External Debt and Economic Growth in Ethiopia (Abstract)

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There is growing concern about the extent to which the accumulated large stock of external debt and its repayments by The Least Developed Countries (LDCs) act as an impediment to therr economic growth and development. The debt crisis experienced by Sub-Saharan African countries which, it has been argued, resulted from a complex combination of elements, some of which are external to the individual debtor countries, while others are direct results of wrong policies, is used as a bench mark for studying the impact of external debt on economic growth in Ethiopia.

Ethiopia's external debt is not simply unsustainable; even the most generous debt relief would not bring the country within reach of meeting its responsibility within the context of global poverty-reduction goals. In line with this, according to the World Bank classification of Highly Indebted Economies, the country is one of the severely indebted low-income countries. Ethiopia's external debt has changed significantly in magnitude, structure and composition over the last quarter of the 20`h century. In 1975, it stood at about US$ 343.7 million, equivalent to 14% of the GDP, and US$ 9.1 billion (214% of GDP) in 1991. As at June 30, 1999 this figure had increased to an equivalent of US$ 10.2 billion and very recently, as at 29 April 2004, following the debt relief granted in accordance with development initiatives designed to benefit the Heavily Indebted Poor Countries (HIPCs), it had declined to US$ 3 billion. Therefore, the problem is how economic growth will be affected by the accumulated external debt stock and the repayment of debt in the long run.

Theoretical and empirical literature covered in this study supports both relationships (positive and negative) between external debt and economic growth. Krugman (1989) defined debt overhang as a situation in which the expected repayment on foreign debt falls short of the contractual value of the debt and showed that there is a limit at which accumulated debt stimulates investment and growth. Similarly, Borenszten (1990) argued that the debt overhang crisis is a situation in which the debtor country benefits very little from the returns on any additional investment because of the debt service obligation. In general, these authors provide empirical supporting evidence that there is a negative relationship between external debt and economic growth, and this justifies the existence of the debt overhang hypothesis.

Osei (2000) noted that movements in the ratio of debt service payments to export of goods and services (debt-service ratio) and total external debt to income (GNP) are the two most important indices used to assess the debt burden; the higher the ratios, the greater the burden. In line with this, researchers like Sachs (1989) and Krugman (1989) have also analyzed the "crowding out" effect of debt service payments. This arises from the fact that many highly indebted poor countries frequently divert resources, including foreign aid and other foreign exchange resources, to take care of pressing debt service obligations, particularly debt owed to the multilateral institutions, which is deemed "nonreschedulable". Looking at the empirical work done in Africa, Isa (2004), Chowdhury (1994) and Elbadawi et al (1996) had arrived at the conclusion that there is no sign of a debt overhang effect in their studies. However, this is totally contradictory to the empirical results obtained by lyoha (2000), which concluded that

in Sub-Saharan African countries the external debt to GNP (EDTGNP) ratio is high and creates debt overhang problems which in turn negatively affect investment and growth.
The main objective of the study is to provide an analysis of the problem of external debt service capacity faced by Ethiopia, and its implications for economic growth. To this end, two hypotheses were formulated and tested. First, a large stock of accumulated external debt has a negative impact on economic growth in Ethiopia, through the debt overhang effect. Secondly, external debt servicing has a negative impact on economic growth in Ethiopia, through the crowding out effect.

To pursue this analysis, adapted from the Chowdhury (1994) structural macroeconomic model, we used a single growth equation model, estimated using the Ordinary Least Squares (OLS) method with data covering the period 1970-2002, after formulating the recent developments in Cointegration and Error Corrrection Models. This regression result partly does not confirm our previous hypothesis that the coefficient of past debt accumulation (LEDTGNPt) relates positively to economic growth in Ethiopia. This outcome is not expected and is in line with the empirical findings (e.g. Isa 2004, Elbadawi et al 1996, Chowdhury 1994). However, it is totally contradictory to what Iyoha (2000) concluded for the Sub-Saharan African countries: the external debt to GNP ratio (LEDTGNP) is highly significant and its sign is negative. On the other hand, the debt service variable (LDSE) has a negative effect on growth through the crowding out effect of public investment and appears statistically insignificant. Thus, the view that amortization of debt is a withdrawal from the domestic economy is confirmed by this study on Ethiopia. Regarding the statistical insignificance of these two major debt variables, it might be due to the fact that the external debt variables have no significant effect directly on growth (real GDP). This is because according to many economic theories, external debt affects output and growth through investment.

In addition, the results tell us that real investment to GDP as a proxy variable to measure capital in the economy significantly affects growth with the expected positive sign. This implies that capital affects output as it is used as a factor of production. Furthermore, the labour force and human capital variables have got the saine positive impact on growth. However, like the two debt variables, these are not statistically significant. This tallies with economic theories which emphasize that investment affects growth through the multiplier effect of capital, and labor force affects output as it is used as a factor of production. Regarding the other two variables (real effective exchange rate and inflation), as expected, they have a negative effect and are statistically significant.

Following the analysis, it is recommended that the govemment should further promote the rational and proper utilization of resources, while increasing the concessionality of newly acquired debt inflows. To this end, measures should be taken to encourage nonborrowed funds, such as Foreign Direct Investment (FDI), portfolio investment and non govemment guaranteed private debts. Finally, in order to mitigate the crowding out effect of external debt, Ethiopia should strive to benefit from additional debt reduction schemes. If this can be combined with the vigorous pursuit of an export expansion policy, it can lower the debt servicing ratio resulting from two positively reinforcing situations to ensure growth and development in the country.

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