29.41	2.60	5.34	4.69	2.68	2.88	2	2.44	3.05	0.94
OFID	56.55	5.00	12.08	5.28	8.72	13.34	8.56	8.24	7.65	5.73
Bilateral	12.78	1.13	2.67	139.75	80.02	113.84	290.45	257.77	405.49	514.65
Paris club(Italy)	-	-	-	133.19	56.18	60.79	39.21	5.11	0.63	0.01
Non paris club	12.78	1.13	2.67	6.56	23.84	53.05	251.24	252.66	404.86	514.64
China	-	-	1.60	5.32	6.79	10.58	183.47	168.84	299.38	371.59
India	-	-	-	-	13.00	32.13	53.56	73.85	84.92	127.19
Kuwait Fund	12.78	1.13	1.07	1.24	1.56	5.94	8.32	6.15	16.39	14.19
Saudi Fund	-	-	-	-	2.50	4.40	5.89	3.82	4.17	1.67
Private creditors	2,399.97	212.19	125.28	41.22	-	-	867.24	449.42	1,001.89	474.42

Source: MOFED public sector external debt bulletin (2002-2011)

On the other hand according to the interview conducted with bilateral Development cooperation directorate, resources from bilateral creditors are more of grants rather than loans. As observed from table 3.1 large amount of loan are given from China. But, the amount of loan given by Italy declined from time to time according to the interview made with the bilateral directorates and also indicated in table 3.1 almost approaching to null in 2011. Therefore, the study focuses more on IFIs whereby large amount of loans are contributed rather than bilateral creditors.

### **3.4 Debt Mobilization, Approval, Disbursement and Repayment Processes**

#### **3.4.1 Debt Mobilization and Approval Process**

As observed from various manuals as well as from directorates responses to interviews, the main responsibilities of international financial institutions and bilateral development cooperation directorates include mobilizing resources from the above institutions, coordination, facilitating and taking part in negotiations, facilitating for signing by the higher officials of the institution, making sure that the resource gained are being utilized on the intended objectives supported by planning directorate for making the government strategy, project appraisal, outlining the government priority areas and reviewing or working project costs. Accordingly, the tasks confirm the react of the directorates that the IFIs and BDC directorates are the main actors of debt management directorates in performing the activities of front office debt management unit based on activities listed on the literature review even if the title of their naming is different from the word debt management.

##### **3.4.1.1 Mobilizing External Loans**

According to the interview conducted with the IFIs and bilateral development cooperation directorates, different projects and programs are being carried out to implement the development policies and strategies of the country and indeed external resource has an important role for the success of the implementation.

To resolve coordination problems seen sometimes on the utilization of external resources, it is key to put additional efforts to make sure that external resources which are increasing from time to time are on the right track of utilization. Among the various works carried out to improve the efficiency as well as to inform relevant bodies, the activities being done by the directorate especially on mobilization of external resources are believed to be vital.

According to the interview made with both IFIs and BDC directorates, resource mobilization starts from the medium or long term strategy where the donors become well informed. From this long term strategy there exist various pillars to be implemented and thereby different projects and programs ideas are generated. Even though it is advantageous to start mobilization from countries strategies and policies it is important to be flexible in times when urgent and unusual cases are created.

Loan mobilization involves submitting specific project profile prepared by IIs (Implementing Institutions) based on the capacity, interest and technical experts that the specific creditor has in order to accomplish the project effectively. During this stage, MoFED will just oversee without deep involvement followed by project appraisal stage by the creditors. MoFED oversees without deep involvement due to the fact the institution is faced with shortage of human labor force which may result in cases where the projects fail to be appraised by the creditors in turn resulting in cancelation of the project. Nevertheless, MoFED has crucial role in ensuring efficiency as well as investing in a way that the desired objectives are achieved whereby the future generation pays. This is an implication that MoFED realizes value of money where the creditors have no interest at all.

Loan mobilizations are used either with various creditors or with the same creditors depending on the cases encountered. From the interview conducted most of the time ways of debt mobilization though independent discussion with higher level officials as well as discussions of the Ethiopia's ambassador with creditor countries take place for mobilizing funds from bilateral creditors such as Japan, China, India and others. In addition the focus for bilateral creditor lies on country's specific draw backs and opportunities such as corruption, kind of labor force in the expectation on how the loan is effective and repaid. But, the focus for IFIs such as IDA, ADF and IFAD lies on the general situation of the country's strategy and policy implementations with their objective of establishment.

#### **a. Creditors Interest/Bases to Provide Loan**

Debt mobilization also involves the study of creditor's interest or bases in order to identify and select the best which fit to implement the country's specific program/project. According to the interview made with the IFIs directorate, ten and fifteen years ago creditors had no interest to give loan for the country like Ethiopia because of political instability, low repayment capacity, low income generation and low implementation capacity of sector institutions. However, currently the creditors are than before to give loan because the country is growing with stable political conditions, improved repayment capacity as well as increasing income generation capacity which is also confirmed through the interview with BDC directorate. In addition, many creditors are very much eager to give loan due to the fact that Ethiopia is committed in mobilizing the money on the planned activities even if delay occurs in the process. This is an

indication that how Ethiopia was in struggle in debt service payment activities some years ago where creditors were more worried about the repayment process, and now the case happens to the contrary. This is observed from the debt capacity analysis of the directorates that Ethiopia's debt is affordable and the country can borrow more.

According to independent interview conducted with each front office directorates, bilateral creditors such as India, Turkey as well as China are very much interested to invest because they have established objective to promote development in low as well as middle income countries like IFIs but also because of large amount of surplus in their deposit. IDA, which is the major IFIs depends on IDA 14 replenishment in giving loan where the credit worthy country gets a 100% concessional loan, the middle credit worthy countries get 50% grant and 50% loan while countries which are not credit worthy at all get 100% grant. Unlike IDA, the bilateral creditors depend on article 4 of IMF report which shows country's repayment and current status of loan are in better conditions. From this it is visualized that the IFIs have general objective of establishment to contribute to all countries depending on the status of that specific country whereas bilateral creditors focus on measuring the status of specific countries that fulfill their interests to give loan focusing on its repayment capacity and its debt burden. So, in fulfillment of creditor's interest it may be to some extent a challenge for the debtor country to fulfill interests of bilateral creditors than IFIs. In addition to the IMF report, the bilateral creditors themselves work with their own assessment either through physical involvement in the project site as Japan made it or through doing assessment being in their home country which is not the case for IFIs which make the country to use international standard ways of large procurement guidelines such as ICB, efficient value for money and financial management. In this case there is no option for the government to discard but to use the international ways in doing the activities because there are no better ways or studies other than these alternatives by the IFIs.

Regarding the influence of policy activities the IFIs specifically IDA advice the country to correct the policy even though it has the right to accept or not due to the respect of the country policy. But bilateral creditors especially China does not involve in the political condition, has favorable terms and conditions and large volume of debt. However, the disadvantage of engagement with China is that most of the loans are tide loans whereby the contractors, supervisors and loans come from China. But, according to the status of the country, the Ethiopian government has no choice for not accepting the tiding process because there are no other

alternative creditors involved in giving large volume of loan as China, reflecting the inaccessibility of creditors as per the interest of debtors. So, the Ethiopian government will be forced to make the project effective rather than allocative efficiency due to the unavailability of alternative creditors.

The creditors have also interest in terms of specific sectors such as water, road, agriculture and others because of specific experts and focus area in their countries whereby some of bilateral creditors are able to make assessment or feasibility study of specific project/program. For instance, in the case of IFIs, IFAD is an independent institution which mostly focuses on agricultural projects as confirmed from the reports of IFIs directorate showing the lists of project run by IFAD, whereas creditors such as China or Japan focus on activities in which full of experts are available in their home countries in order to make assessment or feasibility study of specific program/project. Sometimes it would be a necessary condition for fulfillment of interest of creditors in sector wise because the IIs in Ethiopia may not have experts in performing the feasibility study of specific project/program as well in making them effective.

#### **b. Directorate's Bases in Selecting Potential Creditors**

The interview conducted with both the IFIs and BDC directorates indicates that, in the process to finance the prioritized project/programs there is a need to select potential creditors based on the criteria such as the type of support traditionally provided by the creditor as well as the traditional sectors and projects supported by a particular creditor followed by concessionality and amounts of the loan instrument. For instance, a financing request for an agricultural project is provided to IFAD which is more concerned with agricultural projects than BADEA or any other financier. Regarding the type of support, the government prefers grants rather than loans which are reflected from the current practice being implemented in the country. The government also focuses more on concessional loan having large volume with the lowest interest rate and longer maturity period emphasizing on the need to finance huge projects/programs which reflects how far the front office is careful and planned to reduce burden during repayment.

However, criteria such as the channels through which the resources will be delivered to the country, dialogue on issues related to disbursements of loans, commitment of creditors in delivery of loanable funds, the flexibility of the creditor in accommodating the Government's funding requirements, degree to which a creditor plays an independent role in the policy,

conditionality associated with the disbursements of the committed loans and how strictly they are enforced are not bases in selecting potential creditors. This is due to the fact that most of the creditors are committed in delivery of loanable funds, are flexible in accepting government requirement (respect country ownership policy), have independent role in policy only through giving advice rather than influencing specially China's policy interference are very low almost null. In addition the creditors are not facing any problem in strictly enforcing the disbursement of the committed loans.

But, there is a gap in observing the dialogue relating to disbursement of loans due to the fact that most of the project/ program face delays in making disbursement in turn resulting in delays in final accomplishment of the project/program. In addition, previous contracts that have been signed with the creditor are not reviewed with the objective of looking at improvements in the proposed contract and other clauses for negotiation rather simply concentrating on the amount of loan given and creditors interest (availability of experts) in running the project/program in cooperation with the implementing institutions (IIs) indicating absence of past performance evaluation and monitoring being a problem for improvement and correction.

#### **3.4.1.2 Preparation of Country Strategy Papers**

Based on the document review conducted preparation of country strategy papers is all about setting frameworks on cooperation of the country with development partners that are involved in executing agreement with creditors regarding the amount of loan and countries priority sectors. Most strategy papers are mutually owned through participation of IIs, DMD and creditors for a period of three up to five years.

As mentioned above in the loan mobilization part the papers prepared by IFIs are also based on the country's priorities on the national plans. This reflects that there are no limitations or debatable issues during strategy papers preparation for the purpose of inclusion or exclusion of specific issue in turn showing the existence of respect of country ownership policy and also how the IFIs well inherited or informed about the debtor countries polices, strategies and objectives in supporting the least developed countries like Ethiopia.

In addition to the countries polices and strategies, when the strategy is divided to projects, preconditions include ability of paying back the loan, its effect on loan outstanding as well as on annual debt service payment, the alignment of debt terms and conditions with the country's debt

policy strategy needs to be clarified in detail which is also considered by other creditors as a base for providing loan. This reflects that the strategic paper implementations are free from making any burden on the country and they do not influence the country's policies and strategies in turn respecting the country's ownership. Based on this country strategy papers with IDA, ADF and IFAD are called country assistance strategy, country strategy paper and country strategic opportunity papers respectively are prepared.

According to the interview made with the bilateral development cooperation directorate, like the IFIs the bilateral creditors have their own framework agreement from a period of 3-5 years specifically focusing on specific project based on their interest and expertise they have.

#### **3.4.1.3 Preparation of Projects Financed by External Loan**

The interview conducted with IFIs and BDC directorates indicates the above strategic preparations are not enough. So, additional endeavor is made to mobilize external resources from non-traditional and new financiers beyond those found from cooperation frameworks where the different sector IIs are invited to send project documents due to the fact that the available finance is not enough to achieve all our objectives. This was also confirmed from the office reports of the directorates showing the lists of projects performed by each creditor other than the strategic papers. For instance railway cannot be financed by the IFIs because it needs large amount of resources rather, it can be financed by China or other bilateral corporations who have the ability to finance with large volume of loan with comfortable terms and conditions.

According to the document review conducted the project preparation procedure follows those procedures that are followed by the main financiers. Hence, the project passes through different processes from concept development to its implementation by external finance including among others project document preparation, feasibility studies, pre-appraisal and appraisal, negotiations and signing of loan agreements which has been confirmed by the interview conducted with both IFIs and BDC directorates.

#### **Bases in selecting potential project documents**

Based on various preconditions listed on the literature review during the selection process of potential project documents the main base in choosing the priority area for program/project

financing is the country-financer partnership frameworks which emanate from the national plans followed by creditor interests, according to the interview conducted with the directorates.

However, the probability of choosing projects/programs on the bases of the level of return, capacity of IIs to run the project or based on completion period is very low and almost they are not bases at all. This reflects that there is an influence of higher level officials and policy makers in simply focusing on the achievement of country's national plan without consideration of plan to be made for debt service payment and problems faced during this process. In addition, the inability to observe capacity of IIs to run the project may result in delay of project accomplishment and also low project effectiveness as well.

In addition to the above bases made by higher officials, the directorates also participate in facilitating and submitting the external financing requests of the sector institutions to the creditors after evaluating and facilitating the evaluation by the relevant sections of the ministry. This is important to make sure that the ideas and comments from the different divisions of MoFED is incorporated in to the project document based on proclamation No. 41/1993 which provides MoFED with the responsibility of following up and evaluating the execution of loan of the federal government.

During this process the basic areas to be visualized by IFIs directorate includes, the alignment with strategies and policies, place for investment and correctness of the cost table whereas BDC directorate focuses on , checking whether it is priority area or not, whether it is given for other creditor before, whether it benefits large number of peoples, alignment with their own project preparation guidelines, feasibility study, implementation arrangement, clear objective, necessities of each and every procurements, necessities of the requested expert and consultant employment. In general, visualizing these areas are helpful to prevent the country from future burden, to determine whether the specific project is beneficial for lower group of society as well as to make the current project more effective with the lowest cost and risk.

According to the interview conducted with the front office directorates (IFIs and BDC), the greater advantage is that the project documents which are not addressing the above issues or preconditions will neither be sent to the creditors nor be incorporated in the loan agreement. The project proposal sent from IIs can also be discarded if it is wrongly designed. This is a reflection that the front office directorates are committed to fulfilling the benefit of low income group of society which is important in the achievement of country's development as well as in properly

implementing the project/program. In addition they are responsible to make the IIs learn from their mistakes by themselves so that mistakes will not be repeated again.

Finally, memos will be written to the top management of MoFED for approval so that the projects which are final after comments from different stakeholders will be sent to the IFIs or bilateral creditors to be financed. Accordingly, the directorates facilitate the appraisal by the creditors when feasibility and design studies are completed. The main issues reviewed by creditors at the project appraisal stage include the feasibility study and area of the sector in which they are interested in order to make assessment and confidentially give the requested amount of loan. Finally, it will be published and the negotiation process starts to take place from the appraisal document.

Even though MoFED is bestowed with the responsibilities under proclamation No. 41/1993, the activities were found to suffer from limitations such as inadequate attention given to monitoring and evaluation, focusing on reports submitted to decision makers that there is a potential for the system to be loose and lack enforcement mechanisms to control reluctant implementers. Lastly, absence of comprehensive monitoring and evaluation guideline that treat projects financed from external source due to shortage of labor force in the debt management directorates especially who are engaged in technical monitoring and evaluation process and who design guideline in monitoring and evaluation is the major challenge faced with the directorates.

#### **3.4.1.4 Negotiations of Loans**

After completion of activities in pre-negotiation stage such as project appraisals, disbursement and procurement procedures are reviewed, then the draft loan agreement will be prepared by IFIs as well as by bilateral creditors to be negotiated along with projects appraisal documents and other packages like disbursement letters including legal obligation.

Based on the document reviewed, negotiation delegates comprised of the IIs, the legal and the directorates sections such as, the debt management directorate; the international financial institutions (IFIs) directorate and bilateral development cooperation (BDC) directorate of the MoFED are sent to the financiers. This was confirmed during the interview made with each negotiation delegates.

This interview also indicates that during negotiations, the ideas which are important will be taken in to the loan agreement while ideas or preconditions which are difficult to implement and having problems in implementation will be excluded from loan agreements. Nevertheless, the negotiating team do not have written negotiation strategy in order to run the negotiation process but through experience the IFIs and BDC directorates internalize the crucial areas that the loan must be concessional having 35% and above grant element; projects need to focus on the priority areas of government based on the national plan and understand creditors as well as their own policies and strategies carefully being the general condition for negotiation. However, this absence of negotiation strategy may result in difficulty in negotiation process. This is because the newly employed negotiating team that comes due to high turnover may face difficulty in negotiation as it lacks previous experience and doesn't have a negotiation strategy as reference to run the negotiation process and consequently bringing greater burden on the country in the future. For instance, some of the burden with the accomplishing of certain program/project can be high project cost through the involvement of more international workers and consultants, procurement of more luxury products such as vehicles and others.

**a. Areas of Negotiation and Skills of Negotiating Team**

The front office directorate's interview indicates that the most frequently contentious areas during negotiations between financiers and the government include the legal issues. Because, the legal framework of the country is expected to differ from what the financiers know which is confirmed from the negotiation documents where the creditors give policy advice for debtor country.

According to the interview made with the IFIs directorate, the most frequent debatable areas during negotiations between financiers and the government include procurements of goods and services specifically on the procurements of vehicles, request for international consultant by IIs, as to who and where the work is carried out as well as cost allocation and implementation frame work. On the other hand from the interview conducted with BDC the negotiable areas include amount of commitment fee, management fee, upfront fee, request to give them information on the original or traditional creditors which is non confidential and concessional of the loan. As discussed above even though the negotiating team internalized crucial areas such as the level of concessional and government priority areas there exists debate on these areas. This is an

indication that these areas are not general areas or non negotiable areas of negotiation even though the country is mostly involved in receiving concessional loans which is universal and known by various creditors. As observed from above areas of negotiations most of the time the creditors have no interest on the efficient allocation but on the accomplishment of the project while the directorate's especially IFIs directorate objective focus on a locative efficiency. For instance, the IFIs directorate agrees in the reduction in the amount of commitment fee, checking how much the requested procurements are necessary for the project/program and that the consultant should be national rather than international consultant so that there exists job opportunities.

Based on the interview conducted with both front office directorates, as the government incentives for its employees is minimal, the senior experts mostly resign and hence newly employed experts assigned to negotiate which limits the extent to which the government delegates negotiate in a way the country's benefits can be maximized. In addition, most of the negotiating team members are learned through experience without capacity building and no facility for experts both financially and physically reflecting the need for capacity building.

According to the statements of negotiating teams of IFIs directorate, when the negotiation become more sophisticated there is a need for deep knowledge for each cases by different peoples coming from various sectors with diverse knowledge which is not practical in Ethiopian case. This is an indication for non existence of independent experts in credit market as well as financial risk analysis. This idea was supported by the interview with BDC directorate which indicates that some of the conversations or written activities during negotiation may not be clear for them and they simple pass knowingly or unknowingly which results in difficult situation or great burden for the country in the future. However, most of loans taken by Ethiopian government are concessional and easy for negotiation being less prone to gap in the negotiating team expertise. But, in the future due to country development the loans will be more non concessional necessitating various experts during negotiation process.

### **b. Tasks of Negotiation Team**

The interview made show that the legal office of MoFED is a part of negotiation team. Accordingly, the major issues that needs to accounted in order to give legal opinion to the creditors includes the FDRE constitution, the treaty making procedure proclamation No.25/1988, and definition of powers and duties of the executive organs of FDRE proclamation No.91/1988 in turn to check for the synchronization of loan agreements with the country's legal framework.

On the other hand according to the response made by the debt management directorate task during the negotiation of new loans includes; giving proposal on loan terms, make analysis on the impact of new borrowings on the existing portfolio, observe the alignment of draft loan agreement with the country policy and strategy, checking the conformity of loan agreements with what was agreed during negotiations, and acquiring loan agreement. Until now the debt management directorate didn't face problem of non alignment of loan agreement with the country policy and strategy because the main objective of the government lies on the achievement of country's development and also the creditor objectives lies on promoting the development of low income countries intern making them capitalist state and reducing the level of poverty.

After finalization of negotiation preparation of loan agreement minutes of the negotiation will be prepared, government negotiating team takes into account points of consensus and divergence and finally sends to the higher management of MoFED for approval. However, during negotiation they do not take particular note of nonverbal communications such as appearance, punctuality and conduct except taking the particular note of the composition of negotiating team which reflects the non preparedness, non confidence and non credibility of the team. This is due to the fact that the negotiating teams are not careful to recognize the importance of these non verbal communications may be due to low negotiating skill and absence of negotiation strategy.

Appointment will be made if the loan agreement is to be signed within the country then with that appointment date loan agreement will be signed between MoFED and the financing Institution. On the other hand if the loan agreement is going to be signed outside Ethiopia necessarily, authorization regarding legal service will be given through ministry of foreign affairs. In order to make the loan agreements appropriate for implementation copy of loan agreements will be sent to IIs and other concerned parties.

### **3.4.1.5 Tasks starting from Loan Agreement up to Program/ Project Effectiveness**

Various tasks exist beginning from loan agreement up to the point where the program/project becomes effective. The major task of IFIs and BDC directorate is to follow the concerned IIs in order to meet the exact date for effectiveness of the loan as written on loan agreement.

#### **a. Approval by Councils of Ministers and House of Peoples Representatives (HPR)**

The interview with the front office directorates also shows their activities in making follow up on the approval of loan agreement by councils of ministers through briefing them on loans mobilized from the IFIs or bilateral creditors with the prepared notes and descriptions. In addition, the task involves the process of following loan agreement approval by the HPR after the council of ministers approves mostly taking place with one month time interval. Accordingly, it will be outlined legally through the legal office and finally sent to the creditor institutions.

According to the conversation made with both front office directorates, there are cases where the council of ministers refuse to approve the draft loan agreement even if MoFED participates in defending and making them understand. During the previous time the role of council of ministers was strong and there were cases where the loan agreement becomes cancelled. But, this role in loan approval process has declined through time reflected from the fact that all loan provided to the council of ministers are approved without any comment and discard point. In addition, this reflects the existence of approved projects which are less advantageous to the lower income group of the society in turn becoming less useful to the country development.

The main and important areas visualized by the ministry of councils include checking the ethnicity of regional incorporation, focus on the realization of before investments and the practice must be performed in order to make the lower level of the society advantageous. The HPR also focuses on the same issue but due to their lower level representation they know the specific activities being taking place in specific area and needed by the lower group people. As a whole the tasks of the both the council of ministers as well as HPR lies on the achievement of country national though making the lower income society advantageous due to the fact that large number of population of the country lies on the stage of lower income group. So the decline in the role of council of ministers need to be corrected otherwise the richer group is going to be richer which

creates more gaps between the elite group and the lower income group in turn hindering country development.

**b. Fulfillment of Preconditions for Project/Program Effectiveness**

After final approval by HPR the fulfillment of preconditions such as, administration, financial and legal condition in the IIs which can be handed over by indirect project IIs as well as lists of signatories and signature samples will be sent to creditors. The interview conducted with the directorates indicate that support will also given during the fulfillment of preconditions for project/program effectiveness such as institutionalizing project implementing organs, hiring project coordinators, opening special accounts, sending signatories and legal opinion to the IFIs and bilateral creditors. However, there are delay in fulfillment of the preconditions due to time lag in making disbursement by creditors and also waiting confirmation from co-financers if any has agreed to finance the project/program are the major challenges which laid a major impediment in declaring project effectiveness after loan agreement signing which mostly taking place from 90-120days time interval. In addition, factors such as delays to make disbursement/financial report and the nature of the project/program are also the major factors which make the program/project effectiveness to be delayed.

The interview with the front office directorates also indicates that there are no research work being done in making effective loan allocation however, they are involved in doing assessment on each and every projects in order to identify the problem faced with and accordingly to forward exact solution. This implies that the identification of current problems and solutions do not follow scientific steps of basic research work and do not have an ability for problems not to be created in future or with no future implication. In addition IFIs and bilateral creditors have full mandate to cancel the loan given to specific sector, to divert the location as well as to make additional finance from the government treasury. These decisive powers given to the directorates are important in making the project effective on time through reducing time needed in approval.

For the implementation process such as financial management, procurement procedures full mandate is given to the IIs and report its progress for the DMD as well as for creditors. Even though, the DMD has tasks in restructuring, to shift from one category to other category or to drop the category they face with shortage of skilled technical labor force which is the major

challenge in order to make site visitation than being only dependant on reports which contributes to the quality as well as necessities of longer time interval in the project effectiveness.

#### **3.4.1.6 Additional Finance**

The tasks of facilitating additional finance are part of the responsibilities of IFIs and BDC directorates. According to the interview conducted with BDC directorates, most of the time additional finance is not requested but it can exist, at times when there is delay in the signing of loan agreement by one of co-financer. Nevertheless, the interviews conducted with the IFIs directorate indicate that additional finance is requested mostly in order to expand areas to be covered by the projects which were not planned earlier. In addition, some of the IIs face shortage of finance to complete the project due to various reasons such as flexibility in exchange rate, inflation, design problem, problems in fully envisaging the project, commencing the project without having full finance to complete the project at time of its beginning or implementation, inappropriate project/program feasibility study, change in the government interest may request additional finance other than the amount under loan agreement in order to complete.

Out of the above listed problems flexibility in exchange rate, inflation, change in the government interest, delay in the signing of loan agreement by one of co-financer cannot be controlled or improved by the IIs remaining a challenge in the achievement of project effectiveness but others can easily be controlled by the IIs and resulted due to unskilled workers engaged in that specific project or program showing the necessity for skilled labor force from designing stage up to effective implementation. Sometimes, the financer itself may be motivated during project site visit and be convinced to make additional finance for the expansion of project.

Accordingly, these shortfalls are mostly financed either by fund from creditors especially when the creditor is IDA as observed from Table 3.3 or from governments fund known as matching funds especially for bilateral creditors and also from the government treasury which may be taken either from grants or from other expenditure activities. Additional finance from the government treasury or account may make the government fund to be diverted from other expenditures; accordingly, it reduces the advantages driven from that specific expenditure tasks.

Table 3.2 List of Sample Projects with Additional Finance In Thousands of US Dollar

Program/project	Total additional finance in different years	The source for additional finance	The reason for additional finance
Productive safety net program III	130,281.2	IDA	For activities to allow the program to scale up
Irrigation and Drainage project	2,492.09	IDA	Based on market price it is expected that the current budget would suffice for the construction of entire Megach puls Ribb phase1 including headworks and 3,300ha so additional finance would need to be secured for Ribb phase 2(remaining 10,000 ha)
Energy access project	18,247.98	IDA	Improve the quality and reliability of service and to extend service to additional consumers
Public sector capacity building project	48,811	IDA	Both to extend the coverage of the project and shortage of finance
PBS III	174,730	IDA	Because of shortage of finance
Urban local government development	113, 638.89	IDA	Because there was a need for extending the coverage and also the inflationary conditions.
First road sector development program	69,945.87	IDA	Both to extend the coverage of the project and shortage of finance
Second road sector development program	114,950	IDA	To extend the coverage of the project
Water supply and sanitation	78,316.98	IDA	Both to extend the coverage of the project and shortage of finance
Urban water supply and sanitation	8,758.09	IDA	To extend the coverage of the project and shortage of finance

Source: Report of IFIs directorate: 2014

Long time ago there was large amount of additional finance because of poor planning and low capacity building trend which is not currently the case. From the above table it is clear that almost all of additional finances are covered by IDA but none of other creditors involved in additional finance because of their low ability and capacity to perform and most of the creditors

were financing through phase approach which do not necessitate additional finance. However, IDA is the main IFIs that involve in giving loan to the multi sector projects/programs so that necessitate making additional finance for those projects/programs as confirmed from the above table.

### **3.4.2 The Debt Disbursement**

#### **3.4.2.1 Distribution of External Loan Disbursements**

According to the interview made with the debt management directorate (DMD) debt management office used various kinds of disbursements such as direct disbursement to project account, direct payment to contractors and reimbursement method, which is used when the implementing institutions use from their own resource then they requests creditor for re-fund. The most frequently used disbursement method is direct disbursement while reimbursement method is the less frequently used method because on the one hand most of the IIs do not have enough money to finance and secondly, the method is used only during urgent and unusual cases. Most of the time reimbursements are not executed to finance the whole project/program because of government inability. For instance, for the implementation of the G-equip phases two project which focuses on education there was a need to take finance from the government to enable the workers and consultants, who were participating on phase one project to stay on phase two project. Accordingly, the reimbursement took place when the creditor made the first disbursement for G-equip phase two project.

Based on table 3.4 before 2005 there were some part of external debt that enters to the government budget known as budget support specifically on structural adjustment and reorganization where the disbursement was made directly to the government treasury account. During that time according to the interview conducted, there were no requests made by creditors regarding the areas where the loans are disbursed and whether the loan was effective or not; and the government was not obliged to make past performance report and audit report. But after the year 2009 as shown in the table below the disbursement of external debt other than on specific program/project started to be categorized with protection of basic service taking 15% and 12% of total disbursement in the year 2009 and 2010 respectively. These incorporate various sectors such as education, health and others which are basic for the society as a whole. However, in the case of protection of basic service the interview indicated that there is a need to report the status of each

and every loan mostly through auditing which was not the case for the budget support. The shift in disbursement from budget support to protection of basic service is the best indication that no external debt is being utilized for an unproductive purpose especially starting from the year 2009.

As shown in the Table 3.3 starting from the year 2009 the disbursement made on education start to decline while the disbursement on health become almost null indicating the shift in the disbursement on protection of basic service which takes in to account both education and health sectors in it.

Table 3.3 Percentage Share of External Debt Disbursement by Economic Sectors.

	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
	%	%	%	%	%	%	%	%	%	%
Agriculture	4.12	4.25	6.37	8.41	9.06	5.49	9.72	2.32	0.72	6.29
Financial Sector	7.1	6.81	4.96	2.01	2.64	5.16	4.15	11.23	3.24	-
Transport and communication	40.19	39.21	27.33	11.61	0.55	0.45	44.37	23.08	42.11	19.42
Highway - Transport Infrastructure	12.91	13.67	13.71	6.00	17.08	26.53	7.71	16.91	14.29	16.63
Electricity, Gas and Steam	5.06	6.47	6.30	44.03	36.05	41.83	24.59	18.28	16.96	30.80
Industry and Tourism	0.05	0.07	0.07	0.36	0.45	0.13	3.55	6.69	5.47	9.68
Education and Capacity Building	1.62	1.57	4.81	5.91	14.42	9.98	2.84	1.80	2.64	2.32
Health	6.76	6.60	6.16	5.20	1.67	1.89	0.29	-	-	-
Social & Public	14.26	15.43	10.64	14.04	12.29	-	0.94	2.27	4.24	2.02
Water Works and supply	0.79	0.55	1.74	2.44	5.79	8.55	1.85	2.31	2.63	4.72
Structural Adjustment	7.06	5.32	17.91	-	-	-	-	-	-	-
Reorganization	0.08	0.06	-	-	-	-	-	-	-	-
PBS	-	-	-	-	-	-	-	15.11	12.36	7.70

Source: MoFED Public Sector External Debt Bulletin (2002-2011)

From 2002 to 2007 transportation, communications as well as Electricity, gas and steam were taking the largest share of external debt with almost null resource allocation under both Sustainable Development and Poverty Reduction Program (SDPRP) and Plan for Accelerated and Sustained Development to End Poverty (PASDEP) program focusing on education and road. This indicates the non alignment of country development plan/program with the debt management directorate's disbursement activities.

On the other hand, the lowest loan disbursement was made on industry and tourism sectors due to less focus made by both SDPRP and PASDEP programs. However, in the case of tourism due to the availability of various natural areas to be visited by foreigners, it is important to give attention through country program so as to increase the disbursement on it in order to derive the greater return. Also in the case of the industry sector, in order to achieve the country plans such as ADLI, it is important to focus on industry next to agriculture so that the country can build its capacity further for more industrialization. In addition, even though the resource allocation through PASDEP program was lowest in power sector, the debt management directorate made the highest disbursement especially from 2005 up to 2007 where it contributed more to the country development due to its highest return.

Table 3.4 PASDEP Program Resource Allocation in Million Birr

Sectors	2005	2006	2007	2008	2009	Total
Education	6,618	6,846	7,166	7,737	7,776	36,142
Health	1,291	2,775	3,465	4,204	5,047	16,782
Agriculture and rural development	4,584	3,343	3,155	3,558	5,218	19,858
Roads	4,147	5,317	8,761	10,187	10,587	38,999
Water and sanitation	2,709	2,923	2,811	1,768	1,815	12,026
Irrigation	1,965	3,530	3,262	4,729	5,654	19,140
Power	1,610	3,027	2,023	1,426	1,024	9,110
Urban development	0	3,395	4,200	4,259	6,049	17,903
Telecommunication	0	0	0	0	0	0
Others*	0	1,377	1,206	1,233	1,150	4,966

\* Others: include private sector development, population and development and gender and development  
Source: PASDEP (2005/06-2009/10)

According to the interview conducted, among the major challenges faced with most of the creditors include a delay during loan disbursement for accomplishing the project on time and a cost increase due to various reasons such as exchange rate fluctuations and cost of various inputs. At times when delay exists, the government does not have the capacity to take measures not to be affected by the delay, at least to run the reimbursement in order to furnish start up work or

specifically for project preparation facility such as for the construction of project coordination unit, employment of project consultants, feasibility study, and undertaking of environmental and social assessment which covers mostly 10% of the total loan. For instance, in the case of bilateral corporation the signed agreement may not be disbursed for more than two years which results in delay in project accomplishing period with an increment in cost of project consultant and other inputs.

#### **3.4.2.2 Preconditions in Debt Disbursements**

According to the interview made with the DMD specifically for the occurrence of debt disbursement, various preconditions need to be fulfilled. During the first disbursement the IIs need to fill the withdrawal application form and send directly to the creditors without the approval of the MoFED. However, years ago MoFED would check the application form written by IIs before given to the creditors. But, currently MoFED has given full authorization for IIs to implement the program/project after being approved. One of the reason is that, large amount of projects are to be accomplished to achieve the national plan of the country resulting shortage of human labor in MoFED to approve the withdrawal application forms for disbursement.

The interview with DMD also indicates in addition to the withdrawal application form, preconditions in disbursements includes plan based accomplishing reports, general time plan outlines made on the loan agreement, statement of expenditure showing confirmation on the use of finance, entry financial report that shows the confirmation on distribution of appropriate amount of finance to each region including their confirmation for the acceptance. In addition, if the project implementation period becomes one year and more, the IIs are obliged to attach audit report made by an independent auditor in order to have the second round or other round disbursements. However, one of the strength is that simple requests from IIs without fulfillment of the above conditions cannot be a base for making second round and other round disbursements. This shows that how the creditors are responsible in accomplishing projects on time and for each disbursement in order to accomplish the project without additional cost which will be incurred by either the creditor itself or by the government.

In addition, when there are two or three phases in specific projects the IIs cannot make request for second phase disbursements unless they use 50% of the disbursement in the first phase of the

project which is important for the creditors in order to measure the performance of the first phase project and be confident in making disbursement for the second phase.

Following fulfillments of preconditions such as statement of expenditure, entry financial report and if the projects take place for more than a year audit report in the IIs, information showing disbursements are continue to be sent from creditors and received by implementation and monitoring stakeholders such as Banks and DMD.

### **3.4.2.3 The Debt Disbursement Process**

Based on the document review the disbursement documents have different designation based on different creditors. For instance disbursement document from IDA and IFAD are called 'Debt Advice' while from ADB/ADF are stated as 'disbursement voucher'.

The document review presents that the disbursement information documents received from each creditor will sequentially labeled with successive numbers according to arrival and kept in files. The contents of disbursement documents received from creditors are registered on Form 2A which includes names of the creditors, implementing organizations, creditor's reference numbers and loan number as explicitly assigned to each of loans by DMD. The finalized form 2A will be printed in 4 copies with one copy to beneficiary implementing agency, seeking confirmation to be sent back to DMD, the second sent to central accounts directorate for financial accounts consolidation, the third remains in file with archives for institutional safe keep and the last is kept for quick reference by employee who filled it. Unless the confirmation is made with the IIs the DMD will not record the disbursement made by the creditors on the DMFAS being an indication in control and evaluation of the disbursement process.

The document review also indicates in case where the implementing organizations responded that the information indicated on Form 2A has discrepancies with their records, DMD seeks clarification from the creditor organizations and the appropriate information will be verified. Accordingly, the interview conducted discuss the most common frequent discrepancies created are on the amount of the disbursement due to the fact that the disbursed amount reaches to the project account after 6 or 7 days resulting discrepancies because of day to day exchange rate fluctuations. In addition to the amount, there are discrepancies in disbursement request number and disbursement number which are important to differentiate where there exists the same

amount of disbursement. From this the researcher can draw that Exchange rate fluctuation can be the major challenge that the DMD faced with specifically in making compliance the amount of disbursement with the objective to be accomplished which may necessitates additional finance.

The interview conducted with DMD also indicates that the Information on the Form 2A will be recorded in DMFAS. Revision, adjustments and recording of any missed disbursements are made if the monthly balance on the disbursement summary for each loan is different from that recorded in DMFAS. At the end of each fiscal year verifications are made between records in DMFAS and the information of the disbursements documents of the creditors. However, most of the time discrepancies would not be created during verification if that is occurred, writing a memo to the creditor will hold the solution but exchange rate fluctuation can't be a reason for discrepancies because the currencies are in terms of foreign currency. This indicates the quality of back office in the recording of the amount of debt disbursement.

### **3.4.3 Debt Repayment Capacity Assessment**

The Ethiopian government borrows primarily to finance the cost of capital projects such as, power generation, construction of infrastructures such as roads, bridges, buildings and the purchase of expensive equipment so as to cover its deficit as a result of revenue shortage. This is because capital projects are often expensive in which governments are unable to afford them from the existing funds right away and more importantly borrowing is fairer to the tax payer than paying for capital projects directly from existing funds. However, if the government issues a debt and schedule for a payment scheme that fits the life time utility of the project/ program, the actual users of the project/program service will pay for the construction and operation of the project/program.

In the assessment of the debt repayment capacity the debt management directorate need to answer the following questions; is the current debt level affordable? Can Ethiopia borrow more? If yes how much more can Ethiopia borrow?

#### **3.4.3.1 Assessing the Current Debt Level**

The debt management directorates are involved in assessment of the current debt level in order to identify whether the current debt level is affordable or not. The variables needed in the assessment of the current debt level include the amount of debt outstanding, amount of debt

service payment (principal and interest), the level of export or other variables important in debt service payment. The assessment of debt for the last 10 years looks as follows:

Table 3.5 Public Sector External Debt Outstanding and Debt Service Payments in Million

Year	Currency	Total Outstanding	Total principal repayment	Total interest Repayment	Total Debt service
2002	USD	6,210.00	62.43	29.03	91.48
	ETB	54,169.76	548.25	253.46	801.83
2003	USD	7,317.84	66.91	32.46	99.37
	ETB	63,833.43	587.59	283.41	870.99
2004	USD	5,917.04	73.01	35.66	108.67
	ETB	51,790.49	638.01	311.63	949.64
2005	USD	5,998.53	75.24	33.02	108.26
	ETB	52,677.12	659.85	289.59	949.44
2006	USD	2,314.56	63.49	35.89	99.38
	ETB	21,107.97	564.57	318.10	882.67
2007	USD	2,767.06	57	31.67	88.67
	ETB	26,852.07	531.17	293.76	824.93
2008	USD	4,352.16	48.86	28.31	77.16
	ETB	49,660.30	504.25	299.50	803.75
2009	USD	5,633.26	69.51	41.77	111.28
	ETB	76,991.87	911.5	543.97	1,455.47
2010	USD	7,807.60	180.23	61.65	241.88
	ETB	133,331.81	3,006.21	1,024.45	4,030.65
2011	USD	8,888.65	309.05	103.03	412.07
	ETB	159,176.23	5,415.90	1,813.49	7,229.39

Source: MOFED public sector external debt bulletin 2002-2011

### 3.4.3.2 Determining the Debt Capacity

Two aspects that should be considered in measuring debt capacity include: can the government afford it? Can the community afford it? Accordingly the debt management directorates have used the Bretton Woods Institutions agreed framework that links country's risk of debt distress to the quality of a country's policies and institutions in return helping to examine the debt affordability. The debt indicators with their respective bench mark for country Ethiopia include the following:

Table 3.6 Debt Indicators with their Respective Bench Mark Level (%)

Debt Burden Indicators	Bench mark level
PV of debt/GDP	40%
PV of debt/exports	150%
Debt service/budget revenue	30%
Debt service/exports	20%
PV of debt/budget revenue	25%

Source: IMF: 2013

Among the above debt burden indicators the ratio of present value of debt to revenue, GDP and export are long term indicators of debt burden while the ratio of debt service to revenue and export on the other hand indicate the short term debt burden of the country. Therefore, in measuring the current Ethiopia's debt capacity the debt management directorate uses the debt service to export ratio and for measuring future debt capacity they use the ratio of PV of debt to export. The basic reason in using the amount of export rather than the level of revenue is that most of external debt burden is paid in the form of foreign currency which is generated from the amount of exports useful to avoid the risks associated with exchange rate flexibility.

Table 3.7 Amount of Debt Service Payment, Export and Debt to Export Ratio in Ethiopian Birr (Millions)

Year	Total Debt Service	Total amount of export	Debt service to export ratio (%)
2002	801.83	4,142.36	19.36
2003	870.99	5,176.64	16.83
2004	949.64	7,331.26	12.95
2005	949.44	8,685.38	10.93
2006	882.67	10,457.61	8.44
2007	824.93	13,649.34	6.04
2008	803.75	15,217.75	5.28
2009	1,455.47	26,115.31	5.57
2010	4,030.65	44,525.57	9.05
2011	7,229.39	54,494.77	13.27

Source for Exports: NBE 2002-2011

In observing the trends of debt service to export for the last 10 years, the amount of total debt service payment shows an increase from time to time starting from 2002 as observed in the above table due to large and various necessities of loan in financing capital projects in order to achieve country's development goals specifically the growth and transformation plan of the country. One of the major sources for financing the debt service was generated from the country's export in order to avoid risks faced with exchange rate flexibility.

What is an affordable debt level measured by debt to export ratio? As mentioned above the debt management directorate uses the internationally given benchmark to the low income countries specifically for Ethiopia that any payment level below 20% of the export generated amount is considered as an affordable debt level reflecting that every year's debt level was affordable. Any ratio value higher than this benchmark indicates that the country needs to reduce the level of debt or to increase the amount of export for debt payment.

Table 3.7 shows that in the year 2002 the level of debt service ratio was 19.36% being closer to the benchmark ratio reflecting the inability of the generated export level in repaying the total

debt outstanding. Nevertheless, through time it shows an improvement due to high percentage increase in the total amount of export rather than the increment in amount of total debt service payment.

However, starting from 2010 the percentage share of increment by level of debt service payment was the highest when compared with the increment with percentage increment in the amount of export due to an increase in amount of debt outstanding because of range of necessities for achieving national plan. This results an increase in the debt service to export ratio from 9.05 in 2010 to further increase to 13.27 in 2011.

#### **3.4.3.3 Determining the Additional Debt Capacity**

Even though additional debt capacity exists because, in all years the debt to export ratio was less than the bench mark ratio, the debt management directorates are not participated in showing the exact amount additional debt capacity, the amount to be afforded in principal and interest payment as well as the total affordable debt level. But simply involve in providing information for creditors or any other institution that Ethiopia's level of debt affordability.

#### **3.4.3.4 Determining the Future Debt Capacity**

According to the document reviewed in Ethiopia there exists estimation of debt ratio for the future in order to avoid future debt burden, to mobilize sources for future debt service payment, to detect any change in debt capacity over time and to continue debt sustainability of the country. This was confirmed from the interview conducted with the DMD involved in performing middle office activities.

Even if the debt affordability of the debt management directorate shows that the country can still borrow more during the above years. It is believed that a high percentage increment in debt outstanding than the amount of export forecasted in the next few years will significantly affect the country's debt capacity. Considering several new debt issuances already in the country's capital improvement plan and budget it is believed that the country may not be able to issue any new debt without exceeding the benchmark ratio.

#### **3.3.4.5 Preparing a Debt Capacity Report**

In preparing the debt capacity report, due to an increase in Projected PVD to export ratio (%) in the next five years the debt management directorates advice that, the country should consider to reduce the issuance of any new long term debt that will mature within the next five years.

In addition, in order to keep the country's debt capacity from deterioration for the next five years the country should consider restructuring some of its existing debt to reduce its PVD to export ratio. Option for refinancing the debt to a more favorable term in maturity should be considered. The country should also make an effort to increase its exports and should consider various export generation sources other than the existing to pay for the debt.

#### **3.3.4.6 Factors Hindering Debt Repayment Capacity**

Even though the debt management directorates study show that Ethiopia is having a moderate debt repayment capacity, there are major causes in reducing the debt repayment capacity of the country; first an increasing level of debt outstanding due to the necessities to perform various projects in order to meet country national plan, and second mismatch in allocating payment time.

According to the interview made with the front office directorates, the process of identifying or prioritizing adequate projects for debt financing do not take place, thereby happening of hindrance on the debt repayment capacity. This has also been supported by the interview conducted with the DMD explaining two reasons. First is a case whereby the loan is owned by public sector institutions guaranteed by the government, the economic returns from specific project/program distributed to the implementing institutions for widening the investment area or to finance areas where shortfall were created. The second reason is that most of projects/programs emanated from government national plan do not have financial return in turn to be used either by the government or IIs specifically concentrating on infrastructure, education, health and other projects which make the lower level societies advantageous.

In addition, delay exists in the achievement of the objective due to lack of follow up and evaluation by technical experts after debt disbursement as well as delay in disbursement as discussed before. Even if there are offices such as IFIs directorate and bilateral corporation in evaluation and follow up of loan financed projects they lack technical experts for evaluation and follow up simply focusing on commercial issue. However, this has minimum effect on the debt

repayment capacity due to the fact that the financial return of most of the projects/programs are low and are not take part in the debt repayment activities.

The interview with DMD also indicates that the most critical challenge in effecting debt service payment as per approved loan agreement includes flexibility in market conditions such as exchange rate, market price and others. For instance our currency exchange rate devaluation is the basic reason for reducing the debt repayment capacity.

To reduce the risk or problems faced with budget allocation for debt service payment the government needs to take care at the beginning in taking certain amount of loan to finance specific project/program. However, the interview conducted with the DMD indicates that it is comprehensible that the government was not facing any problem in preparation of detailed budget annual debt service payment. That means there are no challenges in finding source of revenue for debt service payment; the DMD can submit the debt service payment amount to budget office at any time without competition, debt service payment is a priority for the government than any other expenditures. The government must also make a payment and be loyal for the creditor not to be part of default and for other creditors not to be part of cross default in turn to get the requested amount of loan from them in the future. If there are cases where the government become in shortfall for debt service payment revenues were diverted from other parts of expenditure budget to debt service payment. This was also confirmed with the interview made with the experts of DMD specifically involved in debt recording activities.

#### **3.4.3.7 Debt Service Payment Process**

The document review made show that the annual budget plan is prepared for central government debt services of the coming fiscal year through converting different currencies to USD then again to birr which was supported by the interview made with the DMD. However, preparation of budget in birr currency can result more fluctuation from the real situation resulting the budget plan for debt service payment undervalued mostly in case where the government don't have enough foreign currency reserve even though the projected level of exchange rate considered from NBE or macroeconomic sectors.

The annual debt service budget request prepared depending on the debt service plan accordingly sent to the relevant functional units and follow up is made for the approval of the request.

Accordingly budget call will take place for budget defense in order to explain the reason for each budget. There are no problems during the approval process due to the fact that external debt payment has given priority but other sectors may be requested the reason and purpose of their budget. However, even if there are no constraints in debt service payment the government needs to give attention and take part at the start up of signing of new loan and make a plan for its repayment but couldn't rebuffer to make the payment once it is incurred.

Before due date Checking is made if a request for debt service is received from creditors. If a creditor didn't send payment request letter reminder letter is sent 15 days before debt service due date and continues follow up is conducted. Validation is done for the name of the project and the amount to be paid which is separately placed in relevant box files and continuous follow up is made until effect of payment. After duly effecting payments as per order number, withdrawal document of confirmation of due payment (bank debit advice) is collected from the central accounts directorate as received from NBE. If the currency to be paid according to the loan agreement didn't exist in the NBE account, then the NBE will request the correspondence bank. If it didn't exist in the correspondence bank the debtor will pay with an equivalent currency revealing that the debt will not be left unpaid even if shortage exists in the amount of the currency to be paid according to the loan agreement rather it will be paid with an equivalent currency.

## **Chapter Four**

### **4. Conclusion, Implications and Recommendations**

#### **4.1 Conclusion**

The Ethiopian external debt has been increasing from time to time primarily to finance the cost of capital projects such as power generation, roads, agriculture, education, health and other social and development sectors. This study attempted to examine the debt management strategy of Ethiopia as well as practices of external debt management of the country Ethiopia and the challenges encountered in the process.

In visualizing the major components of Ethiopia's debt management strategy, the main objective focused on debt sustainability analysis and less attention has been given to parts of debt management strategy such as, fiscal, legal, institutional and operational measures. Especially there were no conditions to check debt terms and conditions to make them appropriate for project to be financed, project cash flows were not need to be clearly identified as sufficient to make debt repayments and the kinds of interest rate (variable or fixed) were not visualized. In addition, the debt management strategy failed to focus on the development of domestic market.

The major activities being conducted by the debt management directorate include ensuring of the relevance and importance of loans to be borrowed through participation in debt negotiations with creditors, appropriately registering of loans obtained from bilateral and multilateral institutions, preparing of detailed budgets of annual principal and interest debt service on external loans. The activities also include arranging of payment schedule on amounts due, effecting of monthly payments to each creditor as per the approved budget, ensuring the effecting of government debt service according to loan agreements, preparing and sending statements for due collection of proceeds based on loan agreements, keeping collectables and the remaining loan balance document.

Despite the efforts in debt management activities, it is still at growing stage and not performing at its maximum potential. Accordingly, the major challenges faced with the country's debt management practice includes; shortage of human labor force, minimal skills of negotiating teams as well as those who are in charge of monitoring and evaluation process because of minimum working experience in that specific department due to the greater turn over; lack of negotiation strategy; inaccessibility of alternative creditors in order to find creditors whose

interest can easily be matched with the interests of debtor countries; late debt disbursement from creditors after loan agreement signing to make the project effective taking longer time intervals of 90 up to 120 days. The challenges also include the inability of the government to fund expenditures from treasury until the reimbursement made from the creditors; non-existence of past performance evaluation which leads to the repetition of the problems that were faced before and also inability to improve future performances.

The debt management directorates are involved in the assessment of the country's debt repayment capacity in such a way through measuring the current and future debt affordability by using the Bretton Woods Institutions agreed framework. But, the directorates do not participate in showing the exact amount of additional debt capacity, the amount to be afforded in principal and interest payment as well as the total affordable debt level. According to their study, even if Ethiopia's debt is affordable, flexibility in market conditions such as exchange rate, market price, inability in the expansion of export to increase as compared to percentage increment in total debt outstanding and necessitation of large amount of finance in order to accomplish the greater national plan of the country will affect the debt repayment capacity of the country.

## 4.2 Implications and Recommendations

In order to improve the debt management practice with specific focus on the activities of debt approval, mobilization, debt disbursement, debt repayment as well as the debt management strategy the following recommendations and implications are forwarded;

- MoFED needs to prepare the Ethiopia debt management strategy in such a way to give equal attention to fiscal, legal, institutional and operational measures rather than focusing only on debt sustainability analysis.
- The policy makers or the government shall give due attention for an increment of country's export especially through product extension even though it is in the process of expansion. Because, the projection in percentage ratio of PVD to export will increase through time and the government will be forced to move more to non-concessional loans necessitating additional source for debt service payment.
- In most cases with the presence of staff turnover it is important to have written negotiation strategy so that it will be easy for new employees to take part in the negotiation process.
- There should be adequate DMD staff training and other capacity building activities by higher level officials to execute their functions effectively. These may include attachment program with relevant institutions, in-office trainings and provision of courses on debt management by relevant institutions. In addition recruitment of staff with the requisite professional skills and a rigorous on-the-job training program will be necessary.
- The government shall have the system to have extra reserve for expenditures on certain program/project until the reimbursement made from the creditors especially with the conditions of late disbursement.
- MoFED must strengthen the monitoring of projects financed by external loan according to the responsibility given under proclamation No. 41/1993 because the delay on the ongoing project affects the new commitments by indicating that the government doesn't use the resources committed earlier.
- The government needs to be careful that the continued external debt burden may greatly aggravate the poverty trap in Ethiopia due to the fact that debt servicing often

crowd-out the much needed public expenditure on productive and social sectors which affect the long-term productivity of the country's economies.

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## **Annexes**

### **Annex one Interview**

#### **Part One**

##### **In-depth interview for IFIs and Bilateral development cooperation directorates**

1. What are the major tasks of IFI/ Bilateral development cooperation directorate during the process of searching new external loan either from past or new creditors?
2. What are the major and common interests of creditors in giving loan and the constraints in fulfilling them?
3. What are the bases in choosing the priority area for project/program initiation for different sectors as well as in selecting potential creditors?
4. What are the tasks of IFIs, IFIs directorates and Bilateral development cooperation directorates in country strategy paper preparation?
5. What are the issues to be reviewed from the project proposals by MoFED and in turn by creditors for project appraisal?
6. How is the practice of debt negotiation and the status of negotiating team?
7. What kind of research works have been done in order to make effective loan allocation as well as to get additional loan from the financiers?
8. What major reasons or requirements have the implementing institutions brought to IFIs directorates/bilateral development cooperation directorates in order to get additional finance?
9. Specify the regular comments given by MoFED and creditors on project proposal? What kind of project proposal or project feasibility discard from transfer to creditors or to strategy paper for approval in turn on loan agreement?
10. What does is the loan negotiation process of debt management office look like? Are there national negotiation strategies of loans?
11. What are the major areas where constraints encountered during the process of checking the conformity of loan agreement with what was agreed during negotiation?
12. What are the major issues the Ministry of council and HPR observe in approving the loan agreement?
13. What preconditions are major impediments in declaring project effectiveness after loan agreement signing?

14. What are the ways to protect the creditor bank and account details from unauthorized Changes/modifications?
15. How long is the time interval of debt disbursement after the allocation finance by the financier?

## **Part Two**

### **In-depth interview for debt management directorate (DMD)**

#### **Debt disbursement**

1. Does the back office have practical activity in debt service payment and debt disbursement other than recording?
2. What primarily kinds of disbursements are used and why?
3. What are the ways of making debt disbursement when the debt enters directly to government budget rather than on the specific project/program?
4. What are the major issues needed to be analyzed in order to observe the impact of new borrowing as well as in checking the harmony of draft loan agreements with country's debt policy?
5. What are the ways to protect the creditor bank and account details from unauthorized Changes/modifications?
6. What are the major reasons to request for additional finance?
7. What are the preconditions in making the second round and other round disbursements?  
Are there cases where second round and other round disbursements made when the project/program office falls short to reach the planed completion point?
8. Are there cases where the IIs responded that the information on the Form 2A has discrepancy with their records? What are the major areas of discrepancy? What kind of clarification will be made by DMD for that specific discrepancy?
9. Does the borrower have a formal application for the requisite of funds disbursement after the loan become effective?
10. What are the major discrepancies faced during the process of verifications made between the record made on DMFAS and the information of the disbursement documents of the creditors.

## **Debt repayment**

1. What are the major tasks of the debt management directorates in doing Ethiopia's debt capacity analysis?
2. What are the major constraints in determining debt capacity? Is there problem in choosing effective debt burden indicators as well as threshold level? Do the internationally given threshold and indicators have negative or positive impacts on determining the debt capacity?
3. Are there cases where discrepancy was created in checking the correctness of the creditor's bill as per the Loan Agreement? If yes what are the sources and the solutions forwarded?
4. What are the factors that hinder and contribute to effecting payments as per approved loan agreement?
5. What are the specific issues to be considered in evaluating funding prospects impact on the debt portfolio in terms of compliance with the approved strategy?
6. What are the major sources of debt service payment that the government uses in making budget?
7. Who is responsible for approving the annual debt service budget? What are the major constraints encountered during the process? What are the major areas observed during the process? Why is the budget plan made in birr?
8. What are the ways for debt service payment when the government becomes in shortfall in allocating for debt service payment in its budget?
9. What are the constraints in preparing of detailed budget annual debt service and the source for debt service payment?
10. What are the major problems in projecting amount of debt or debt service payment for future years?
11. What are the bases in making debt service payment forecast?

Annex 2 Amounts of Exports (2002/03-2011/12)

Commodity	2002/03	2003/04	2004/05	2005/06	2006/07	2007/08	2008/09	2009/10	2010/11	2011/12
Coffee	1,418,323.93	1,926,678.82	2,901,327.29	3,076,493.99	3,741,744.77	4,897,344.10	3,932,229.39	6,913,379.56	13,617,880.48	14,424,847.58
Oilseeds	395,565.10	712,737.99	1,082,215.25	1,835,270.13	1,654,707.49	2,037,089.95	3,819,428.63	4,670,848.56	5,282,979.34	8,174,105.27
Hides & Skins	448,002.81	375,844.17	585,184.51	651,332.69	789,162.45	917,533.77	763,692.13	732,602.79	1,690,160.65	1,894,380.86
Pulses	171,243.68	194,678.54	306,609.32	320,969.14	619,559.70	1,333,631.14	946,826.06	1,677,731.48	2,232,691.58	2,762,646.37
Meat Products	20,781.49	66,675.88	126,151.99	160,842.08	135,517.72	193,943.55	273,517.90	440,952.18	1,024,706.39	1,358,079.34
Fruits & Vegetables	82,118.01	109,662.71	139,052.79	114,541.27	142,207.59	118,398.30	124,029.10	412,604.91	512,634.57	775,375.00
Sugar	153,712.13	88,632.48	5,277.14	-	-	17,879.50	178,586.52	124.42	-	-
Flower	68.65	19,821.17	67,807.63	189,006.22	561,307.24	1,037,924.21	1,374,357.48	2,204,195.02	2,845,760.29	3,402,183.98
Live Animals	4,129.02	16,453.94	110,874.61	239,240.22	323,065.63	376,474.28	539,985.47	1,177,285.50	2,387,245.58	3,565,928.36
Chat	497,866.40	758,878.39	866,802.94	773,235.44	816,802.09	1,000,784.64	1,448,074.53	2,710,332.16	3,836,251.05	4,144,328.09
Petroleum Products	0.26	-	-	-	-	-	-	-	-	-
Bee's Wax	4,032.26	8,280.41	9,587.91	12,551.48	16,089.81	17,091.37	16,436.57	20,605.35	29,126.93	37,332.63
Gold	361,026.31	419,858.09	513,364.45	562,141.00	863,856.01	735,122.13	1,034,497.58	3,709,811.71	7,540,511.64	10,417,359.48
Others	585,485.89	478,441.56	617,001.74	749,752.14	793,594.64	966,121.82	766,091.49	1,444,832.22	3,525,616.53	3,538,200.34
RE-exports	0	0	0	0	0	0	0	0	0	0
<b>Total Exports</b>	<b>4,142,356</b>	<b>5,176,644</b>	<b>7,331,257.6</b>	<b>8,685,375.8</b>	<b>10,457,615.1</b>	<b>13,649,338.8</b>	<b>15,217,752.9</b>	<b>26,115,305.9</b>	<b>44,525,565.0</b>	<b>54,494,767.3</b>

**Declaration**

I, the undersigned, declare that this thesis is my original work and has not been presented or submitted partially or in full by any other person for a degree in any other university, and that all sources of materials used for the purpose of this thesis have been duly acknowledged.

Declared by:

Name: Abeba Abebe

Sign\_\_\_\_\_

Date\_\_\_\_\_

Confirmed by Advisor

Name: Fenta Mandefro (Ph.D)

Sign\_\_\_\_\_

Date\_\_\_\_\_