Growth and foreign debt: the Ethiopian experience: 1964-86

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Introduction

Hans W. Singer, a prominent development economist, described the 1980s as a lost decade for the developing countries as a group (Singer, 1989). The 1950s and 1960s are characterised as "golden years" not only because the rate of growth of their economies was high, but because the achievement was home-grown. These were the decades in which the LDCs increased their investment with the least dependence on external resources. The growth of the 1970s was, on the other hand, "debt-led" in the sense that these countries ran a persistent current account deficit, and borrowed heavily on the international money and capital markets to finance the payments gap.

Indeed, during the three decades beginning in the 1950s, deficits in the current account were considered not only normal but even advisable. Countries were encouraged to borrow abroad and create an environment conducive to foreign investment to boost their economic growth. In the process, not very much attention was paid to the liabilities side of the recurring current account deficit which increased the external indebtedness of these countries.

The end of this period of belief in the non-detrimental nature of an unrelieved current account deficit financed by external borrowing came in the summer of 1982, when Mexico suspended repayment of the principal. Ever since, the issue of external debt and its servicing has assumed critical importance, and introduced "debt-crisis" into modern economic lexicon.

The African experience conformed to this general picture in the 1980s. Growth in Sub-Saharan Africa (SSA) declined which, with the soaring population growth, resulted in the inevitable decline in per capita welfare. A number of factors have been cited to explain the negative outcome — the constantly deteriorating terms of trade, high foreign interest rates, recession in developed countries, inappropriate domestic policies, and natural calamities such as drought.

Attempts to turn the tide have taken various forms. While some countries have expressed interest in, and in many cases attempted to restructure their economies, they have sought to enlist the support of the developed countries to share the social costs that such an adjustment is bound to entail. A prominent aspect of this cost sharing is the debt issue.

The desire of the developing countries to have their debts written off, against the creditors' interest in being repaid in full, seems to have found an
operational balance in rescheduling. But as some countries have found from experience, the restructuring of foreign debt is at best a stop-gap measure, and does not offer a lasting solution.

In the debate about debt, an interesting issue, and one that is seldom addressed, or at best is glossed over, is how loans were used by the debtors. The result of such an enquiry may offer a clue as to how to get out of the existing debt mire and to avoid slipping into one in the future. This paper is part of an attempt to answer this question. In this paper a macro-model is used to examine the relationship between external debt and economic growth, using Ethiopian data. The idea behind the model is that a country’s rate of economic growth must at least match the annual rate of growth of its external debt if it is to avoid problems of debt servicing. If the rate of growth of the latter is higher than that of GDP, the country transgresses the commonsense canon that at macro level it should create additional income from which to service the debt, if it is not to be over-burdened. The inevitable consequences of such transgressions are that the debt will be serviced from existing wealth, an option many countries may find difficult, if not impossible, to pursue.

The rest of the paper is structured as follows. Part II surveys the post-war literature on foreign capital and economic development. Part III focuses on the historical evolution of policies with respect to private foreign investment and external credit in Ethiopia. Part IV deals with the very difficult issue of the quantitative measure of debt along with source and use. Part V examines how the long-term external credit was used. Part VI develops a macro model relating external debt and growth, and uses it to examine their relationship in the Ethiopian context, and Part VII concludes the paper. The poor availability of data, in particular those of the national account and its components, has limited the coverage to the period from 1964 to 1986.

Domestic currency is extensively used in the paper. The following conversion rates can be used to gauge the value in US dollars: (a) up to 1971, US$1 = BIRR2.5; (b) 1972 US$1 = BIRR2.3; (c) from 1973 US$1 = BIRR2.07.
II Foreign capital
and economic development

The role of capital in economic growth

The origin of the economic theory of capital can be traced as far back as the classical school, where it was included as an essential argument in the production function. Although the recognition of the vital role of capital in the production process antedates theorization, what controversy there was centred on the degree of its importance and the form it should take to provide maximum utility. A current but isolated position down-plays its importance relative to various other factors giving it only an adjunct role (for a modern pronouncement of such a minimalist position, see, for example, Cameron, 1966). The more interesting and influential controversy focused on the form capital should take. Beginning in the 1960s, the Chicago School’s down-playing of the role of physical capital in favour of human capital has helped to shift the focus from the former to the latter. But whatever form it may take, the crucial role of capital in the production process is solidly established (Harcourt, 1972).

In addition to establishing its uncontroversial role, economic theory explains the factors that determine increased accumulation of capital. Provided the reward is sufficient, income recipients are expected to transfer their consumption from the present to the future, and the un consumed part of this income would supply the source of capital. On the demand side, the savings of the community, mobilized through various means, including deposits in financial institutions, transactions in money and capital markets, etc., would be made available to potential investors, who, again if the reward is right, i.e. the difference between the cost of borrowing and the return on investment is sufficiently high, would convert these resources into means of production.

The generalized condition of allocative efficiency dictates the employment of capital in the most profitable and productive activities. Thus the most efficient investment is where its marginal efficiency (under macro conditions) or the internal rate of return (in the micro case) is higher than the cost of capital. This simple rule has grown into one of the most sacrosanct axioms in economics. No resource (borrowed or own - fund) should be invested in any
activity unless the cost of capital is less than the rate of return of the investment.

The final point links the wealth of nations and their capital stock. Since capital contributes to output, the conclusion is that the more of it a country has, the larger its output (income) will be, leading to larger volume of savings resulting in higher rates of investment, which increases the capital stock, and thus catapults the country into the virtuous circle of riches.

Capital and the developing countries

Given this background, it should not come as a surprise that early post-war reflections on the problems of developing countries led to the identification of insufficient capital stock as the cause of their low income. Among economists who made such prognoses, the most notable are Hans Singer and Ragnar Nurkse. According to Singer (1949, p. 5) the less developed countries suffer from "a dominant vicious circle of low production — no surplus for economic development — no tools and equipment — low standard of production". An underdeveloped country is "poor because it is poor". According to Nurkse (1953, p. 5), the problem of these countries was that

"... there is small capacity to save, resulting from low level of real income. The low level of real income is a reflection of low productivity, which in turn is due largely to the lack of capital. The lack of capital is a result of small capacity to save."

It is evident that to break out of this vicious circle, the country must increase its savings.

"The country’s incremental saving ratio ... is the crucial determinant of growth ... the general problem is to maximise the marginal saving ratio, i.e., the proportion of any increment in income that is saved". (p. 142)

In reaction to suggestions that the less developed countries should use the surplus labour in agriculture to develop their economies, a point that was to be made prominent later, Nurkse noted that,

"... there is hardly any need to stress the obvious point that it is not enough to get labour released from agriculture, that is, ‘saved’. The labour at once must be employed for productive capital formation, that is, ‘invested’, otherwise the manpower released will be wasted." (p. 53)
The dual emphasis that there must be prior saving which must be invested creates not only demand for additional manpower but also the income to absorb the output of an expanding economy. Nurkse was far from being an isolated advocate of increased saving as the only salvation for the developing countries. Evsey Domar, one of the pioneers of growth economics, enunciated that "in underdeveloped countries it is clearly capital rather than labour that is the factor limiting growth" (see Domar, 1957).

These pronouncements were accepted by other development economists of the period. W. Arthur Lewis in his famous article (Lewis, 1954, p. 416) states that,

"... the central problem in the theory of economic development is to understand the process by which a community which was previously saving and investing 4 or 5 per cent of its national income or less, converts itself into an economy where voluntary saving is running at about 12 to 15 per cent of national income or more. This is the central problem because the central fact of economic development is rapid capital accumulation."

This position was further advocated by Rostow who, as a condition for take-off, underlined the need to increase savings from 5 per cent to 10 per cent or more of national income (Rostow, 1985, p. 39).

These early diagnoses included various strategies as to how the savings rate could be increased. For example, Lewis (1955) argued that since the users and sources of the savings are the private sector, the government should develop and implement policies which would encourage saving, including tax exemptions and granting monopoly rights, while Galenson and Leibenstein suggested redistribution of income from workers whose propensity to save was zero, to capitalists whose propensity to save was high (Galenson and Leibenstein, 1955). Where the private sector cannot discharge this responsibility, the government (whose propensity to save was assumed to be close to unity) was urged to shoulder the burden of mobilizing the necessary volume of saving by diverting resources to itself through higher taxes (Kaldor, 1955).

These considerations were based on the heroic assumption that a developing economy has the potential to finance its investment requirement, if only the government would create an environment conducive for its mobilization and effective utilization. Unfortunately, these optimistic expectations were not realized since the volume of saving was too low on account of the low income, or was not mobilized for lack of appropriate policies and/or lack of essential
mechanisms such as financial institutions, or was inappropriately utilized, etc., thus giving rise to new approaches.

Given the need for larger capital stock and the inadequacy of domestic saving to finance investment that would make this possible, it was concluded that domestic saving should be supplemented by foreign resources. This shifted the issue from whether external resources are useful to developing countries to how much was sufficient to help them realize their growth potential. This issue gained popularity in the late 1950s and 1960s, and developed in two directions – the supply side and the demand side.

The supply side of the volume of foreign resources required by the developing countries was initiated and propagated by the UN and its specialized agencies such as UNCTAD as well as private bodies such as the Pearson Commission. These organizations and commissions, both for reasons of equity (the huge and growing gap between the rich and the poor countries) and economics (a richer country is a better trading partner), aimed for a maximum feasible volume of foreign resources. The target ranged from 0.7 per cent of the Pearson Commission to the 1 per cent of national income of the UN and its specialized agencies.

While this approach advocated an increase in the volume of resource flows, it nevertheless suffered from a number of problems. First, the recommended level included all resources without distinction between the different types of flows such as aid, direct and portfolio investment and credit from all sources. Neither did it deal with the terms and conditions under which these resources were to be provided, including the thorny issue of whether they were to be tied or untied. Second, the proposals did not have anything to say on the distributional mechanism, i.e., how, if the targeted amount is made available, the amount is to be distributed among the needy countries, and who should have the responsibility of doing so.

An approach that paralleled the supply side and became more popular on the strength of its pragmatism is the demand-determined foreign resource requirement. Based on purely economic criteria, this approach identifies the resource needs of developing countries on an individual basis, given each country’s absorptive capacity and the constraints that limit the productive utilization of its resources.

This method of determining foreign resource requirements has been justified on a number of grounds, without materially affecting the final outcome. One of the earliest justifications was that since the developing countries did not have the necessary volume of savings, foreign resource inflow could supplement domestic resources to increase investment and thus make possible a rate of growth that would be higher than that attainable in its absence. Among the early proponents of this approach are the UN (1951), Rosenstein-
Rodan (1961) and Paul Hoffman (1960). These approaches start from a specific minimum acceptable growth rate (2 per cent proposed by the UN) which with an assumed capital output ratio (Rosenstein-Rodan's 2.8:1, Hoffman's 3:1 and the UN's 5:1) is used to estimate the required volume of investment. The required foreign capital was estimated as the difference between an assumed domestic savings (UN) or projected levels of savings on the basis of average and marginal savings rate (Rosenstein-Rodan and Hoffman) and the required investment.

These models did not differentiate between foreign exchange and domestic savings as a constraint on the growth effort of developing countries, but approached the problem simply as the gap between investment and saving. Later models attempted to adjust for this weakness. One approach confined itself to the foreign exchange problem. Although not brought out explicitly, the logic here seems to have gone as follows. Assume that a country has mobilized sufficient domestic savings and yet cannot fully utilize it because its foreign exchange earnings are insufficient to finance the necessary volume of imports. This obviously shifts the constraint to foreign exchange which is derivable as the difference between the volume of imports required and the value of projected exports. This approach was favoured by, among others, Alfred Maizels (1963), Bela Balassa (1964) and UNCTAD (1964, p. 92-101).

The final development in the attempt to quantify the foreign resource needs of developing countries combines both the above methods. This model, which later came to be known as the two-gap approach (TGA), was developed by a number of economists (McKinnon, 1964; Vanek, 1967; Bruno, 1964; and Hollis B. Chenery, who is the person most identified with it). In a series of papers, Chenery and his associates (Chenery and Bruno, 1962; Chenery and Adelman, 1966; Chenery and MacEwan, 1966; Chenery and Strout, 1966) developed a sophisticated mathematical approach using inter-industry programming models. In his paper with Strout, Chenery generalized the approach, identifying three constraints faced by developing countries as

"1) the supply of skills and organizational ability; 2) the supply of domestic savings; and 3) the supply of imported commodities and services." (Chenery and Strout, 1966, p. 683-85)

Where the first two resources, i.e. skills and savings, are the binding constraints, the situation is described as "investment limited growth", and where the balance of payments limit is effective, the situation is identified as "trade limited growth", and they go on to build growth models under each scenario. The analysis reaches the overall conclusion that
"in the short run the effectiveness of external resources depends on their use to relieve shortages of skills, saving and imported commodities" (p. 724)

while the long run fate of these countries depends on "the use that is made of the initial increase in output" (p. 724).

The idea that foreign resources would supplement available resources, remove the bottlenecks and make higher rates of growth feasible is not limited to Chenery and his associates. McKinnon (1964) developed a model for a country whose growth rate depends both on imported and domestically produced inputs and uses it to estimate "the total aid required to reach independently sustained growth" (p. 401). In the same vein, Vanek (1967) constructed a model to estimate foreign resource needs of developing countries with application to Colombia.

While the two-gap approach has gone out of fashion in academic circles, nevertheless it is still used by donor agencies and multilateral organizations, of which the World Bank is the best known, and it is extensively used as part of its "World Development Report" exercise. The model has grown to assume a life of its own as the Revised Minimum Standard Model (RMSM) and not only serves "as a means to establish consistent approach to projection for all countries and to facilitate inter-country comparison " (Gupta, Schwartz and Padura, 1979, p. 179), but is also used extensively by national planning agencies.

The World Bank model, which is summarized below, is conceptually different from the Chenery-McKinnon-Vanek two-gap type models, in that while foreign resources have the dual role of removing the foreign exchange and/or saving constraint in the latter approaches, the former model concentrates on the foreign exchange gap only. In the World Bank model, the client members are expected to mobilize domestic resources by means of appropriate policies to overcome the savings constraint, while the foreign resources supplied by it are to be used to cover the external shortcomings.

Whether in the World Bank version or others, the two-gap approach rests on the simple extension of the Harrod-Domar model, the essence of which is presented below following Khan, Montiel and ul Haque (1986, p. 7-21).

(a) Calculate the incremental capital output ratio (ICOR) either historically or technologically:

\[
k = \frac{\Delta K}{\Delta Y}
\]
where \( k \) is ICOR, \( K \) is capital stock and \( Y \) is income/output, and \( \Delta \) represents change. Thus, the \( (\Delta K) \) represents additions to the capital stock and \( (\Delta Y) \) additional output attributed to the increase in the capital stock. To bypass the problem of measuring capital, the addition to capital stock is measured by the monetary value of net investment.

(b) Determine the desired level of output \( Y^* \) and, using this, obtain the amount of additional investment \( (I^*) \) necessary to achieve this output:

\[ I^* = kY^* \]

(c) Project the possible level of domestic and foreign savings that could be generated by the country:

\[ S = (Y - T - Cp) + (G - Cg) + (M - X - R) \]

where \( S \) is total resources made up of:

i) private sector domestic saving, which equals income \( (Y) \) less taxes \( (T) \) and private consumption \( (Cp) \);

ii) government saving which equals revenue \( (G) \) less government consumption \( (Cg) \); and

iii) foreign savings which equals imports \( (M) \) less exports \( (X) \) and net transfers \( (R) \).

The volume of savings thus generated is compared with the volume of investment required, and where there is inequality, attempts are made to remove the difference by either scaling down investment and/or increasing saving through foreign resource inflow.

Note that the transition from the above to an explicit two-gap model is simple. The foreign saving \( (M - X - R) \) is compared to the difference between the necessary investment \( (I) \) and national saving, i.e.

\[ (M - X - R) < I^* - (Y - T - CP) + (G - Cg) \]

In the case where the left-hand side is greater, it would be the savings gap, and if the inverse, then the foreign exchange gap would be binding.
Foreign capital and economic development: some dissenting views

The beneficial impact of foreign resources on the economy of developing countries has been taken both as an article of faith and the logical conclusion of analytical models until the early 1970s, when both economists and policy makers were inundated with doubts. Although these groups may concur in their conclusions, they nevertheless proceed from different premises.

Economists have taken issue with promoters of the idea that foreign resources boost the growth efforts of developing countries by removing the foreign exchange and/or savings constraint. First, they contend that the presumed positive impact of foreign resources on the volume of savings is not supported by empirical evidence. Cross-country and time-series studies suggest that there is a negative correlation between domestic savings and foreign resource inflow (Rahman, 1968; Chenery and Eckstein, 1970; Griffin, 1970; Griffin and Enos, 1970; Weisskopf, 1972). According to Griffin and Enos,

"... foreign resource inflow may have retarded development by lowering domestic savings, by distorting the composition of investments and thereby raising the capital output ratio, by frustrating the emergence of an indigenous entrepreneurial class, and by inhibiting institutional reforms." (p. 326)

Weisskopf (1972) concluded from his time-series study that "the numerical results support the hypothesis that the impact of foreign capital inflow on ex ante domestic savings ... is significantly negative".

A surprising conclusion, and one that increases the credence of the critiques, is that of a study of sixteen Latin American countries which showed that "in twelve out of sixteen cases, the impact of additional foreign capital on saving was found to be negative". This finding is astonishing, not only because it tallies with that of the critics of the two-gap model, but also because it was arrived at by Chenery, the person who is most closely identified with the model.

The policy makers’ perplexity with external debt was triggered by the debt service burden. Up to the end of the 1970s, developing countries relied on foreign resources as much, if not more, than their internally generated savings. Then, in the 1980s, external debt became the nightmare of policy makers rather than their considered blessing, not only because the interest and principal needed to be paid, but because such servicing was to be made from ever-decreasing foreign exchange earnings from the export of goods and services. In the 1970s and 1980s, there were a number of developments in the
world economy which adversely affected the position and prospects of the
debtor nations. First, the post-1977 price of their exports plummeted, and the
volume of their exports fell due to the recession in the OECD countries. The
result was a serious decrease in their foreign exchange earnings. Second, the
first- and second-round increases in the price of oil and inflation in the
developed countries raised the import bill, pushing these countries into deeper
trade deficit. Third, servicing foreign debt became more and more onerous
because of higher world interest rates and/or the bunching of maturing debts,
which, in the face of a widening trade deficit, compounded the problem.
Fourth, efforts at mobilizing foreign resources were not very successful due to
the declining, or at best stagnating, real ODA capital flows, attributable to the
recession in the traditional donor countries, the high cost of borrowing and
conditions developing countries found hard to accept. The apparently easy way
out of the quandary was to protect their external flank by suppressing imports
and protect domestic welfare by reflation. This, however, had the predictable
negative impact of deepening stagflation.

In conclusion, then, one has to appreciate the central role of capital in the
development process. The issue of how to increase it remains as thorny and
problematic as at the beginning. The debate between economists on the merits
and demerits and the apprehensions of the ministers of finance and governors
of central banks of developing countries, notwithstanding, their demand for
foreign resources remains as high as ever.
III Foreign capital in Ethiopia: policy history

Pre-1974 policy

The current Ethiopian polity can be traced to 1945. The country was liberated from five years of Italian occupation in 1941. The period between 1941 and 1945 was taken up by efforts toward pacification and re-establishment of the central government and its authority over the entire country. By 1945, the structure for a stable state was completed and the government was able to face the challenges of socio-economic development.

From the very beginning, the government had no illusions about its own endowments, nor the entrepreneurial capacity of its people to bring about accelerated and self-reliant development. First, it was governing a people ravaged by poverty, ignorance, ill-health, and war. Second, the means at its disposal were meagre. Thus, the dependence on external resources was inevitable. Between 1941 and 1945 the government was totally dependent upon the British who, through their expeditionary force, helped to liberate the country from the Italians. But it was soon obvious that the usefulness of the British was limited, and allegiance shifted more and more to the United States of America.

The benefits forthcoming from this new ally were immediate and impressive. When in 1945 the modern currency was issued, it was made possible by the help of the USA, who, through its lend-lease programme, provided the material (including copper and silver for the coins) and covered the minting, printing and the transport costs. These were followed by capacity enhancing projects such as rehabilitation and expansion of roads, development of communication infrastructure, and so on.

Although there may not have been a clear and unambiguous articulation of the modus operandi, the general policy towards foreign resources seems to have been developed early, and relative to the form they may take. First, there seems to have been a strong aversion to grants in aid, as the country never developed an active policy for their mobilization. This may have been due to the unpleasant and discouraging experience with the British during the 1941-5 period, coupled with imperial pride. Another reason may be the absence of colonizer turned mother country, whose past conscience or present interest would have increased its generosity. Whatever the motive, the government
never pursued an active and effective campaign to get as much out of aid as it could have. It took what was offered and no more. The result was that even at its height, Ethiopia ranked among the lowest in per capita receipt of grants in aid.

The second form of foreign capital is public long-term credit. Here the government pursued an active policy of seeking credit from whatever source. While the relentless drive was in part based on economic motive, the political element must have established itself as part of the calculus of sources. The government’s foreign policy was directed towards minimizing enemies, even if this did not maximize friends. So, as a gesture and evidence of non-alignment, the government sought and succeeded in mobilizing resources from both Western and Eastern bloc countries. While this is true with respect to mobilization, it was not so with their utilization. Credit obtained from the Eastern bloc countries went unutilized for a long period. For example, a large amount of credit from the USSR and China, contracted in the 1960s, was not used until it was resurrected by the new regime in the post-1974 period. On the other hand, the utilization of credit originating in the West was more prompt.

It was the third type of foreign resources, foreign investment, that the government went out of its way to attract. This was the resource that the Imperial regime believed would most complement its attempts at development.

So, it is understandable that when the government launched its industrialization programme in 1945, there was the simultaneous issue of the first investment policy to attract foreign investors into the country. However, this first step did not come in the form of legislation, but as a statement of intent. The first legal document was the statement of policy for the encouragement of foreign capital investment in Ethiopia (Imperial Ethiopian Government, 1950) which provided a five-year tax holiday, duty free importation of machinery, and remittance of profit. Interesting points in the policy statements were the fact that there was no mention of minimum size of investment that would make it eligible for the benefits, the absence of the government body responsible for its implementation, and the explicit mention of the government’s position that while it welcomed and encouraged equity participation of Ethiopian capital, it would nevertheless not require it as a condition for foreign investment.

In 1953, the government legislated the marine industry proclamation to encourage registration of ships under Ethiopian law, with complete tax exemption save for a token registration fee and annual tax (Imperial Ethiopian Government (IEG), 1953).
In 1954, the government, with the objective of enhancing the expansion of agricultural and industrial investment, exempted imports of any and all machinery and implements from all duties and taxes (IEG, 1954).

The income tax proclamation of 1961 (IEG, 1961) granted tax exemption on dividends from bodies incorporated in Ethiopia. It further exempted profit from tax for five years from the date of commencement of operations for new enterprises investing a minimum of Birr 200,000 in industry, mining, and transport, and for the same duration if existing enterprises invested a minimum of Birr 500,000 for expansion. Income from rental of new buildings was also exempted for three years.

In 1963, the government launched its second five-year development plan (IEG, 1962) with a total investment bill of Birr 2.7 billion, with the objective of shifting the structure of the economy from agriculture to industry, which was expected to result in an annual GNP growth rate of 4.6 per cent and a per capita growth rate of 2.8 per cent. Since the country could not conceivably cover the required expenditure, the plan envisaged an inflow of foreign capital to the tune of Birr 639 million, amounting to 26 per cent of the total, and 44 per cent of the capital expenditure.

The second five-year plan was launched with the background of frustrated expectations of foreign capital inflow during the first five-year plan (1958-62). To ensure an adequate inflow of foreign resources, the government proposed to intensify the drive to mobilize foreign resources by expanding the range of existing benefits, privileges and exemptions.

In 1963, the government legislated an investment decree and established an implementing office. The "Investment Decree" (IEG, 1963) consolidated the hitherto scattered investment policies and broadened their coverage. At the same time, it created the "Investment Committee" composed of the Ministers for Commerce and Industry (Chairman), Finance, Agriculture and the heads of the Central Bank and Planning Commission. Investors were offered the following benefits.

(a) *Income tax relief* for five years if the investment is new and is valued at no less than Birr 200,000, or three years if the investment is an extension of an existing enterprise, operated independently of the established plant and the investment is valued at no less than Birr 400,000.

(b) *Import duty relief*: imports related to the investment were to be free of import duty.

(c) *Remittance* in foreign exchange to be provided by the Central Bank.
(d) Export duty relief: outputs of the investment were to be exempted from export tax.

(e) Protection was to be provided in the form of tariff and/or quantitative restrictions where this was thought necessary.

At the end of the plan period, the inflow of foreign capital was more than anticipated and so proved the success of the policy.

The third five-year development plan was launched in 1968. Again, foreign resources were expected to play a crucial role. The government can have felt no need to amend the investment policy substantially other than for the standardization of the requirement for a minimum investment of Birr 200,000. The decree was upgraded to a proclamation in 1966 (IEG, 1966).

At the end of third five-year plan, the government sought to follow it up with the fourth for which the draft was completed and new investment policy proposed. However, this intention was not carried through because of the revolution in 1974.

Post-1974 policy

The economic policy of the government that ousted the Imperial regime was one that limited the role of foreign and domestic private direct and indirect investment, itself assuming the burden of developing the country using resources mobilized by and through it. Shortly after assuming power, the Military Government nationalized land, industries, commercial farms, financial institutions, houses etc., and curtailed the market and instituted central planning as the means of allocating resources.

The reorganization of the economy and society, pursued on the basis of the classic Soviet model, discouraged foreign investors and the government did not do anything to allay their apprehension. With respect to public long-term capital, however, there was less change in the substance than in direction and emphasis. Foreign aid was not to be pursued any more actively than in the past. Foreign credit was to continue to be mobilized — with one important change. Rather than depending on resources from the West (which countries the regime abhorred and vilified), credit and assistance was to be actively sought from the socialist countries.

As a matter of policy, the government did not rule out the participation of foreign investment in the economy. The economic policy issued early in 1975 specified the activities in which foreign capital was to team up with that of the government. In particular, the government expected foreign investment in the
extractive (with the exception of precious metals and radio-active materials) and heavy industries. However, the contradictory stance between policy and action and the ideological shift conspired to deny the country any foreign investment.

In 1983, the government promulgated the Joint Venture Proclamation, specifying the conditions and areas in which foreign capital could be invested in the country. By and large, the conditions were that public and private foreign capital could team up with state capital in which the latter was to have a minimum of a 51 per cent share, and that the manager of such an enterprise was to be Ethiopian. These, and the other conditions, must have proved unattractive to potential investors and nothing came of it.

In 1989, the government liberalized investment possibilities through special decrees. The revised joint venture law eased the conditions and extended the opportunities to domestic private capital. At the same time, an office was established to oversee its implementation. However, given the other constraining policies of the government, nothing much seems to have come from this venture either.

Assessment of the foreign resource mobilization performance of the military regime shows a marked degree of success, although repeated natural disasters forced the government to seek international support. With respect to external borrowing, the government continued to rely on multilateral institutions such as the World Bank and the African Development Bank. Bilateral sources of credit shifted more towards the Eastern bloc countries. With the exception of Italy, long-term credit from the West more or less dried up.
IV Ethiopia’s external debt

Problems with the measurement of debt

The measurement of external debt of the developing countries is not an easy matter. Conceptually, the difficulty revolves around the issues of what constitutes debt, whether it should be limited to disbursed funds, or should include the undisbursed portion of the loan agreement, since the latter carries administrative costs, whether it should be treated as gross or net where the latter is obtained as the gross less external reserve, and if so, whether the external asset should be on a net or gross basis.

Another conceptual issue is whether to include direct foreign investment, since the repatriation of proceeds requires a foreign exchange outlay similar to the interest payment on foreign debt (Aliber, 1980), and the inclusion or exclusion of short-term loans. To iron out these and related problems, four international institutions interested in external debt established a working group in 1984. Experts from the IMF, World Bank, OECD and Bank for International Settlement (BIS) got together and produced the following "core" definition:

"Gross external debt is the amount, at any given time, of disbursed and outstanding contractual liabilities of residents of a country to non-residents to repay principal with or without interest, or to pay interest, with or without principal." (World Bank et al., 1988, p. 19)

Notwithstanding this agreed-upon definition, there are still wide differences that need to be cleared up in order to produce a consistent approach to external debt.

Another set of problems focuses on whether the debt (however defined and presented) should be measured in nominal or real terms, and if the latter, what deflator from among the vast array of options should be used.

An equally, if not more, vexing problem is one of measurement. An important omission in the available debt statistics is the military-related debt, a category that is important not only because of its magnitude, but also because it does not leave behind productive projects which could provide export earnings to service it. A related problem is that published external debt figures may be incomplete since they may not include all the private-sector
debt, being limited to public and publicly guaranteed ones. This was a serious problem in pre-1974 Ethiopia up to the early 1960s, when the government rectified the situation by setting up a system in which all private-sector foreign borrowing needed to be approved and registered, and the value of direct foreign investment appraised as a condition for making foreign exchange available for repayment or repatriation of profit. While this was an important step in that it consolidated both private and public debt, its critical contribution was in laying down an excellent base for debt management. The centralization of all debts made surveillance of the volume of indebtedness, as well as the tracking of servicing, manageable. After the revolution, all foreign debt became public or publicly guaranteed since the private sector was prohibited from borrowing.

This catalogue of problems is further accentuated by discrepancies in the debt-reporting data. The reported debt figures are available on the Gregorian calendar year for some years, the Ethiopian fiscal year (July 7) for others, and the Ethiopian calendar year (September 11) in the earlier cases. While efforts have been made to adjust all the data to the Ethiopian fiscal year, the figures have been taken on an "as is" basis, where this was found to be difficult or impossible.

A further problem is the inconsistency in the data as reported by different institutions (e.g. the government’s different publications, the World Bank and World Debt Tables and the IMF in its IFS and Government Finance statistics), as well as by the same institutions in their different publications. This is listed in Table 1.

It is evident from Table 1 that the nationally reported figures are closer to those of the World Bank than the IMF. This should not come as a surprise since the Bank obtains its information on the basis of the debt reporting system, but a surprising anomaly between the Bank and the national figures is that the World Bank figures are consistently lower than the national figures. Given the debt reporting system, and the government’s published figures, one wonders why the Bank figures are different. The credibility of the Bank figure would have been stronger if it were larger, not smaller, than those reported nationally, since the difference could be attributed to the amount the government failed to report, but that were obtained by the Bank from other sources. Consequently, the national figure, as reported by the Ministry of Finance, is used in this paper, not only because it is presumed that it is more accurate (with the exclusion of military related debt) relative to alternative figures, but also because of the additional advantage in consistency when considering the sectoral distribution and debt-burden considerations.
<table>
<thead>
<tr>
<th>Year</th>
<th>IMF</th>
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<th>Ethiopian Government</th>
<th>Ministry of Finance</th>
<th>NCCP</th>
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Notes:
7. NCCP (National Committee for Central Planning).
The issue of whether to treat the debt in real or nominal terms was also considered and was resolved in favour of the latter after attempts were made to deflate the debt using different deflators, including import and export price indices, the domestic and foreign, particularly US, price indices, etc. The primary reason for abandoning the treatment of the debt on a "real" basis was because, in addition to the different deflators resulting in figures in which "real" debt varies, no clear economic meaning could be ascribed to the figures. The issue of whether to use the undisbursed or disbursed figure was resolved in favour of the latter.

The magnitude of external debt

The extent of Ethiopia's external indebtedness is given in Table 2, along with related statistics.

Given the different policy environment between the pre- and post-revolution periods, as discussed in Part II, it was deemed profitable to discuss the debt situation accordingly. Although the Military Government was established in September 1974, its history with external debt is assumed to have started in 1975.

By 1964, the country utilized Birr 247.9 million, of which Birr 48.0 million was repaid, and the outstanding debt amounted to Birr 199.9 million. By 1974, the cumulative disbursement was Birr 875.9 million, of which Birr 227.7 million was repaid leaving an outstanding balance of Birr 648.2 million. Thus, over the 1964-74 decade, the cumulatively disbursed debt increased by more than 250 per cent, growing at an annual average rate of 13 per cent. Debt outstanding and disbursed increased from 6.7 per cent of GDP and 58 per cent of exports of goods and services to 12 per cent of GDP and 78 per cent of exports at the beginning and end of this period.

On a net basis, external debt increased from Birr 46.3 million in 1964 to reach a maximum of Birr 380 million in 1972, declining to Birr 173 million by 1974. The decline in the net indebtedness after 1973 was due to an increase in the external reserve occasioned mainly by the increase in export earnings as well as increased transfers to support the drought victims.

Sub-dividing the pre-revolution period into two segments of half a decade each, the growth rate of debt was higher during the 1964-9 period, amounting to 16.2 per cent per annum, while there was a considerable slowing down during the 1970-4 period at 9.7 per cent. During the same periods, the GDP growth rate in real terms was 4.7 per cent and 3.4 per cent, while the growth rate of exports was 6 per cent and 12 per cent, respectively.
## Table 2

<table>
<thead>
<tr>
<th>Year</th>
<th>External indebtedness (including undisbursed)</th>
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<th>Utilization rate (2) as % of (1)</th>
<th>Gross foreign reserves</th>
<th>Net debt</th>
<th>GDP</th>
<th>As % of exports</th>
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<td>Debt outstanding and disbursed</td>
<td>Utilization rate (2) as % of (1)</td>
<td>Gross foreign reserves</td>
<td>Net debt</td>
<td>As % of GDP</td>
<td>As % of exports</td>
</tr>
<tr>
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Source: Ministry of Finance and National Bank of Ethiopia
During the post-revolution period, debt outstanding and disbursed increased from Birr 648 million (12 per cent of GDP and 78 per cent of exports) to Birr 4.8 billion (43 per cent of GDP and 326 per cent of exports) in 1986. Such a phenomenal increase is due to a number of factors:

(a) The volume of disbursed debt increased by more than seven-fold between 1975 and 1986 at an average annual rate of 20 per cent.

(b) During the same period, nominal GDP averaged 5.8 per cent (and close to 1 per cent in real terms) which was considerably lower than the rate of growth of debt.

(c) Export earnings increased at an annual rate of 7.6 per cent.

The combination of the higher growth of external indebtedness relative to the rates attained by GDP and export earnings increased the ratios of the two indicators.

On a net basis, the stock of external debt increased from Birr 103 million to Birr 4.1 billion because of the depletion of the country’s international reserve.

Sources of credit

The country has borrowed from all willing sources without making any distinction on grounds of ideology or the level of their development. While all possible lenders are represented in the array of creditors, official sources are dominant, as shown in Table 3.

The major providers of credit to the country are official sources whose share of the total debt amounted to 90 per cent. The balance was supplied by private creditors, of which the financial markets share amounted to 6 per cent, and suppliers’ credit to 4 per cent of the total debt of the country. Private credit is more prominent in the short rather than long term.

There are two official sources of long-term credit to the country — bilateral and multilateral. The bilateral supply was dominated by the US during the pre-revolution period, to be supplanted by that from the USSR after 1975.

Of the multilateral sources, the most important are the World Bank Group (WBG), with an outstanding balance of 77 per cent of the multilateral, 33 per cent of the official, and 27 per cent of the total long-term credit by 1986. Of the WBG sources, IDA credit accounted for 93 per cent, and that of IBRD for only 7 per cent of their total. Other multilateral suppliers of long-term credit
are the African Development Bank Group, EEC and the Arab Development Fund.

Table 3  Source of disbursed and outstanding debt, 1963-86 (per cent)

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</table>

Sources: Ministry of Finance and National Bank of Ethiopia.

From the mid-1960s to the early 1970s, there was an upward trend in private sector long-term credit. However, beginning in the early 1970s, this line of credit declined, both for domestic and external reasons. Externally the increased risk factor perceived by lenders occasioned by international disorder and inauspicious government policies must have contributed to its retardation. Domestically, the country had large external reserves and the mid- to late 1970s were periods when investment declined, reducing the need to borrow from the private sector. Because of this, as well as the higher interest rates, the government must have deliberately minimized its private sector debt. While acknowledging this external influence, the observation that the decision must have been that of the government is made on the grounds that the international capital markets were highly liquid and credit was easily available beginning in the mid-1970s, following the first oil price increase which engendered the need to recycle the surplus petro-dollars.

The last six years in our series saw the growth of credit from the private sector as domestic investment picked up and the international reserves of the country further deteriorated. As would be expected under such circumstances, suppliers’ credit increased in tandem.
While the government maintained the policy of minimizing credit form the private sectors in the 1970s, a tight monetary and fiscal policy was pursued by the major OECD member countries to stabilize their own economies. This credit crunch by the Western bilateral source governments was buttressed by the shift in alignment when the new government in Ethiopia changed its ideological stance from the West to the East, as a result of which the most important source — the US government — cut off all credit. At the same time, and for the same reason, the multilateral sources, and particularly the WBG, tied their credit to compensating the foreign owners of the industries and other interests nationalized by the government. The decrease in these lines of credit was, nevertheless, made up for from COMECON countries.

Between 1967 and 1975 (the year when the shift in policy by the new government became obvious) credit from bilateral sources increased at an average rate of 12 per cent, while those from multilateral sources registered 20 per cent. Over the next three years, the bilateral sources increased their lending at the annual average rate of 5 per cent. After this it picked up to 25 per cent, first because of the increased flow from the COMECON countries, and later by being bolstered by Italian credit, the only one of the OECD countries to provide long-term loans to the military government. On the other hand, credit from the US dried up, while that of the multilateral institutions (specifically that of the World Bank Group) plummeted to 2 per cent per annum. In later years, and in particular the latter three years in our series, the growth rate picked up to 21 per cent, mainly due to increased lending by the ADB group and the restoration of IDA credit which was resumed in the early 1980s, when the government complied with the World Bank compensation condition.

Terms and conditions

The fact that the country mobilized most of its credit from official sources has also conferred on it the advantages of contracting the loans on soft terms. In particular, most of the long-term loans were obtained on concessional terms, as Table 4 indicates.

While the pre-revolution loans averaged 67 per cent of the loans on concessional terms, the post-1974 loans increased their concessionality to 82 per cent, mainly because the world was willing to make credit available under soft terms in sympathy with the victims of the drought. The share of loans contracted on the basis of variable terms (i.e. market rate) declined during the post-revolution period until 1981, when they started to increase again. The grant element was relatively high until 1979, as was the grace period. The decline in these two indicators is most probably due to the increase in Eastern
bloc loans, where the repayment period is short (maximum of 10 years) and the loans carry a relatively higher interest rate, with very little, if any, grant element. This is compounded by the diminution of credit from the West which is characterized by a high grant element as well as generous grace periods.

Although the share of debt service in both exports and GDP has been increasing, on the whole, the country has nothing to complain about as far as the terms and conditions under which it has mobilized long-term loans are concerned. The increase in the extent of external indebtedness relative to GDP and export earnings is due more to the stagnating or declining performance of these key parameters.
Table 4  Average terms and conditions for loans contracted and debt service

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<tr>
<td>Concessional as % of total</td>
<td>54.1</td>
<td>69.2</td>
<td>73.8</td>
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<td>84.4</td>
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<td>Variable interest loans (%)</td>
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<td>1.9</td>
<td>1.4</td>
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<tr>
<td>Average interest rate (%)</td>
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<td>1.3</td>
<td>1.2</td>
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<tr>
<td>Maturity (years)</td>
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<td>36.9</td>
<td>43.7</td>
<td>41.2</td>
<td>41.9</td>
<td>32.7</td>
<td>18.1</td>
<td>18.7</td>
<td>29.3</td>
<td>25.9</td>
<td>24.4</td>
<td>31.4</td>
<td>20.0</td>
<td>31.6</td>
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<tr>
<td>Grace period (years)</td>
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<td>6.8</td>
<td>10.3</td>
<td>8.8</td>
<td>8.7</td>
<td>7.4</td>
<td>5.7</td>
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<td>5.2</td>
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<td>6.3</td>
<td>4.3</td>
<td>6.7</td>
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<tr>
<td>Grant element (%)</td>
<td>46.3</td>
<td>67.9</td>
<td>78.0</td>
<td>72.8</td>
<td>74.6</td>
<td>62.3</td>
<td>38.6</td>
<td>43.1</td>
<td>44.6</td>
<td>44.3</td>
<td>59.7</td>
<td>47.4</td>
<td>56.4</td>
<td>38.8</td>
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<tr>
<td>Interest payment as % of exports</td>
<td>na</td>
<td>4.7</td>
<td>4.9</td>
<td>3.9</td>
<td>3.6</td>
<td>4.1</td>
<td>2.8</td>
<td>4.7</td>
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<td>7.1</td>
<td>6.9</td>
<td>7.3</td>
<td>8.4</td>
<td>8.4</td>
</tr>
<tr>
<td>Principal repayment as % of exports</td>
<td>10.8</td>
<td>3.0</td>
<td>3.9</td>
<td>3.4</td>
<td>3.0</td>
<td>3.1</td>
<td>2.2</td>
<td>1.1</td>
<td>4.7</td>
<td>7.1</td>
<td>11.2</td>
<td>20.4</td>
<td>28.8</td>
<td>32.0</td>
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<tr>
<td>Debt service as % of exports</td>
<td>10.8</td>
<td>7.7</td>
<td>8.8</td>
<td>7.3</td>
<td>6.6</td>
<td>7.2</td>
<td>5.0</td>
<td>5.8</td>
<td>10.6</td>
<td>14.2</td>
<td>18.1</td>
<td>27.7</td>
<td>37.2</td>
<td>40.4</td>
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<tr>
<td>Debt service as % of GDP</td>
<td>1.2</td>
<td>1.1</td>
<td>1.0</td>
<td>0.0</td>
<td>0.6</td>
<td>0.9</td>
<td>0.7</td>
<td>0.8</td>
<td>1.0</td>
<td>1.2</td>
<td>1.4</td>
<td>1.7</td>
<td>2.1</td>
<td>3.0</td>
</tr>
</tbody>
</table>

Source: World Bank World Debt Tables, various years.
V Utilization of foreign credit

The utilization of long-term borrowing is considered first in terms of volume, and then by area of utilization.

Volume

The Ethiopian current account has been in surplus for only three years over the last quarter of a century. If one takes the data prior to 1964 as being reliable and goes back to 1948, the first year for which balance-of-payments statistics are available, the surplus years would increase to six. But regardless of deficit or surplus in the balance of payments, the country has increased its level of indebtedness from year to year.

It may be difficult to conclude that the current account was in deficit because of the availability of external credit, i.e., that the long-term inflow of capital was supply-determined, or that the government borrowed because the current account was in deficit, i.e. external borrowing was demand-determined, from the balance-of-payments figures. Circumstantial evidence strongly suggests that there is an element of both.

As an underdeveloped country with a strong ambition to develop quickly, the obstacles facing Ethiopia were too numerous and complex to be removed with its own resources and know-how. This created the demand. However, this need for foreign resources was evaluated by the donor agencies, the figures arrived at, and granted. In particular, since most of the long-term credit was targeted to specific projects, the balance-of-payments position does not seem to have been a major driving force. The fact that the volume of credit forthcoming was based on the estimated and projected resource requirements rather than the absorptive capacity of the country, lends credence to the supply-determined aspect of its indebtedness. Of the total credit available, the country never surpassed a 70 per cent utilization rate, and the average disbursement to loan ratio amounts to no more than 50 per cent. The level of utilization of the annually committed credit, i.e., the annual disbursement as a proportion of commitment, is low, mainly because of the absorptive capacity
of the economy. This is evidenced by Table 2, where the proportion of disbursed credit to total resources available is shown to have been low, although it has improved lately. This also correlates with the annually implemented versus planned investment of the government, which has never exceeded 70 per cent.

While credit from financial institutions is free of all conditions and is available once committed, the other lines of credit are tied to projects whose disbursement requires that the projects must be well prepared and approved by the lenders as a condition for release of the funds. The weakness in timely project preparation and submission to lenders for funding is one hindrance that limited the fulfilment of investment plans and subsequent utilization of foreign resources is acknowledged by the government.

Sectoral distribution

The sectoral distribution of foreign credit is dictated both by domestic and external conditions. In a country where the absorptive capacity is a limiting constraint, it should come as no surprise that external as well as domestic resources were utilized to mitigate this structural weakness. As is evident from Table 5, the bulk of the long-term credit mobilized externally was allocated to improve the physical and human infrastructure, rather than directly to productive activities.

<table>
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<tr>
<th></th>
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<th></th>
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</thead>
<tbody>
<tr>
<td>Infrastructure</td>
<td>64.3</td>
<td>53.7</td>
<td>43.9</td>
<td>47.7</td>
</tr>
<tr>
<td>Industry</td>
<td>15.8</td>
<td>5.2</td>
<td>2.8</td>
<td>13.9</td>
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<tr>
<td>Agriculture</td>
<td>2.9</td>
<td>17.2</td>
<td>22.0</td>
<td>28.2</td>
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<td>Health and education</td>
<td>11.5</td>
<td>12.7</td>
<td>11.9</td>
<td>4.8</td>
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<tr>
<td>Financial institutions</td>
<td>3.4</td>
<td>11.2</td>
<td>0.2</td>
<td>2.4</td>
</tr>
<tr>
<td>Others</td>
<td>2.1</td>
<td>-</td>
<td>19.2</td>
<td>16.4</td>
</tr>
<tr>
<td>Total</td>
<td>100.0</td>
<td>100.0</td>
<td>100.0</td>
<td>100.0</td>
</tr>
</tbody>
</table>

Source: Calculated on the basis of information obtained from the Ministry of Finance and National Bank of Ethiopia.
Prior to the 1974 revolution, no less than 70 per cent of the externally generated loans were used to improve infrastructure (roads, power generation, communications, etc.) and upgrade the productive capacity and well-being of the people through extensive and intensive education and training, and by expanding health facilities and services. The directly productive activities in industry and agriculture enjoyed a lower priority as their claim on borrowed resources clearly indicates.

After 1975, there was a noticeable shift from infrastructure-expanding and upgrading activities in favour of directly productive ones, although the former continued to absorb a major part of the long-term foreign loans.

The shift from infrastructural in favour of directly productive activities is partly reflective of the different policies pursued by the two governments. While the Imperial Government left directly productive activities to private domestic and foreign investors, it concentrated on the provision and expansion of the physical and human infrastructural needs which, along with the incentives it provided, were expected to encourage their increased utilization. The military regime, on the other hand, pursued policies that were diametrically opposed to this. While it assumed the responsibility of providing the needed physical and human infrastructure, it also took upon itself the goal of developing directly productive activities. As a result, a larger chunk of the externally generated resources was diverted to directly productive activities.

The utilization of external resources in this way had both internal and external logic. During the pre-1974 era, the long-term development needs, external influence as well as the division of labour between government and the private sectors, pushed investment in favour of infrastructural rather than directly productive activities. The building up of both human capital and physical infrastructure emanated from the need to exploit its resources. There was an obvious dearth of skill so that the government needed to expand education and training facilities. There was a noticeable deficiency in the number and quality of medical facilities and other physical infrastructure was equally lacking. Highways were limited to those built by Italians over the five years of their occupation, most of which were destroyed during the independence struggle. There were no feeder roads connecting the rural areas to the highways. One reason why Ethiopian Airlines was established as early as 1945 was to connect the different parts of the country which were otherwise inaccessible. The telecommunications system needed to be developed to ease communication. The country's vast hydro-electric potential needed to be tapped as a source of energy.

There were also the external factors – in particular the interests and philosophy of the lenders. As discussed in Part III, the major sources of foreign credit were governments and multilateral institutions. Both of these
sources had their own vision as to what was best for the country in terms of development and expansion of the nation’s infrastructure. The most important source of the multilateral credit, the World Bank Group, was in part constrained by its charter which limits its activities to those areas where it will not compete, but support and encourage the private sector by creating an environment conducive for investment. Therefore, up to 1961, the World Bank’s credit concentrated on financing those activities that were unlikely to be of interest for private sector financing. When IDA was established in 1961, it took over the financing of the infrastructural development from the World Bank. The International Finance Corporation invested mainly in the industrial sector, but this was in too small an amount to have had a major impact on the structure of the economy.

The United States, the largest of the bilateral sources of credit in pre-revolutionary Ethiopia, concentrated on defence and infrastructure. Credit from the US made possible the expansion and development of transport, especially Ethiopia Airlines, health facilities (particularly malaria eradication), education and agricultural research and extension services. The Swedes, another important source of credit, were in telecommunications, in which the Swedish company, Ericsson, assumed the responsibility of building up the telecommunications facilities, only to shift to agriculture in the late 1960s when this part of their activity was taken up by credit from IDA. The result was that the larger portion of foreign credit was concentrated in the development of infrastructure.

In an effort to redress the situation, the government devised the strategy of mobilizing credit from the Eastern bloc countries to expand investment in directly productive activities following the unsatisfactory level of direct foreign investment. The credit obtained from the COMECON countries was used to establish some of the big enterprises, such as the oil refinery, leather processing, canvas and shoe factories. In addition, the government was also involved in the establishment of directly productive enterprises in partnership with foreign and domestic capital. Thus, up to 1974, credit from the West was mainly in infrastructure, and credit from the East, in industry.

The 1974 revolution brought about not only a change of regime, but also of ideology. Socialism came to be the modus vivendi, and state enterprises the modus operandi of national development. Accordingly, alliances and reliance shifted from the West to the Eastern bloc countries. At home, the new government nationalized industries, financial institutions and commercial farms, thus reversing the policies of the previous government. Private domestic capital was marginalized and limited to small-scale industries, while foreign investment was discouraged but not banned altogether.
The ideological shift also increased the government's dependence on the Eastern bloc countries for long-term development financing. In addition to their military-related credit, they also extended loans for the financing of industries. This, of course, did not mean a complete rupture of credit originating from the West. While there was a drastic decline of Western bilateral sources, the multilateral institutions continued providing credit to expand, improve and maintain the infrastructure of the country.
VI Foreign capital, domestic saving, growth and debt servicing

The crucial issue about foreign debt is its impact on the domestic economy. These effects are usually treated relative to their influence on domestic saving, its contribution to economic growth, and the issue of servicing the debt. These three aspects will be treated in turn.

Foreign capital and domestic saving

One line of controversy pointed out in Part I, was the possibly perverse impact of inflow of foreign resources on domestic saving. It was pointed out that cross-country and time-series evidence suggested a negative correlation between the two.

The evidence from Ethiopia may also seem to confirm this position, since domestic savings rates have been declining, particularly since 1975, as shown in Table 6. However, consideration of the factors that have contributed to the decline in savings and the increase in foreign resource inflow strongly suggest that this is not the case. In fact, the opposite seems to be true, in that foreign resource inflow is greatest when domestic resources are insufficient to support life at subsistence level, such as in the 1974 and 1983-6 droughts. In other words, the decline in domestic savings was independent of foreign resource inflow. This issue is considered in more detail below.

Savings in Ethiopia have been declining primarily because of the increasing government deficit along with diversion of resources, particularly from public enterprises into the treasury. During the pre-1975 period, the government pursued a conservative fiscal and monetary policy and kept its deficit at the minimum possible level. As a result, the maximum deficit was 1.4 per cent of GDP (1967 and 1972). This deficit was incurred at a time when the country suffered from drought, which increased government expenditure while decreasing its revenue. Nevertheless, the decline in government saving was more than compensated for by that of the private sector, so much so that national savings was on the increase. This period also witnessed a steady, if low, rate of economic growth. Furthermore, it is evident from Table 6 that
amortization and interest payments were increasing at a faster rate than GDP growth until 1970. Thereafter GDP grew faster than debt servicing.

<table>
<thead>
<tr>
<th>Year</th>
<th>Gross national saving (1)</th>
<th>Foreign resource (2)</th>
<th>Government deficit</th>
<th>Investment</th>
<th>Debt servicing</th>
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<td>1964</td>
<td>10.8</td>
<td>1.6</td>
<td>0.9</td>
<td>12.4</td>
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<td>1.1</td>
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<td>11.2</td>
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<td>1.1</td>
<td>12.9</td>
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<td>1.1</td>
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<td>3.9</td>
<td>3.8</td>
<td>8.8</td>
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<td>1982</td>
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<td>15.3</td>
<td>8.0</td>
<td>11.2</td>
<td>3.0</td>
</tr>
</tbody>
</table>

Source: National Bank of Ethiopia, and Office of National Committee for Central Planning

(1) Excludes net transfers from abroad
(2) Includes transfers

In the post-revolution period, the philosophy of economic management changed from government revenue limiting its expenditure, to expenditure being limited by the will of the state. Planning was to guide the allocation of
resources, and what was planned should not be curtailed for lack of financial resources. This approach gave impetus to a spending spree, and the size of the deficit was limited, not because the government restrained its expenditure, but because either the money could not be spent sufficiently fast, or the necessary foreign exchange was not available to import complementary inputs. In addition, the government was fighting wars which, along with inhospitable weather, contributed to increase its expenditure and therefore its deficit.

Business saving does not exist. Public enterprises are expected to transfer their net profit, retaining only 10 per cent annually, until this fund equals 30 per cent of their capital. Thereafter, they are required to transfer 100 per cent of their net profit, which is used to finance government expenditure. The value of such transfers is given in Table 7.

Table 7  Transfer of resources from public enterprises to state Treasury, 1981/2-1987/8

<table>
<thead>
<tr>
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<td>Capital charge</td>
<td>60.3</td>
<td>66.5</td>
<td>70.9</td>
<td>82.4</td>
<td>69.3</td>
<td>93.4</td>
<td>94.5</td>
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<td>Profit tax</td>
<td>272.8</td>
<td>255.0</td>
<td>273.3</td>
<td>312.2</td>
<td>298.8</td>
<td>369.9</td>
<td>340.7</td>
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<tr>
<td>Residual surplus</td>
<td>382.5</td>
<td>338.2</td>
<td>344.7</td>
<td>402.2</td>
<td>423.6</td>
<td>464.4</td>
<td>466.8</td>
</tr>
<tr>
<td>Total</td>
<td>715.6</td>
<td>659.7</td>
<td>678.9</td>
<td>706.8</td>
<td>791.7</td>
<td>926.7</td>
<td>902.0</td>
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<tr>
<td>Total as % of GDP</td>
<td>8.0</td>
<td>7.2</td>
<td>6.8</td>
<td>8.0</td>
<td>8.0</td>
<td>8.6</td>
<td>8.1</td>
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<tr>
<td>Residual surplus as % of GDP</td>
<td>4.3</td>
<td>3.7</td>
<td>3.4</td>
<td>4.0</td>
<td>4.3</td>
<td>4.3</td>
<td>4.2</td>
</tr>
</tbody>
</table>

Source: ONCCP

State enterprises have transferred an annual average of 7.8 per cent of GDP in the form of taxes on profit, capital charge, and residual surplus. Had it not been for this transfer, business, i.e. public enterprise, savings would have been much larger as would the savings rate. In particular, the transfer of the residual surplus (which averaged 4 per cent of the annual GDP) has contributed to the fall in their savings rate.

Private business has been discouraged and those businesses that do exist are forced to limit their operation to small-scale enterprises. Furthermore, the tax on profit is extremely high (the highest marginal tax rate is 89 per cent for profit above US$18,000 per annum). Neither can one talk about household savings. With the freeze on salary and wage increases at a rate lower than the rate of inflation, real income has declined continuously over the last decade.
and a half. In addition, there has been a noticeable demographic shift, increasing the dependent population. These factors have been responsible for the lack of household savings.

Two interesting issues are the relationship between domestic saving and foreign capital inflow and the impact of debt servicing on investment. The relationship between domestic saving and foreign resource inflow is brought out in Figure 1. What is evident is that when domestic saving was high (particularly up to 1975) foreign resource inflow was considerably lower. On the other hand, when domestic saving began to decline (beginning in 1977) foreign resource inflow started to rise. The increase in the inflow was necessary if there was to be any investment in the country as well as financing the purchases of strategic imports such as cereals and industrial inputs. While the two, i.e. domestic saving and foreign resource inflow, have moved in opposite directions, the decrease in domestic saving was definitely not due to the increase in foreign credit. On the contrary, the increase was prompted and made necessary by the fall in domestic savings and the serious depletion of its foreign reserve. The conclusion that one could draw from the Ethiopian experience, while not intended to disprove findings from other countries, is that the increase in resource inflow was a function of the decrease in domestic saving, and that this decline was not brought about because of the anticipated or expected increase in the latter.

**Figure 1** Gross national saving and foreign resource inflow: 1964-86
The other interesting issue is the relationship between debt servicing and investment. This link becomes important because of the impact of the former on the latter, and is much discussed in the literature. If the proportion of income that goes to service the debt is larger than the return on investment, i.e. countries suffer from the "debt overhang", then they may prefer not to invest. In the Ethiopian case, this has not been the outcome, as evidenced by columns five and six of Table 6. Although debt service has claimed an increasing proportion of exports and GDP (Tables 4 and 6), this is not because of the high rate of debt servicing. The evidence does not, therefore, show that there is a problem of "debt overhang".

The debt–growth relationship

To gauge the relationship between the external debt and growth of the Ethiopian economy, a simple open macro model is developed. The model is derived from Lance Taylor (1985, Chapter 7), with adjustment to reflect Ethiopian conditions.

The production function

Goods and services \( Q \) in this simple economy are produced by using imported \( (M) \) and domestically produced inputs \( (I_d) \) and labour \( (L) \):

\[
Q = f (M, I_d, L)
\]

The labour input is divided into two, skilled \( (L_s) \) and unskilled \( (L_u) \). It is assumed that the supply of unskilled labour is no constraint given the huge unemployment pool, and that the demand for skilled labour is satisfied from domestic sources. This later assumption may seem implausible for a country at a low level of development, but is nevertheless true considering the fact that no managerial, technical or administrative post is held by a foreigner. The aggregate production function could therefore be simplified to:
\( Q = \min \left( \frac{1}{\lambda} K, \frac{1}{\beta} M_e \right) \)

where \( K \) is the capital stock, \( \beta \) is imported intermediate goods per unit of output, \( \lambda \) is the capital ratio which is assumed to be equal to the incremental capital output ratio (ICOR).

The capital stock, as well as additions to it, are obtained from domestic source (\( \alpha \)), and the balance (1-\( \alpha \)) is imported.

\[
\begin{align*}
    K &= K_d + K_i \\
    K_d &= \alpha K \\
    K_i &= (1-\alpha)K
\end{align*}
\]

The imported portion of the capital stock, as well as intermediate goods (\( M_i \)) and consumer goods (\( M_c \)) are paid for by exports (\( X \)) whose proportion, i.e. \( X/GDP \), is given by \( \pi \).

\( \pi Q = (1-\alpha) K_i + M_i + M_c \)

The economy augments the foreign exchange earned from exports of goods and services (\( \pi Q \)), by transfer payments (both private and public) (\( T \)), and foreign borrowing, whose net flows (i.e. borrowing less amortization) is represented by (\( B \)). Thus (\( B \)) is the amount by which the stock of the debt (\( D \)) increases annually. The overall external balance of the economy can now be presented as,

\( -(B+T) = \pi Q - \Theta Q - I(1-\alpha) \cdot M_i - rD \)

i.e. net flows (\( B \)) plus transfers (\( T \)) are equal to exports (\( \pi Q \)) less imports of intermediate goods (\( \Theta Q \)) less imported capital goods (1-\( \alpha \)), less imports of consumer goods (\( M_i \)), and less interest payment on debt (\( rD \)). Equation 9 assumes that no payment is made from reserves and that there are no arrears. Both are plausible assumptions for Ethiopia, since the country has few reserves, and uses whatever is available mostly to finance imports other than those detailed above, i.e. capital goods, consumer goods, and intermediate goods. Secondly, the country has no arrears since it has been respecting its external obligations.

To convert the variables in Equation 9 into a common measure, we divide it by \( Q \) to obtain Equation 10.
\begin{equation}
\frac{B}{Q} + \frac{T_e}{Q} = \frac{\pi Q}{Q} - \frac{\theta Q}{Q} - \frac{I}{Q}(1 - \alpha) - \frac{M}{Q} - \frac{\gamma D}{Q}
\end{equation}

Letting \( T/Q = t \), \( D/Q = \Delta \), \( M/Q = m \), represent the ratios of net transfer (public and private), the stock of debt and import of consumer goods to GDP respectively, Equation 11 is obtained.

\begin{equation}
\frac{B}{Q} - t = \pi - \theta - \frac{I}{Q}(1 - \alpha) - m - r\Delta
\end{equation}

Assuming that the rate of growth of the stock of debt increases at the same rate as GDP, so that the debt/output ratio remains constant, i.e.,

\begin{equation}
\frac{B}{D} = \frac{g_d}{D} = g
\end{equation}

and substituting this, and noting that the economy under the circumstance mentioned earlier attains a growth rate equal to the growth rate of capital stock, i.e.

\begin{equation}
g = \frac{Q_t - Q_{t-1}}{Q_t} = \frac{K_t - K_{t-1}}{K_t} = \frac{1}{\kappa} \frac{I}{Q_t}
\end{equation}

where \((t-1)\) is the previous and \((t)\) is the current period and solving for the growth rate of the economy from Equation 11, yields

\begin{equation}
g = \frac{\pi + t - \theta - m - r\Delta}{\kappa (1 - \alpha) - \Delta}
\end{equation}

Since our interest is in gauging the effect of external borrowing on economic growth, we should consider the partial derivative of growth \((g)\) in Equation 14, with respect to \((\Delta)\), which yields equation (15).
\[
\frac{\delta g}{\delta \Delta} = \frac{[\pi + t - \theta - m_c - r(1-\alpha) \lambda]}{[\lambda(1 - \theta) - \Delta]^2}
\]

This is nothing but the marginal condition relating the growth rate of the economy \((g)\) when the debt to GDP ratio increases over time. Since the denominator is positive, the necessary condition for the increase in external debt to growth of the economy follows from equation (15), giving

\[
\frac{\delta g}{\delta \Delta} > 0, \text{ if and only if } \pi + t - \theta - m_c > r(1-\alpha)\lambda.
\]

The interpretation of condition (16) is straightforward.

Assuming other things remain constant, foreign borrowing would contribute to the growth of the economy provided:

(a) the share of exports in GDP \((\pi)\) is high;
(b) transfer payments as a share of GDP \((t)\) is high;
(c) imports of intermediate inputs \((\Theta)\) are low;
(d) imports of consumer goods \((M_c)\) are low;
(e) the share of imported capital \((1-\alpha)\) is small;
(f) interest rates on foreign debt \((r)\) are low;
(g) capital is used efficiently, i.e. the ICOR \((\lambda)\) is low.

**Empirical results**

In the following we will use the condition provided by (16) to examine the advantages that were taken of foreign debt by the Ethiopian policy makers. Table 8 provides the details of the growth to debt relationship.

Table 8 relates exports \((\pi)\), private and public transfers \((t)\), import of raw material and semi-processed goods (including fuel) \((\Theta)\), import of consumer goods \((m_c)\), all in real terms, as a share of GDP in 1980 prices. Export values were deflated by the export unit value index \((1980=100)\), while the import components, i.e. raw material semi-finished goods and consumer goods, were deflated by the import unit value index \((1980=100)\). The value for \(\alpha\) is calculated as \((1-MI/GFCF)\), where MI is import of capital goods, and GFCF is gross fixed capital formation, both in 1980s prices.
<table>
<thead>
<tr>
<th>Year</th>
<th>$x$</th>
<th>$x$</th>
<th>1+2=(3)</th>
<th>$\theta$</th>
<th>$M_t$</th>
<th>$\theta_tM_t$</th>
<th>$L_{side}$</th>
<th>$r$</th>
<th>$(1-\alpha)$</th>
<th>$n\left(1-\alpha\right)\sigma$</th>
<th>Debt Growth $\left(11\times7\times10\right)$</th>
</tr>
</thead>
<tbody>
<tr>
<td>1964</td>
<td>0.187</td>
<td>0.010</td>
<td>0.197</td>
<td>0.046</td>
<td>0.053</td>
<td>0.099</td>
<td>0.096</td>
<td>2.2</td>
<td>0.537</td>
<td>0.056</td>
<td>+</td>
</tr>
<tr>
<td>1965</td>
<td>0.197</td>
<td>0.015</td>
<td>0.212</td>
<td>0.046</td>
<td>0.063</td>
<td>0.109</td>
<td>0.103</td>
<td>2.4</td>
<td>0.640</td>
<td>0.072</td>
<td>+</td>
</tr>
<tr>
<td>1966</td>
<td>0.193</td>
<td>0.014</td>
<td>0.207</td>
<td>0.049</td>
<td>0.058</td>
<td>0.107</td>
<td>0.100</td>
<td>1.8</td>
<td>0.610</td>
<td>0.052</td>
<td>+</td>
</tr>
<tr>
<td>1967</td>
<td>0.195</td>
<td>0.020</td>
<td>0.205</td>
<td>0.048</td>
<td>0.045</td>
<td>0.093</td>
<td>0.112</td>
<td>1.6</td>
<td>0.444</td>
<td>0.033</td>
<td>+</td>
</tr>
<tr>
<td>1968</td>
<td>0.194</td>
<td>0.012</td>
<td>0.206</td>
<td>0.051</td>
<td>0.052</td>
<td>0.103</td>
<td>0.103</td>
<td>2.3</td>
<td>0.528</td>
<td>0.057</td>
<td>+</td>
</tr>
<tr>
<td>1969</td>
<td>0.183</td>
<td>0.011</td>
<td>0.194</td>
<td>0.045</td>
<td>0.054</td>
<td>0.099</td>
<td>0.095</td>
<td>2.3</td>
<td>0.375</td>
<td>0.041</td>
<td>+</td>
</tr>
<tr>
<td>1970</td>
<td>0.173</td>
<td>0.010</td>
<td>0.183</td>
<td>0.049</td>
<td>0.057</td>
<td>0.106</td>
<td>0.077</td>
<td>2.0</td>
<td>0.461</td>
<td>0.043</td>
<td>+</td>
</tr>
<tr>
<td>1971</td>
<td>0.178</td>
<td>0.010</td>
<td>0.188</td>
<td>0.051</td>
<td>0.052</td>
<td>0.103</td>
<td>0.085</td>
<td>2.4</td>
<td>0.459</td>
<td>0.052</td>
<td>+</td>
</tr>
<tr>
<td>1972</td>
<td>0.156</td>
<td>0.012</td>
<td>0.168</td>
<td>0.037</td>
<td>0.040</td>
<td>0.077</td>
<td>0.091</td>
<td>2.1</td>
<td>0.381</td>
<td>0.038</td>
<td>+</td>
</tr>
<tr>
<td>1973</td>
<td>0.160</td>
<td>0.013</td>
<td>0.173</td>
<td>0.039</td>
<td>0.037</td>
<td>0.076</td>
<td>0.097</td>
<td>1.9</td>
<td>0.290</td>
<td>0.026</td>
<td>+</td>
</tr>
<tr>
<td>1974</td>
<td>0.186</td>
<td>0.023</td>
<td>0.209</td>
<td>0.051</td>
<td>0.049</td>
<td>0.100</td>
<td>0.109</td>
<td>1.6</td>
<td>0.216</td>
<td>0.018</td>
<td>+</td>
</tr>
<tr>
<td>1975</td>
<td>0.171</td>
<td>0.017</td>
<td>0.188</td>
<td>0.067</td>
<td>0.051</td>
<td>0.118</td>
<td>0.070</td>
<td>1.7</td>
<td>0.191</td>
<td>0.015</td>
<td>+</td>
</tr>
<tr>
<td>1976</td>
<td>0.105</td>
<td>0.025</td>
<td>0.130</td>
<td>0.051</td>
<td>0.046</td>
<td>0.097</td>
<td>0.033</td>
<td>1.8</td>
<td>0.324</td>
<td>0.027</td>
<td>+</td>
</tr>
<tr>
<td>1977</td>
<td>0.111</td>
<td>0.020</td>
<td>0.131</td>
<td>0.045</td>
<td>0.045</td>
<td>0.090</td>
<td>0.041</td>
<td>1.8</td>
<td>0.423</td>
<td>0.036</td>
<td>+</td>
</tr>
<tr>
<td>1978</td>
<td>0.119</td>
<td>0.028</td>
<td>0.147</td>
<td>0.042</td>
<td>0.044</td>
<td>0.086</td>
<td>0.061</td>
<td>4.1</td>
<td>0.505</td>
<td>0.097</td>
<td>+</td>
</tr>
<tr>
<td>1979</td>
<td>0.113</td>
<td>0.024</td>
<td>0.137</td>
<td>0.062</td>
<td>0.055</td>
<td>0.117</td>
<td>0.020</td>
<td>3.4</td>
<td>0.681</td>
<td>0.109</td>
<td>+</td>
</tr>
<tr>
<td>1980</td>
<td>0.142</td>
<td>0.018</td>
<td>0.160</td>
<td>0.075</td>
<td>0.034</td>
<td>0.109</td>
<td>0.051</td>
<td>3.3</td>
<td>0.499</td>
<td>0.076</td>
<td>+</td>
</tr>
<tr>
<td>1981</td>
<td>0.120</td>
<td>0.014</td>
<td>0.134</td>
<td>0.060</td>
<td>0.035</td>
<td>0.090</td>
<td>0.044</td>
<td>3.8</td>
<td>0.442</td>
<td>0.079</td>
<td>+</td>
</tr>
<tr>
<td>1982</td>
<td>0.115</td>
<td>0.031</td>
<td>0.146</td>
<td>0.073</td>
<td>0.050</td>
<td>0.123</td>
<td>0.023</td>
<td>4.1</td>
<td>0.544</td>
<td>0.105</td>
<td>+</td>
</tr>
<tr>
<td>1983</td>
<td>0.118</td>
<td>0.025</td>
<td>0.143</td>
<td>0.060</td>
<td>0.053</td>
<td>0.133</td>
<td>0.010</td>
<td>4.5</td>
<td>0.586</td>
<td>0.124</td>
<td>+</td>
</tr>
<tr>
<td>1984</td>
<td>0.127</td>
<td>0.033</td>
<td>0.160</td>
<td>0.059</td>
<td>0.062</td>
<td>0.121</td>
<td>0.039</td>
<td>4.6</td>
<td>0.498</td>
<td>0.108</td>
<td>+</td>
</tr>
<tr>
<td>1985</td>
<td>0.114</td>
<td>0.035</td>
<td>0.143</td>
<td>0.059</td>
<td>0.076</td>
<td>0.145</td>
<td>0.014</td>
<td>3.4</td>
<td>0.561</td>
<td>0.090</td>
<td>+</td>
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<tr>
<td>1986</td>
<td>0.136</td>
<td>0.028</td>
<td>0.164</td>
<td>0.053</td>
<td>0.072</td>
<td>0.125</td>
<td>0.039</td>
<td>3.6</td>
<td>0.648</td>
<td>0.110</td>
<td>+</td>
</tr>
</tbody>
</table>
The ICOR ($\lambda$) was obtained by OLS since the year-on-year data exhibited considerable variation, including negative values for some years. The figure obtained for the ICOR following this method is 4.7, which was used for the entire period under consideration.

The empirical results, which seem very plausible, show that external capital contributed positively to growth between 1964 and 1977, and thereafter, it had a negative impact. It should be emphasized that it is not foreign debt, but rather how it was used, that made the difference. In other words, the country failed to make effective use of the resources it mobilized. The tentative explanations are as follows.

It has been pointed out that foreign capital is directed towards improving the infrastructure of the country. These are not directly productive, but are rather catalytic in the growth process.

During the pre-revolution period, particularly until 1974, economic policies in Ethiopia were such that the expansion of physical infrastructure such as roads into hitherto inaccessible regions was more likely to be followed by developers, thus justifying their cost. During this period, GDP continuously increased, albeit at an irregular rate, without any record of decline.

Foreign exchange earnings from exports were also on the increase, mainly as a result of increases in volume as well as diversity of exportables. Coffee, which is the most important export commodity, had its share of export earnings declining from 61 per cent in 1964 to 28 per cent in 1974. The growth in export revenue was so much that, with a fairly liberal import policy, the country recorded positive trade and current account balances during the period 1972-74. At the same time, imports of raw materials and consumer goods were claiming smaller proportions of the foreign exchange earnings from export and transfer payments.

During the first three years of the revolution (1975-77), this trend continued, partly because of the impulse of the previous trend and the commodity price boom.

The years after 1978 show a decline in economic activity. The first two years (1978-79) were years of economic revival, during which period the government's rehabilitation efforts paid off. But beginning in 1980, the economy experienced decline. In addition to external factors (increase in the price of oil, recession in the OECD countries, and declining prices of primary commodities, mainly coffee) the government's policy of suppressing the private sector resulted in a downward slide. In addition, the inauspicious weather and continued civil strife failed to lend a supportive hand to the economy.

Consequently, export earnings stagnated. Transfer payments — which have never been a strong feature in the supply of foreign resources — remained very
low, except for the years when the drought was at its worst. The country which was on the verge of food self-sufficiency prior to the revolution reverted to a situation of massive imports in addition to the huge inflow required to feed the drought victims.

The burden on coffee as the major foreign exchange earner increased as the state farms (which were private commercial farms before the revolution) shifted from export and import substituting crops to food crops as a matter of policy, and the private sector followed suit because the terms of trade between exportables versus food were moving in favour of the latter.

In addition, the economy was suffering from growing inefficiency. If the ICOR could be taken as a rough measure of efficiency, it increased from an average of 3.6 over the period 1961-69, to 4.2 for the 1967-73 period, and 8.9 over the 1973-79 period. These adverse domestic developments were augmented by increasing interest rates. While interest rates averaged 1.98 per cent over the 1964-74 period, they increased to 3.34 per cent over the 1975-86 period.

That the combination of these developments resulted in a negative correlation between growth and external debt should not come as a surprise. It should again be borne in mind that foreign debt had nothing to do with the negative result. The problem lies in how well it was used.

The debt servicing problem

The debt service problem is a post-revolution phenomenon. Prior to 1975, larger export earnings and low interest rates meant the problem was a small one. With stagnant or declining foreign exchange earnings in the face of increasing debt service requirements, the economy is now forced to divert resources from other uses to pay the principal and cover the interest payments.

There is more to the debt servicing burden, at least in the Ethiopian case. In the literature it is often assumed that new borrowing is partly used to pay for amortization and the interest costs to obtain the net transfer. In the Ethiopian case, this avenue is not available. With the exception of borrowing from financial institutions, which is very small, the bulk of the credit is tied to either projects or goods, and utilization is closely supervised to ensure that the resources are not diverted to other uses. This is especially true of the credit made available by multilateral institutions such as the World Bank and African Development Bank.

Official bilateral credit is tied at the source where payments are made for import of goods purchased — including capital goods for projects whose
resources are not available for alternative uses. The same goes for suppliers' credit.

As a result, the whole of the debt burden falls entirely on the foreign exchange earned from exports of goods and services. This is because of the transfer problem. Even if the society saves enough to finance not only domestic investment but also to service foreign debt, the only way such saving can be used is first to convert it into foreign currency, an option that is not available other than through export earnings.

In a way, therefore, the golden rule of borrowing must be converted from a GDP–debt relationship to an export–debt relationship, i.e., for the country to minimize the burden of debt servicing the rate of growth of exports should be greater than the rate of growth servicing the debt.

What is apparent from Table 9 is that uncommitted foreign exchange earnings have not kept pace with the import requirements of the country. The result was the compression of development related imports in favour of consumables imports, resulting in a further slowdown of economic activity.
<table>
<thead>
<tr>
<th>Year</th>
<th>Export of goods and non-factor services Value (millions of Birr)</th>
<th>Growth rate (%)</th>
<th>Transfer payments Value (millions of Birr)</th>
<th>Supply of foreign exchange (4)</th>
<th>Debt servicing (5)</th>
<th>Uncommitted foreign exchange (6) = 4-5</th>
<th>Import of goods and services</th>
</tr>
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<tbody>
<tr>
<td>1964</td>
<td>345.6</td>
<td>19.4</td>
<td>16.9</td>
<td>362.8</td>
<td>21.6</td>
<td>341.2</td>
<td>375.4</td>
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<td>390.4</td>
<td>12.9</td>
<td>32.8</td>
<td>423.2</td>
<td>24.5</td>
<td>398.7</td>
<td>456.2</td>
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<td>397.8</td>
<td>1.9</td>
<td>29.7</td>
<td>427.5</td>
<td>31.9</td>
<td>395.6</td>
<td>496.6</td>
</tr>
<tr>
<td>1967</td>
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<td>-5.0</td>
<td>15.8</td>
<td>393.8</td>
<td>38.8</td>
<td>355.0</td>
<td>454.7</td>
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<td>1968</td>
<td>427.4</td>
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<td>29.4</td>
<td>456.8</td>
<td>42.1</td>
<td>414.7</td>
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<td>27.9</td>
<td>470.4</td>
<td>48.9</td>
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<td>5.5</td>
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<td>56.1</td>
<td>430.0</td>
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<td>22.5</td>
<td>497.9</td>
<td>43.7</td>
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<td>40.6</td>
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<td>719.0</td>
<td>569.7</td>
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VII Conclusion

In the Ethiopian case, long-term foreign credit has had a positive impact on the economy. While in the pre-revolution period and the early post-revolution years the relationship is positive, it turned negative during the post-revolution era. However, the post-revolution performance cannot be attributed to foreign debt. Rather, the problem was one of inappropriate domestic policies. As evidenced in the body of the paper, the major portion of resources mobilized externally was used in areas that enhance the productive use of the national resources, i.e. the expansion of physical and human infrastructures rather than in directly productive activities. Against this background, the regime’s policy of curtailing private-sector economic activity, coupled with its own, not only limited, but grossly inefficient utilization of resources, failed to take full advantage of the existing infrastructure.

Neither could foreign investment make use of these resources because of the hostility that the government had for it. What attempts there were to allow foreign investment to operate in the country were made in ways that were contrary to their interest, as a result of which such inflows dried up altogether.

The lesson one draws from the Ethiopian experience is that while external factors could be contributory, major responsibility seems to lie in domestic factors. The main stumbling block in the Ethiopian case is found to be the policy of the government.
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