Amar Bhattacharya, Geske Dijkstra, Martin Gilman, Florence Kuteesa, Matthew Martin, Mothae Maruping, Wayne Mitchell and Rosetti Nayenga

HIPC Debt Relief

Myths and Reality

Edited by
Jan Joost Teunissen and
Age Akkerman

FONDAD

HIPC Debt Relief: Myths and Reality

Forum on Debt and Development (FONDAD)

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Director: Jan Joost Teunissen

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Abbreviations

AERC	African Economic Research Consortium
AfDB	African Development Bank
AfDF	African Development Fund
BWIs	Bretton Woods institutions
CABEI	Central American Bank for Economic Integration
CAFOD	Catholic Agency for Overseas Development
CIRR rates	Commercial Interest Reference Rates (official lending rates of export credit agencies)
DAC	Development Assistance Committee of the OECD
DFID	Department for International Development (UK)
DSA	Debt Sustainability Analysis
ECAs	export credit agencies
EIB	European Investment Bank
ESAF	Enhanced Structural Adjustment Facility
ESAIDARM	Eastern and Southern African Initiative in Debt and Reserves Management
EU	European Union
EURODAD	European Network on Debt and Development
FDI	foreign direct investment
G-7	Group of Seven (Canada, France, Germany, Italy, Japan, UK, US)
G-8	Group of Eight (G-7 + Russia)
GDP	gross domestic product
GNI	gross national income
GNP	gross national product
HIPCs	heavily indebted poor countries
HIPC I	original HIPC Initiative (1996)
HIPC II	Enhanced HIPC Initiative (1999)
IADB	Inter-American Development Bank
IBRD	International Bank for Reconstruction and Development (World Bank)

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IDA	International Development Association
IFIs	international financial institutions
IMF	International Monetary Fund
IOB	Policy and Operations Evaluation Department of the Dutch Ministry of Foreign Affairs
MDGs	Millennium Development Goals
MEFMI	Macroeconomic and Financial Management Institute of Eastern and Southern Africa
NCM	Dutch export credit agency
NEPAD	New Partnership for Africa's Development
NGO	non-governmental organisation
NPV	net present value (see Glossary)
ODA	official development assistance
OECD	Organisation for Economic Cooperation and Development
OED	Operations Evaluation Department (of the World Bank)
OPEC	Organization of the Petroleum Exporting Countries
PAF	Poverty Action Fund (Uganda)
PRGF	poverty reducing growth facility
PRSC	poverty reduction support credit
PRSP	poverty reduction strategy paper
PV	present value (see Glossary)
SADC	Southern African Development Community
SDR	special drawing right
SILICs	severely-indebted lower-income countries
SIMICs	severely-indebted middle-income countries
SPA	Special Programme of Assistance
STABEX	multiple-purpose funding instrument of the EU used both for development and trade policies
TRIPS	trade-related aspects of intellectual property rights
UK	United Kingdom
UN	United Nations
UNCTAD	United Nations Conference on Trade and Development
US	United States
WB	World Bank

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Glossary

Completion Point: The date at which a country completes the key structural reforms agreed at the HIPC decision point, including implementation of its poverty reduction strategy. The country then receives the bulk of HIPC debt relief without further policy conditions. As of January 2004, 10 countries reached completion point: Benin, Bolivia, Burkina Faso, Guyana, Mali, Mauritania, Mozambique, Nicaragua, Tanzania, and Uganda.

Cutoff Date: The date prior to which loans must be contracted in order to be eligible for rescheduling. The cutoff date is usually 6 to 12 months before the date of the first rescheduling agreement and typically remains fixed in all subsequent rescheduling.

Debt Overhang: The excess of a country's external debt over its long-term capacity to pay.

Decision Point: The date at which HIPC debt relief is committed and begins on an interim basis, to be followed by HIPC completion point.

Enhanced HIPC Initiative: A major review of the HIPC Initiative in 1999 to provide deeper, broader and quicker debt relief.

HIPCs (heavily indebted poor countries): There are currently 42 countries defined by the IMF and World Bank as HIPCs. HIPC criteria include assessment by the World Bank and IMF showing a "potential need for HIPC debt relief" and per capita income below $785, with entitlement to borrow on IDA-only terms from the World Bank and from the IMF's PRGF.

London Club: An informal grouping of commercial banks who meet to determine a common approach to rescheduling commercial bank debt to a country. The London Club does not have a secretariat comparable to the Paris Club.

Millennium Development Goals (MDGs): Goals for poverty reduction and development agreed by the United Nations in 2000.

NPV (Net Present Value): See PV.

Paris Club: The forum of creditor governments belonging to the Development Assistance Committee of the OECD to negotiate the rescheduling of the debts owed to them – mainly aid loans and guaranteed export credits. Rescheduling is actually put into effect by a series of bilateral agreements negotiated separately by each individual creditor some time after the Paris Club agreement.

Poverty Reduction and Growth Facility (PRGF): Established as the Enhanced Structural Adjustment Facility (ESAF) in 1987. Used as the IMF's concessional lending facility, which provides finance for Poverty Reduction Strategy Papers (PRSPs).

Poverty Reduction Strategy Paper (PRSP): PRSPs describe the country's macroeconomic, structural and social policies and programmes to promote growth and reduce poverty, as well as associated external financing needs and major sources of financing. In order for a country to qualify for multilateral debt relief, access PRGF and IDA concessional lending, it must produce a PRSP.

PV (**Present Value**) (of debt): The discounted sum of all future debt service at a given rate of interest. If the rate of interest is the contractual rate of the debt, by definition, PV equals the nominal value, whereas if the rate of interest is the market interest rate, then PV equals the market value of the debt. Present Value is sometimes mis-described as Net Present Value.

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Introduction

Jan Joost Teunissen

When I was asked in early summer of 2002 by officials of the Dutch Ministry of Foreign Affairs whether I was willing to organise an international workshop on how debt relief for heavily indebted poor countries (HIPCs) could be made more effective, my first thought was: "Gosh, why did they let this problem drag on for so many years? They should have resolved it long ago!"

In my opening remarks to the workshop in August 2002, I hinted at my spontaneous (but silenced) outcry in somewhat more diplomatic, but still provocative, terms, saying that I hoped the Forum on Debt and Development (FONDAD) would not be asked in three years time to organise yet another workshop on how the HIPC Initiative could be made more effective.

"The Initiative should just achieve what it is meant to do: get rid of the debt problem," I stressed.

During the coffee break, one of the Ugandan participants came to me and said with an ironic smile "You have been pretty tough with us."

"No," I answered, amused, "I wasn't blaming you so much, but rather the officials in the rich countries."

"Come on," she said, "we share part of the blame."

Lessons from the 1980s Debt Saga

The first international workshop I organised on how to resolve the debt problem of developing countries dates back to March 1984.

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The meeting took place in Amsterdam and was held a year and a half after the international debt crisis erupted in August 1982 when Mexico could no longer repay its debts to the western commercial banks. At the time, discussions often included the issue of who was to blame for the emergence of the debt crisis: the poor countries, the western banks, or the rich countries?

The rich countries and the western banks tended to downplay or even dismiss their responsibility. Instead, they shifted (most of) the blame onto the developing countries, accusing them of having borrowed too much, adjusted too little, and pursued bad economic policies.

As chair of that March 1984 workshop in Amsterdam, I gave ample room to a Brazilian professor of economics, Maria da Conceiçao Tavares, who had a different analysis. She eloquently presented the view that the United States and Western Europe were, for a large part, to be held responsible for the emergence of the debt crisis in 1982.[1]

Basically, her argument boiled down to the thesis that the debt crisis had deep roots in how the international monetary and financial system had been operating since the establishment of the Bretton Woods system in 1944. The lack of will of the United States and Europe to reform the system and de-link it from the US dollar as the key currency, first led to an explosion of international interest rates at the end of the 1970s and then, as a consequence of the extension of roll-over credits by the banks to debtor countries at very high interest rates (to repay the banks), to the outbreak of the debt crisis in August 1982.

In Tavares' succinct and intriguing synthesis: "It all started with the foreign debt of the United States!"[2]

Obviously, some European officials disagreed with Tavares' analysis. And when she suggested that the Latin American debt could be easily resolved by establishing a special agency that would convert defaulting debts into long-term loans with a 7 percent rate of interest – as had been proposed by some Brazilian and American bankers – one of the participants, an official from the Dutch central

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1 See for an account of her view and that of other economists, including the late Robert Triffin, Jan Joost Teunissen, "The International Monetary Crunch: Crisis or Scandal?", In: *Alternatives*, Vol. XII, No. 3, pp. 359-395, July 1987.

2 See for an explanation of this uncommon statement, my article in *Alternatives* mentioned in footnote 1.

bank, said: "I have a problem with these designs for a global solution. The countries with high debt are very different. Brazil, for example, is a completely different case from that of South Korea. Moreover, these countries themselves are not interested in global solutions because they fear they might be cut off from access to commercial bank loans in the future. Indeed, Jan Joost is right that the ministries of finance and central banks of the industrial countries are not eager to bail out the banks. For such a bail-out, we would need the agreement of the industrial countries. In the present circumstances it is absolutely unthinkable that the US Congress would agree to such a solution."

What lessons can we learn from this debt debate of twenty years ago? Many, but I want to highlight only three of them.

The first lesson is that the creditor countries were consciously delaying debt reduction measures. In this way, they gave the banks sufficient time to build up reserves for the eventual debt reduction that would have to come. After seven years, a global solution was finally adopted which previously had been said to be "unthinkable". In 1989, Brady bonds (named after the US minister of finance Brady) were created to substantially reduce the debt burden of Latin American countries.

Second, the debtor countries were unable to get their acts together and negotiate a quicker and better solution. They talked a lot about forming a debtors' cartel, but it never got off the ground. In the meantime, the creditor countries had their own effective cartel, the Paris Club, and almost full control over the IMF and the World Bank as instruments to "guide" the economic policies of debtor developing countries.

Third, the creditor countries and the IMF and World Bank were successful in convincing (others might say: forcing) the debtor developing countries to "adjust" and liberalise their economies. Even though adjustment and liberalisation helped them to regain creditworthiness and investor confidence, it also led to what in Latin America is called the "lost decade" of low economic growth, high unemployment and social suffering.

Can similar lessons be drawn for the HIPC case? Before answering that question, I will say a few words about the slowness of action on the part of the policymakers of the rich countries (including the IMF and the World Bank) prior to launching the HIPC Initiative, mention the major criticisms of the Initiative, and summarise the main suggestions of what needs to be done to resolve the debt problem of low-income countries.

The Long Way to the HIPC Initiative

The debt debate of the 1980s concentrated on the debt problem of, in World Bank and IMF parlance, severely-indebted *middle*-income countries (SIMICs). In the late 1980s and early 1990s, the debate shifted to the debt problem of severely-indebted *lower*-income countries, or SILICs, most of them being in Africa. At the same time, the discussion shifted from debt owed to *commercial* banks to debt owed to *official* creditors – donor governments and international financial institutions (IFIs). Official debt relief can be split into two segments: (i) debt owed to donor governments, i.e. *bilateral* debt; and (ii) debt owed to IFIs, i.e. *multilateral* debt.

Professor Gerald K. Helleiner of the University of Toronto was one of the first experts who warned at an early stage that African countries were running into serious problems with the servicing of official debt. In his introduction to the proceedings of a conference held in Nairobi in 1985,[3] Helleiner observed that, as a result of a collapse in commodity prices, high international interest rates and protectionism, many countries in Africa were facing debt servicing obligations that appeared "to exceed prospective servicing capacity".

Helleiner noted that while a whole range of debt relief measures were proposed at the Nairobi conference, the IMF paper was very cautious. Instead of emphasising the need for debt relief, the IMF paper just emphasised the need for "improved domestic-debt management systems".

In another book published by the IMF, *Analytical Issues in Debt*,[4] Joshua Greene of the IMF's research department discussed in a similar cautious vein a whole range of proposals for multilateral debt relief. Greene saw many obstacles in putting any of these proposals

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3 The conference was moderated by Helleiner and jointly sponsored by African central banks and the IMF. The proceedings were published by the IMF, Gerald K. Helleiner (ed.), *Africa and the International Monetary Fund*, IMF, Washington D.C., 1986.

4 Jacob A. Frenkel, Michael P. Dooley, and Peter Wickham (eds.), *Analytical Issues in Debt*, IMF, Washington D.C., 1989.

into practice, the main obstacle being that bilateral donors would have to provide the necessary funding. Such funding would be highly unlikely, said Greene, "given the present budgetary positions of the leading donors".

Helleiner's concern about the rising debt problems of poor African countries was shared by another Canadian economist, Roy Culpeper of the North-South Institute, who was advisor to the Canadian executive director at the World Bank from 1983 to 1986. In an April 1988 study, Culpeper observed: "Despite the growing 'menu of options' for debt relief offered to individual debtor countries and their respective creditors, in early 1988 one obvious option, *debt reduction* or *partial debt forgiveness*, was still conspicuous by its virtual absence. ... The best examples of the scope for debt reduction derive from the debt of low-income Africa. The debt of this region is insignificant in global terms."[5]

The lack of will of the IMF and the World Bank (and the rich countries controlling these institutions) to consider multilateral debt relief for poor countries in Africa prompted former high-level World Bank expert Percy Mistry to present compelling arguments in favour of official debt relief at meetings that FONDAD organised for European and Latin American development NGOs in the late 1980s.[6] Mistry undertook a number of studies that showed the urgent need for debt relief to low-income countries that would go much further than the terms offered in Paris Club deals. In his path-breaking study, *African Debt Revisited: Procrastination or Progress?*, (FONDAD, 1991),[7] Mistry stressed: "Debt relief ... is still being provided to Africa on a 'too little, too late' basis."

It was another study by Mistry, *Multilateral Debt: An Emerging Crisis?* (FONDAD, January 1994),[8] that contributed to putting increasing pressure on western policymakers to consider substantial

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[5] See Roy Culpeper, *The Debt Matrix*, The North-South Institute, Ottawa, Canada, April 1988.

[6] These meetings resulted in the establishment of the European network of NGOs engaged in debt campaigning EURODAD.

[7] This study was the key document at a conference in Abidjan in July 1991 that was attended by African and Western parliamentarians and former World Bank president Robert McNamara among others, resulting in a 11-point action plan on debt relief for poor African countries.

[8] This study built on previous work done by Matthew Martin, one of the contributing authors to this volume.

debt relief for poor countries. But it would still take almost two years before the Development Committee of the IMF and the World Bank asked the staff of the Fund and the Bank (October 1995) to come up with proposals for dealing with the multilateral debt problem.

In April 1996, the staff presented "A Framework for Action to Resolve the Debt Problems of the Heavily Indebted Poor Countries". In June 1996, the framework was followed by a proposal to create a Multilateral Trust Fund for the financing of multilateral debt relief. And, finally, in September 1996, the IMF and the World Bank launched the HIPC Initiative.

The key objective of the Initiative was to provide a permanent exit from the repeated debt reschedulings of HIPCs in the Paris Club and bring their external debts to sustainable levels. Three years later, in 1999, when it became clear that the original framework was insufficient, the HIPC Initiative was enhanced. However, progress in implementation remained slow, instigating observers and policymakers in both HIPC and donor countries to review critically its effectiveness.

Criticisms of the HIPC Initiative

The criticisms of the HIPC Initiative are manifold and can be summarised as follows.

First, since the Initiative has not resulted in long-term debt sustainability, private investors remain reluctant to invest in HIPC countries. In Chapter 2 of this book, Matthew Martin strongly advocates that debt sustainability would become an intrinsic goal of the Initiative, rather than something one hopes would happen after the debt relief is fully granted. Such a wishful policy "leaves the attainment of genuine debt sustainability to initiatives beyond and after HIPC," observes Martin.

Second, growth assumptions and projections of future debt levels have proved to be unrealistic. Uganda is a clear example. As Florence Kuteesa and Rosetti Nabbumba observe in Chapter 3 of this book, the debt-to-exports ratio of Uganda was in June 2003 fifty percent higher(!) than before Uganda obtained debt relief under the HIPC Initiative.

Third, the current requirement to spend all savings from debt service solely on social expenditures is seen by most of the debtor countries as highly inflexible.

Fourth, the implementation of the Initiative has been (extremely) slow, as the limited number of countries that have reached the decision point for actual implementation of debt relief indicates. As Martin Gilman and Wayne Mitchell of the IMF report in their contribution to this book (Chapter 5), of the 38 countries eligible for the Initiative, until now (December 2003) only 10 have reached the completion point and have thus received the debt relief committed by the international community. In Chapter 4, Mothae Maruping stresses that the HIPC process has been "slow and inadequate" in delivering urgently required debt relief to countries in Eastern and Southern Africa

Fifth, the eligibility criteria exclude countries that are as poor and hard hit by high debts as the selected group of HIPCs.

Sixth, the Initiative has done very little to protect countries against exogenous shocks such as the volatility in commodity prices, and thus failed to address the impact of these shocks on debt sustainability. Again, star HIPC country Uganda is a good example. As Florence Kuteesa and Rosetti Nabbumba report in Chapter 3, Uganda experienced a fall of 28 percent in export earnings during the three years it received debt relief, which undermined its debt sustainability.

Seventh, the Initiative has provided very little additional financing for development – if at all. As Matthew Martin shows, large amounts of aid are being diverted from bilateral budgets to fund relief by multilateral institutions. In Chapter 7, Geske Dijkstra adds another interesting and alarming element to the additionality debate: large amounts of aid are being used to repay loans due to western companies! In an evaluation study of the results of debt relief, Dijkstra reports that during the years 2000-2002, when implementation of the Enhanced HIPC Initiative began, the amounts of debt relief destined to repayment of Dutch export credits exploded. This led to what innocent observers might applaud as an all-time high of debt relief granted by the Netherlands in 2002. However, in practice it meant, as Dijkstra emphasises, "that much less money became available for regular aid".

Eighth, the Initiative is not linked to the funding of the Millennium Development Goals (MDGs). Matthew Martin argues that the key question here is whether debt relief is freeing funds for government spending on poverty reduction. His conclusion is that many HIPCs do not include achievement of the MDGs in their HIPC programmes, and that the current design of HIPC relief does not maximise its potential contribution to poverty reduction. In Chapter 6, Amar Bhattacharya, of the World Bank, argues that the goals of the HIPC Initiative and the MDGs can only be met if the rich countries give enough aid. "The HIPC Initiative will reduce the average debt servicing burden to less than 2 percent of GDP by 2005. But on average, HIPCs will need 10 percent of GDP or more in net transfers if they are to lay the foundations for sustained growth and accelerate progress towards the MDGs ... Before the launch of the [HIPC] Initiative, debt and debt service reduction was the first priority. Looking ahead, it will be additional financing in suitable terms and form that will be the key," stresses Bhattacharya.

Ninth, HIPC conditionality impedes the attainment of the MDGs. Geske Dijkstra comes out strongest against conditionality. According to her, there are three arguments against setting conditions for debt relief: (i) HIPCs are forced to spend more on social projects from their tax income while in many cases debt relief does not free resources for such expenditures; (ii) it implies the "double tying" of aid since conditions are first set for the original loans, and then *new* conditions are posed to the relief on these same loans; (iii) the setting of conditions to aid in general has little effect because governments will not carry out policies that they do not believe in while the donors seldom impose real sanctions on lack of performance.

What Needs to Be Done?

The answer to the question of what needs to be done to resolve the debt problem of poor countries depends on what one wishes to achieve. Protestors on the streets of Seattle, Genova or Cancún have urged for putting an end to IMF and World Bank "interference" in poor countries (or even the outright abolition of the Fund and the Bank) and for a total cancellation of debt. Others, in a more moderate tone, have advocated more effective debt relief and a redefinition of the roles of the IMF and the World Bank in developing countries.

In the following chapters, this book provides a wide range of suggestions of what needs to be done. They can be summarised under three broad categories: (i) speed; (ii) depth; and (iii) time-horizon.

The *speed* of providing debt relief is severely hampered by the conditions set for the implementation of debt relief. The main hindrance to quicker debt relief seems to be the traditional IMF macroeconomic conditionality. Therefore, many experts argue that such conditionality should either be minimal or even completely abandoned. The IMF, the World Bank and the rich countries, on the other hand, oppose this view and argue that conditionality is needed to guarantee future debt sustainability. In addition to the traditional conditions applied by the IMF, there is the more specific HIPC conditionality of reaching agreement on a Poverty Reduction Strategy Paper (PRSP). Here the story is the same: some observers suggest eliminating the PRSP as a condition for debt relief while others claim the need to stick to its adoption.

The *depth* or profoundness of debt relief granted under the HIPC scheme has fallen short of what would be needed to achieve debt sustainability, as Martin Gilman and Wayne Mitchell acknowledge in Chapter 5. This is awkward and in clear contrast with the stated objective of the Initiative. Therefore, many observers argue that additional debt relief is needed and that the problems of domestic debt and private debt should be addressed as well.

The *time-horizon* of debt relief in the context of the HIPC Initiative is too limited. Instead of just looking at the period in which countries enter and complete the debt reduction scheme, attention should be focused on the longer-term future of debt sustainability. It is suggested that bilateral donors should stop bailing-out the multilaterals (see Chapter 7) and that aid should be given in the form of grants rather than loans. It is also suggested that the IMF should completely withdraw from long-term lending to poor countries, implying that the poverty-reducing growth facility (PRGF) should be abolished altogether.

The Future of HIPC Debt Relief

At the August 2002 workshop on HIPC Debt Relief organised by FONDAD, it was remarkable how many of the African participants hastened to blame themselves for the lack of progress in achieving debt sustainability and poverty reduction. It is encouraging that African officials take their own responsibility. Northern officials, on the other hand, tend to be less critical about their policies. So it was equally remarkable that a Dutch Treasury participant exclaimed at the end of the workshop: “We are putting so many conditions to HIPCs that we don’t even apply to ourselves!”

Just as happened during the debt crisis of the 1980s, the HIPC creditors remain reticent in providing substantial and prompt debt relief. The following chapters provide useful insights into why this happens. And just as happened before, the creditors remain successful in putting conditions to the delivery of debt relief. In this way, they make sure that the IMF and the World Bank continue to exercise influence over the economic policies of the poor nations. The poor debtor countries, on the other hand, are having even less power than the middle-income debtor countries had in the 1980s to influence creditor action (or lack of action) on the debt issue.

This book presents a thorough analysis of the successes and failures of the HIPC Initiative. Although the contributing authors have diverging views, they share the common objective of providing facts and arguments that aim to resolve the HIPC debt problem. The crucial question is, however, how quickly and thoroughly the problem will be solved.

2

Assessing the HIPC Initiative: The Key Policy Debates

Matthew Martin[1]

In 1996, the international community introduced the Heavily Indebted Poor Countries Debt Relief Initiative (HIPC I). In 1999, it reinforced this initiative, transforming it into the Enhanced HIPC Initiative (HIPC II). This chapter assesses the achievements of these Initiatives. In particular, it looks at the potential role of debt relief in financing the Millennium Development Goals (MDGs), which aim to halve world poverty by 2015, by comparing it with other sources of financing for the MDGs,[2] and assesses whether the Initiatives have fulfiled this potential.

HIPC II will provide a large amount of debt relief. In terms of the "debt overhang", it has promised to reduce the "present value" (PV) of HIPCs' debt by $31 billion for 28 countries. When relief is delivered to all 34 countries which are currently believed to be

1 Published sources for this chapter are listed in the bibliography, but the main source is my work with 44 developing countries, through the HIPC Debt Strategy and Analysis Capacity-Building Programme (funded by the Governments of Austria, Canada, Denmark, Ireland, Sweden, Switzerland and the UK), and the work of Development Finance International on aid management and private capital flows. I am most grateful to colleagues in these programmes for their input, and especially to the opinions of HIPC Finance Ministers represented through the declarations of the HIPC Ministerial Forum (1999-2002), on which this paper is largely based. For more details, see www.dri.org.uk. However, the views expressed in this chapter are entirely personal and do not represent those of the Programme or its donors.

2 For more detail, see Martin (2002a).

From: HIPC Debt Relief - Myths and Reality
FONDAD, February 2004, www.fondad.org

eligible for the Initiative, pre-HIPC debt overhang will be reduced by 40 percent. The total amount of debt relief will be $39.4 billion in PV-terms.

In terms of "liquidity" relief (the flow of future payments on debts), HIPC will provide $58 billion of relief over 33 years. This equals 47 percent of scheduled debt service. Additional pledges of debt relief by creditor governments, beyond HIPC but linked to its framework, will add $8 billion of PV relief and $11 billion of service relief. In total, HIPCs will eventually have their debt reduced by 49 percent and their debt service by 56 percent.[3]

Yet the HIPC Initiative has been surrounded by myths and misunderstandings since its inception. On one side, creditors and international institutions have made exaggerated claims of its successes, based on the assumptions that all its promises have been fulfilled. On the other, NGOs and civil society organisations dismiss HIPC as a total failure or a means of imposing additional conditionality on developing countries without providing enough funding. Neither of these perspectives are accurate: the truth is that HIPC has the potential to achieve much more if reinforced and surrounded by other initiatives. This chapter attempts to present the reality of the HIPC Initiative, as perceived by the HIPC governments themselves and their ideas for how HIPC can help to reach the MDGs.

1 Key HIPC Myths and Realities

Debate 1: HIPC Does/Does Not Provide Debt Sustainability

Proponents of HIPC claim that relief is based on objective criteria which allow it to make debt sustainable (i.e. payable), at least at the time of the completion point when full debt relief is delivered, thereby providing a basis for HIPCs to maintain their debt sustainability thereafter. Opponents of HIPC claim it does not achieve this.

Judging whether developing country debt is sustainable involves four sets of issues: the way to measure debt burdens; the types of debt

[3] All of the data on relief in this paragraph are based on joint publications by the IMF and World Bank (2002c, 2003a, 2003b, and 2003c).

to include in the measurement; the way to judge payment capacity; and the thresholds to set to judge debt sustainability.

Measuring Debt Burdens

Three elements are usually suggested for measuring debt burdens: (i) debt stock – the nominal amount of debt owed by a country; (ii) debt service – the annual amounts payable on the debt; (iii) the present value (PV) of debt – future debt service aggregated based on its cost in today's money (see Martin, Johnson and Aguilar, 2000, for detail).

Until the early 1990s, stock and service were the preferred debt burden concepts. They were easy to understand and to calculate for governments, creditors and foreign and domestic private sector investors. They remain the key concepts private investors and rating agencies use to judge debt burdens. Nevertheless, in the 1990s, the concept of PV debt reduction was introduced to allow Paris Club creditors to show that their different ways of providing debt relief (some cancelling debt up-front, other reducing interest rates and therefore providing relief over several decades) were of equal value to a debtor country (even if this was not the debtor's viewpoint). It is now often suggested that PV is the most theoretically valid concept. However, while PV reflects the concessionality of the debt owed by low-income countries, it is not an accurate measure of what is known as the "debt overhang" – the burden of debt stock which deters investors and has other pernicious effects.

First, no private market actors assess debt burdens using PV – they all use the nominal "stock" of debt. While creditors may wish to pretend that reductions of stock and service are equivalent by using PV calculations, the investor community and civil society in the debtor country react very differently to reductions in debt stock and service. In Guyana, where civil society believed the press releases that Guyana would receive $636 million of (PV) debt relief under HIPC I, they failed to understand PV and burned down part of the Finance Ministry when the Minister tried to explain that this would be delivered only over 30 years through gradual debt service reduction. If HIPC is to continue to use PV rather than stock, creditors and investors need to be educated about its meaning and trained to track it – but it would be preferable to abandon the concept altogether and revert to stock.

Second, many also question the validity of how PV is calculated.

The IMF (2003f) indicates that the PV discount rate should be based on the interest rate which countries could earn by investing the loan disbursements internationally. This would currently be around 2.5 percent, after a dramatic fall in 2001-2003. Yet the actual discount rates used for HIPC II and IMF calculations of the concessionality of new loans, are linked instead to the cost of borrowing export credits from OECD governments (so-called CIRR rates), which are around 4 percent. So the PV is actually discounted much more heavily than it should be and therefore seems less of a burden, depriving countries of debt relief. These interest rates also fluctuate. With their rise in 1999-2000, countries entering the HIPC programme by reaching decision points in 2000-2001 lost hundreds of millions of dollars of debt relief without any objective justification. As interest rates tumbled after September 11, 2001, when terrorists attacked the World Trade Center and the Pentagon, countries with the worst adjustment "track record" gained hundreds of millions of dollars of debt relief at decision point. If the international community insists on retaining PV for the overhang measure, it would be far more equitable among countries and over time to freeze discount rates at those applying on investments by developing countries (around 2.5 to 3 percent).

Which Debts to Include

If we are serious about making debt sustainable, we need to include all types of debt which are important to sustainability. HIPC analysis has omitted two types of debt which are burgeoning in low-income countries – domestic debt and private sector debt – largely because the international community does not wish to relieve these debts using HIPC funds. The IMF (2003f) suggests including domestic and private sector debt in wider debt sustainability analysis, but hints that these would not be important for most low-income countries. HIPCs' own analyses, however, reach different conclusions.

Domestic debt is a huge burden in most HIPCs (see Johnson, 2000), even though Treasury bills, bonds and stocks are small in many countries, partly because they are only just now beginning to use market-based instruments. However, when less traditional debt – central bank overdrafts, arrears to suppliers and government employees – is taken into account, the burden of domestic debt service is higher than external debt service for more than 20 HIPCs.

PRGF programmes largely ignore the domestic debt burden of HIPCs, assuming optimistic rapid clearance of domestic arrears, or falls in inflation which reduce domestic debt interest rates. It is impossible to ensure adequate resources for poverty reduction spending unless we analyse and resolve the domestic debt problem. The international community insists that this burden cannot be reduced using resources committed for HIPC, but there are many other ways of doing so, using programme aid or privatisation receipts (Cape Verde, Ghana, Tanzania). As a result, HIPC Ministers have insisted that all debt sustainability analyses and PRGF documents should examine total (domestic and external) debt burdens, while the international community should give high priority to solving domestic debt problems, since these are undermining the private sector, the economic growth prospects and the sustainability of external debt.

Another key burden emerging for low-income countries, especially those which have liberalised capital accounts and have received large foreign investment (e.g. Bolivia, Gambia, Ghana, Guyana, Mozambique, Tanzania, Tchad, Uganda and Zambia) is the rapidly growing private sector debt to finance foreign investment projects or export/import transactions. A recent IMF Board paper (IMF, 2003f) asserts that most low-income countries have low private capital flows, but this is not so (Martin and Rose-Innes, 2003). Private sector debt stocks of 50 to 100 percent of export earnings are not uncommon in these countries. So there is an urgent need to enhance monitoring and analysis of these debts in order to ensure that they will stay sustainable and not produce foreign exchange crises in the recipient countries if private sector debtors fail to reimburse the debts or foreign exchange reserves become short for other reasons (Baball, 2002; Martin, 2002b).

The recent debate about debt sustainability launched by the IMF and the World Bank may also run a risk of reducing the breadth of analysis. Until now, the HIPC Initiative has taken into account all publicly guaranteed debt in debt sustainability analysis, including debt contracted by other public sector institutions (parastatals, federated states, municipalities), as well as debt contracted by the private sector but guaranteed by the government. Recently, however, the IMF has suggested that some of such debt (subject to case-by-case country examination) might be excluded because it is to finance "enclave" projects which earn enough foreign exchange to repay it.

However, excluding such loans from past IMF programme concessionality ceilings encouraged irresponsible lending of expensive, less high-quality finance by export credit agencies and commercial lenders, often providing continuing "escape funding" to parastatal agencies which therefore failed to restructure. Also, high projected foreign exchange earnings often fail to materialise, and then the debt service falls on the government or undermines the foreign exchange market. Finally, all international institutions still treat such debt as publicly guaranteed debt (see IMF, 2003a). Therefore, HIPCs would rather see all such debt included in analysis – though some of it might need to be treated outside the HIPC framework.

Judging Payment Capacity

There is a lot of confusion about how to judge the payment capacity of a country. Theoretically, one could use GDP/GNI, exports or budget revenue, preferably expressed in present value terms if PV is being used as the measure of the debt. But the fundamental issue remains who pays the debt service.

Export earnings are not a good indicator of payment capacity, since most African governments have liberalised foreign exchange markets and do not have captive private sector export earnings to pay debt service. In addition, they may be unable (or unwilling given inflationary risks) to buy foreign exchange in the markets to transform private export earnings into government forex to pay external debt service (or local currency to pay domestic debt service). This is particularly true when most export earnings are held in offshore accounts and used to repay private sector debt; or when export-earning projects are given long tax holidays, so that they contribute no tax revenue to government. Export earnings can be used to judge total national capacity to pay debt (public and private sector), because private sector export earnings are available to pay private sector debt. However, it is vital in most African countries to analyse government, parastatal and private sector export earnings (breaking down the private sector where necessary into sub-sectors or mega-companies or projects) and their fungibility, to assess the risk of foreign exchange shortage.

It is very difficult to see what relevance *GDP/GNI* has to any assessment of payment capacity for low-income countries, as there is no necessary correlation between it and the availability of resources to pay debt.

Payment capacity for government external (or total) debt basically depends on *budget revenue*. It is sometimes argued that budget revenue is subject to manipulation by governments and therefore risks a moral hazard that they would reduce their budget revenue collection efforts (or falsify its reporting) in order to increase debt relief. However, this argument is purely theoretical since budget revenue collection and monitoring is one of the key elements of IMF programmes. It should be easy for the international community to trust the IMF to monitor such efforts and avoid any moral hazard. HIPCs are convinced that budget revenue should be the key measure of payment capacity for government debt.

Ratios and Thresholds

The amount of debt relief under HIPC has been determined by eligibility thresholds which (according to public statements by Fund and Bank officials) were based on initial analysis (e.g. Humphreys and Underwood, 1989) and then modified to suit political compromises among G-7 creditors, balancing the need to include strategic G-7 allies and the desire to keep costs down. These compromises explain the focus, above all, on PV in the two main criteria for debt relief; PV allows different forms of debt relief to appear equal in their impact. Moreover, G-7 officials regarded debt overhang as more of a burden than debt service. The PV/exports threshold was set at 150 percent (initially 200-250 percent) and the PV/budget revenue threshold at 250 percent. Political compromises especially explain the "Côte d'Ivoire" criterion – the PV/budget revenue threshold which was set at a level just low enough to include Côte d'Ivoire, and accompanied by empirically unjustified sub-criteria to exclude other countries and keep down costs.

Several studies (Cohen, 2000; Elbadawi *et al.*, 1997; Johnson, 2000; Martin, 1999a; Pattillo *et al.*, 2002; and Vaugeois, 1999) have examined the levels of debt which have proven historically or econometrically unsustainable. They have found that the PV/export criterion of 150 percent in HIPC II is near sustainable levels. However, the PV/budget revenue criterion of 250 percent is far from sustainable. Vaugeois (1999) and Martin (1999a) indicate that it should be reduced to 155 percent. Johnson (2000) finds that the

PV/budget revenue ratio of total (external plus domestic) debt has proven unsustainable at 150 percent, implying that much lower thresholds are needed for external debt. HIPCs believe that the PV/budget revenue threshold should be reduced to 150 percent.

The dominance of G-7 views in the discussions also explains why debt service ratios were given much less prominence. The debt service/exports ratio was treated as a secondary criterion, but at a high level of 15-20 percent compared to independent studies which indicate that it has been unsustainable at 12 percent. In spite of the fact that all HIPCs regard the debt service/budget revenue ratio as the key indicator of debt burden if the aim is to free resources for poverty reduction spending to reach the Millennium Development Goals, HIPC II continues to avoid systematic attention to this ratio. It aims only for a debt service/budget revenue ratio which is "low and declining". This leaves a large leeway for subjective viewpoints, and especially for tailoring the profile of relief to creditor preferences, leaving many HIPCs with high ratios in the initial years of HIPC debt relief. Independent analysis has found that this ratio should be set at around 13 percent – a level near the 10 percent endorsed by bodies as diverse as Oxfam and the US Congress. HIPCs advocate a debt service/budget revenue ratio of 10 percent as the key criterion for judging debt sustainability, in order to free the maximum funding for anti-poverty spending.

Summarising, the HIPC Initiative makes some important progress towards debt sustainability: before its creation, creditors did not take notice of debt sustainability, instead sticking to debt relief rules which virtually ignored debtor needs. However, to live up to its promise of making debt sustainable, it is not enough to broaden sustainability indicators and tailor analysis to country circumstances only after HIPC completion point (see IMF/World Bank, 2003a). As long as HIPC analysis continues to focus excessively on the PV/exports ratio, it leaves the attainment of genuine debt sustainability to initiatives beyond and after HIPC.[4] HIPC itself should be giving top priority to reducing debt service/revenue ratios below 10 percent, to free funding for poverty reduction spending.

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[4] Many have also argued that judging debt sustainability by ratios of debt indicators compared to economic indicators is too narrow, and that true sustainability should be judged by whether sufficient funding is released for poverty reduction (CAFOD *et al.*, 2003). This chapter returns to that issue under Debates 4 and 5 below.

Debate 2: HIPC Does/Does Not Make All Creditors Share the Burden

One of the main claims for HIPC is that it includes all creditors and obliges them to share the burden of debt relief to the limits of their abilities (though it does not have the ability to mandate or force creditors to provide relief). Yet its critics claim that it gives preferential treatment to some creditors and many others are not participating.

Preferential Treatment

Before the HIPC Initiative, multilateral creditors had "preferred creditor" status as a result of which they did not provide debt relief. It was argued that this was essential to their financial health and sustainability, although many (Mistry, 1994; UNCTAD, 1993) disagreed with this assessment. With the launching of HIPC it was acknowledged that they could provide some debt relief without disastrous effects, but they retained "slightly less preferred creditor" status. They only share the burden of additional debt relief that is, when needed, provided after the 67 percent debt reduction from bilateral and commercial creditors. However, nobody has made a convincing argument for keeping this status once the multilaterals have agreed they can provide relief without damaging their own funding – except to say that the cost of relieving all of the debt would be too high. Some have argued that they could easily cancel all of the debt owed to them without any damage (notably Debt and Development Coalition Ireland, 2003).

In addition, even to the degree that multilateral institutions are participating in relief, they are not making the maximum possible contributions to HIPC from their own resources. While they have gone further than before, there remain reserves (including IMF gold), provisions and reflows which could be used, notably those of the IMF, World Bank and Inter-American Development Bank, to fund their own relief – and even the relief to be provided by other multilateral and sub-regional organisations – without damaging their financial credibility or future lending to HIPCs or other member states. Instead, bilateral donors are having to divert grant funding to support part of this relief, reducing availability of direct bilateral grants (see Debate 4 below and also Chapter 7 of this volume).

Non-Participating Creditors

Many creditors of HIPCs are not fulfilling the terms of HIPC agreements by participating fully in the debt reduction.

Thirty-two *non-Paris Club creditor governments* are refusing to participate. These fall into 5 categories: creditors which are non-members of the Bretton Woods institutions (BWI) or take little notice of their decisions because they are under international sanctions; middle-income Arab or North African countries; Asian countries (largely China and India); former Eastern European countries; and other HIPCs. In the last 18 months some of these creditors (e.g. India, Libya) have indicated in principle their willingness to participate. However, these statements have not been materialising as actual debt relief for countries (e.g. India has been relieving only aid debt and not export credits; Libya had not signed a relief agreement yet).

HIPCs owe $2 billion in PV terms to *commercial creditors*. A worrying recent trend has been of some non-Paris Club governments and commercial creditors refusing to participate and suing debtors (usually successfully) for full recovery of debt. Though the original debt is small, judgements in international courts have awarded 3 to 4 times this amount to creditors, due to accumulation of interest and legal fees, forcing some debtors to pay amounts as large as $50 million in a year, undermining poverty reduction spending plans.

The Paris Club has made major steps forward under HIPC II. It has agreed that, for many HIPCs where Cologne terms will be insufficient, it will cancel up to 100 percent of pre-cutoff date debt, and most Club members have gone further to cancel post-cutoff date debt where necessary to attain sustainability thresholds. However, a few creditors are charging excessive interest rates, fees or penalty interest in Paris Club bilateral agreements (failing to provide agreed PV reduction). Also, a considerable number of HIPCs (Bolivia, Ethiopia, Gambia, Guyana, Nicaragua, São Tomé, Uganda and Zambia) have not received relief immediately under HIPC, because amounts were small, the period between decision and completion point was short, there was an administrative backlog in the Club, or there were delays in creditor discussions or PRGFs.

All major *multilateral creditors* have agreed to participate in the HIPC Initiative and some have agreed to provide interim relief between decision and completion points. However, seven regional and sub-regional institutions (representing 1.4 percent of total HIPC debt) have not yet agreed to participate in HIPC.

At a global level, non-participation was long seen as insignificant (representing 10-15 percent of total debt), leading the international community to ignore the problem. Yet, for individual HIPCs, and at the margin, it is a critical factor in debt sustainability. HIPCs themselves estimate at 22 (eight more than the BWIs) the true number of countries which will be unsustainable at completion point if non-participation is taken into account. They also indicate that six of the first nine countries to reach completion point cannot be sustainable if deadlock with various creditors continues.

In 2001-2003, partly due to dialogue with HIPCs, the international community has realised non-participation is seriously undermining sustainability for many HIPCs. Yet it has made little progress in resolving the problem. HIPCs have urged it to:

- Establish a rapid response legal assistance facility to help HIPCs to discourage or deal with creditor litigation, run by an appropriate independent institution. In spite of the urgency of this issue, there has been no progress. The Bretton Woods institutions have argued that they cannot run such a facility without appearing to take sides in legal disputes.
- Publish the details of creditors that refuse to provide relief. The BWIs are now publishing these annually in BWI Board Papers. HIPCs are also publishing such details and working with BWIs and civil society to change such creditors' minds;
- Widen the use of the IDA commercial debt reduction facility to cover such creditors. This is currently being studied, and HIPC Ministers have recently expressed their impatience at the slowness of this process (HIPC Ministerial Network 2003b);
- Create a separate Trust Fund for clearing HIPC debts to other HIPCs (and to other countries which have debt cancellation from the Paris Club).

Unequal Burden Sharing

Some creditors are now formally sharing more burden than others. The cancellations of 100 percent of debt announced by various OECD governments were supposed to provide a further $5 billion of PV relief, and to bring down PV/export ratios by an average extra 21 percent (ranging from 1 percent to 41 percent for individual HIPCs).

However, they are not being allowed to do so, due to shortage of funds to finance the overall HIPC relief: without much public discussion, this "safety margin" of 21 percent has simply been abandoned. Therefore, in calculating the sharing of the burden, the intended extra relief provided by some creditors is being used to ensure that HIPCs reach the HIPC thresholds, and other creditors are "free riding" on the extra relief. In addition, the cancellations are not comparable in their coverage or timing – and in some cases are not cancellations at all. Only Australia, Canada, Italy, Norway, the UK and the US are genuinely cancelling 100 percent of all bilateral debt from the decision point. Other G-7 governments are excluding post-cutoff date debt, or ODA debt. Others are implementing cancellation in ways (via debt conversions – France and Italy) which provide no additional budget savings for spending on poverty reduction. HIPCs therefore urge creditors to ensure that 100 percent cancellations are treated as genuinely additional, allowing them to reduce their burdens below HIPC thresholds and forcing all creditors to share the burden; and that all "cancellations" are genuine.

Summarising, the HIPC Initiative has made major progress in obliging most creditors to provide relief. Before HIPC, multilateral, non-OECD and some commercial creditors provided no relief. Now most are providing a large amount and participating in the Initiative – but those which are not participating risk undermining the credibility of the Initiative and denying HIPCs' debt sustainability – and some which are participating could do more to share the burden themselves. If the international community is serious about debt sustainability, it will need to introduce measures to protect countries against lawsuits.

Debate 3: HIPC Does/Does Not Protect Against Exogenous Shocks

Severe, lengthy and frequent so-called "exogenous shocks" (unexpected factors beyond the control of the government which undermine economic prospects) are a crucial factor which regularly undermine debt sustainability for almost all HIPCs. They impact negatively directly on the denominators of debt sustainability ratios (exports and budget revenue) and indirectly on the numerators by expanding fiscal and balance of payments financing gaps, thus inducing more borrowing by countries to fill the gaps (see Martin and Alami, 2001; IMF, 2003c; and, World Bank, 2003c).

The HIPC Initiative was never intended to protect HIPCs against exogenous shocks, even though certain public statements and modifications of the Initiative led countries and civil societies wrongly to assume that it might. Two policies led to this assumption.

First, HIPC introduced at a relatively early stage some allowance for export volatility, allowing exports to be presented on the basis of a multi-year average which would show a more true picture of medium-term export trends. Somehow this was transformed in practice into a fixed 3-year average of exports, which does not by any means reflect export volatility in all HIPCs. In addition, the use of multi-year measurement does not apply either to the PV/budget revenue ratio, or to the debt service/export ratio, both of which are based on the most recent year only. So HIPC relief does not really take much account of recent volatility of exports or budget revenue.

Second, HIPC II agreed to reassess debt sustainability at the time of completion point, to take account of interim exogenous shocks to the economy. If prospects had changed negatively, it was to grant "topping up" (more debt relief) to the HIPC. But almost immediately, worries about cost implications (given that 14 of 24 HIPCs analysed were believed to need topping up) led to restrictions limiting topping up to countries where shocks "lead to fundamental changes in a country's economic circumstances". As a result, only Burkina Faso has received topping up (though Benin and Mauritania also had unsustainable ratios). In addition, topping up aims to reach sustainability only at the moment of the completion point. Burkina Faso has qualified, but will nevertheless have unsustainable debt ratios for the next 16 years due to future borrowing. Topping up provides little hope of real long-term debt sustainability.

The flexibility of the HIPC Initiative was never intended to cover the impact of exogenous shocks between decision and completion points, or after completion point. While many HIPCs conduct their own debt sustainability analysis at these times, debt relief is not adjusted to offset the negative economic impact of exogenous shocks. As a result, the Initiative is effectively providing debt sustainability only at one snapshot date. Bolivia and Uganda have both suffered post-completion point shocks making debt highly unsustainable. So HIPC II is largely ignoring shocks.

However, more fundamentally, the Initiative is not surrounded by a comprehensive international financial architecture to protect HIPCs against exogenous shocks. In particular, projections of economic prospects in the PRGF programmes of the IMF, which accompany HIPC relief, continue to take far too little account of potential "shocks" to aid flows, commodity prices and climate. The BWIs often argue that such shocks cannot be foreseen or that the programme projections are no more optimistic than those of other analysts. Yet shocks of similar magnitudes have happened many times in recent decades, a secular decline or stagnation in the prices of most commodities is now beyond doubt, and climatic shocks are predictable where they occur with regular frequency (for example in Malawi and Niger). In this light, BWI programme and HIPC document projections are systematically overoptimistic, and many shocks are really "non-shocks" (i.e. should have been foreseen). This leads to systematic underestimates of balance of payments "financing gaps", future borrowing and debt burden (see also Serieux, 2002).

Moreover, PRGF programmes focus excessively on the balance of payments impact of "shocks", while failing to analyse sufficiently their impact on the budget, GDP growth or poverty. They also largely ignore another key "non-shock" – the potential impact of the HIV-AIDs pandemic on growth and debt sustainability. UNAIDS and the World Bank indicate growth could fall by 2.5 percent a year in the worst-affected countries, sharply reducing budget revenue and exports by eliminating skilled labour. Yet only three HIPC analyses have taken this into account.

Until recently, responses to shocks by the international community were woefully inadequate, focused on emerging market and other large economies while ignoring any well-structured mechanism for low-income countries. The responses have consisted of (predominantly) asking countries to adjust their economic programmes and projections downwards to match the shocks, and (secondarily) providing additional disbursements of multilateral and bilateral programme loans and grants to compensate for part of the shocks and fill gaps remaining after additional "adjustment". In the past these responses have usually proven too little and way too late to protect key anti-poverty expenditure from drastic cuts. In general, they have not included accessing international contingency and compensatory facilities such as those of the IMF (which are too expensive for low-income countries), and EU STABEX (which was notorious for virtually never disbursing). Nor have they distinguished between permanent shocks, to which a country should be expected largely to adjust, and temporary shocks, which could require external financing.

However, this system of responding to shocks cannot work in the context of the Millenium Development Goals. Every dollar of "adjustment" by an African country due to inadequate or inaccessible financing, or decisions that shocks are "permanent", is a dollar less spending (some of which will need to be cut from spending to reach the MDGs). In addition, this attitude is completely inconsistent with that of the HIPC Initiative, in which permanent shocks are compensated while temporary shocks are not!

Recent BWI papers argue that shocks can be overcome largely by measures beyond debt relief, such as reducing the "over-optimism" of BWI projections and conducting "stress tests" or "sensitivity analysis" in programmes. They have also suggested several piecemeal measures to protect African governments against shocks, such as lending in local currency, or measures to hedge against commodity price shocks.

HIPCs see these measures as inadequate to reach the MDGs. They suggest that:

- All 'likely shocks' must be in baseline scenarios of BWI programmes, including the impact of HIV/AIDs on poverty for countries with prevalence of 5 percent; regular or frequent disasters (e.g. droughts or floods twice in a decade); average volatility of commodity prices over the last 10 years; and, average aid shortfalls compared to projections.
- Analysis of shocks should be conducted in every semi-annual review of each IMF programme, to ensure that measures to offset them are taken very rapidly.
- All baseline scenarios must attain the MDGs (and other national poverty reduction goals) for all African countries. A Fund Board paper this year suggested that countries which could not mobilise financing to attain MDGs or were projecting over-optimistic growth might project "alternative realistic baseline" scenarios which would not reach the MDGs, as the basis for PRGFs. Subsequently, many African countries faced IMF pressure to be "realistic", leading to abandonment of the MDGs, without discussion with donors or civil society.
- Baseline scenarios should also contain realistic measures to reduce vulnerability to shocks, e.g. implementing the recommendations of the World Bank Task Force on Commodity Risk Management,

focusing PRSPs on export diversification into higher value-added products, and opening OECD markets for such products.
- All PRGF alternative scenarios should also aim to reach the MDGs, regardless of the scale of less likely shocks presented, with explicit discussions of the need for government measures or donor financing to accelerate poverty reduction.
- IMF PRGF Board Papers should include much broader contingency measures to protect against shocks, quantifying possible additional necessary external and budget financing, and mobilising up-front pledges by donors, through contingency tranches of donor funding which can be disbursed (e.g. by the EU, IMF, WB and other donors' budget support) to offset shocks immediately.

Summarising, the HIPC Initiative has done very little to protect countries against exogenous shocks, but has led the international community to focus more closely on their severity and frequency for low-income countries. Improvements in HIPC forecasts and many wider measures are needed to stop shocks from derailing progress to the MDGs.

Debate 4: HIPC Does/Does Not Supply Additional Finance for Development

Proponents of HIPC have generally argued that it has mobilised additional financing for development, while opponents inside and outside the Bretton Woods institutions have argued that it has not been additional (or additional enough).

HIPC debt relief has freed additional resources to finance development – notably via IMF gold sales. Moreover, international pressure to relieve debt and fund poverty reduction has made a major contribution to increasing aid budgets in some OECD countries (notably the UK and Ireland), to accelerating aid disbursements (AfDB and EU), to providing aid as grants rather than loans (AfDF, IDA), and especially to pledges at the Monterrey Summit which could increase annual aid flows by $16 billion by 2005. So HIPC has certainly not, as some feared at the beginning, been a zero-sum game in which "one dollar more debt relief is one dollar less aid".

However, there is some reason to worry that the funding of HIPC relief is not sufficiently additional – largely because multilateral institutions are not providing enough funding from within their own resources. As a result, large amounts of aid are being diverted from bilateral budgets to fund relief by multilateral institutions: over $3.4 billion of OECD aid has been promised to the HIPC Trust Fund or used for bilateral payments of multilateral debt in the HIPC framework; additional contributions to the IMF PRGF-HIPC Trust are $1.5 billion in end-1999 PV terms; and, donors have also funded relief by the IADB separately. Though disbursement of these funds will be spread over several years, there is strong evidence of aid diversion to fund debt relief.

This limited overall additionality is different from additionality at an individual recipient country level. Here recent BWI analysis (IMF/WB, 2002c) indicates that most HIPCs have experienced an increase in net flows in 2000-2002 due to a resumption of Fund and Bank assistance, and a (probably related) increase in loans and grants from other sources – the total additionality is estimated at about $3 billion a year for all HIPCs combined. However, this message is qualified by the fact that eight of the 27 countries reaching decision point did not experience increases in net flows. The fall in flows for these countries reflected either interruptions in PRGF programmes (for Guinea-Bissau, Malawi, Nicaragua, São Tomé and Senegal) or delays or reductions in grant disbursements in spite of good track records (Mali, Mauritania and Rwanda). It remains to be seen whether the overall increase in flows to HIPCs will continue, as it may well be linked to the acceleration of decision points and PRGF programmes at the end of 2000. Much will depend on whether the emerging delays in HIPC progress (see Debate 6) can be overcome, and on whether the Monterrey Summit promises materialise. At the moment, these promises do appear to have increased aid flows in 2002 – though some of the increased flows to HIPCs represent diversion from non-HIPCs.

Even though debt relief is a more desirable way of funding than most aid (see Section 2 below), this advantage depends largely on the speed with which it is provided. It is obvious that diverting funds away from fast-disbursing programme aid to trust funds, which provide debt relief over a long period, is not the fastest way to reduce poverty. Donors need to minimise diversion and maintain programme aid levels to give recipients maximum choice in how to fund poverty reduction (see also Section 2 below).

In addition, the international community is not yet acting as if extra funding is available or desirable, given the way it designs and implements IMF programmes. For example, while allowing Burkina Faso and Niger to increase future funding of poverty reduction through external borrowing or grants, the IMF has recently been insisting that several countries (Ethiopia, Mali and Rwanda) cut poverty reducing spending in order to reduce new borrowing and maintain debt sustainability.

In the future, the IMF and World Bank need to take a more active role in: (i) calculating financing and growth needs for attaining the MDGs and then mobilising the necessary funding; (ii) mobilising additional grants to keep debt sustainable; (iii) advocating a flexible interpretation of debt sustainability to allow countries to absorb prospective increased aid loans for anti-poverty spending; and, (iv) ensuring that grant flows go to countries which are most committed to poverty reduction rather than those which are donor "favourites".

Summarising, HIPC has produced considerable extra resources to fund development. However, given the small scale of debt relief compared to aid and private capital flows, overall additionality and the availability of sufficient funding to meet the MDGs will depend on the degree to which donors supplement it with extra aid (especially fast-disbursing and predictable budget aid to support poverty reduction spending), and to which debt relief encourages private capital to flow to low-income countries.

Debate 5: HIPC Can/Cannot Fund the Millennium Development Goals

Proponents of HIPC have suggested that while it can make some contribution to funding the MDGs and halving world poverty by 2015, it was not designed to do this. Critics have indicated that it does not maximise the potential contribution of debt relief to funding the MDGs.

The key issue here is the degree to which debt service relief is freeing funds for government spending on poverty reduction. Developing countries are receiving a total of $55 billion a year in aid (OECD/DAC, 2004). According to the most reliable available estimates (World Bank, 2001; Zedillo, 2001) this implies a $48 billion annual shortfall of funding for attaining the MDGs.

This compares to total current annual HIPC relief of only $1.5 billion. Even cancellation of all HIPCs' debt would provide only around $3.2 billion a year. As a result, HIPC makes only a small contribution to funding the MDGs. In addition, the impact on each country varies considerably. There are two main reasons.

First, some HIPC countries are not reducing their debt service payments even though BWI data indicate an average debt service reduction of 30 percent during 2001-2005 compared to actual service in 1998-1999 (and about 45 percent compared to scheduled service for 2002-2005). Five countries will be paying almost as much as before HIPC (Ethiopia, Guinea-Bissau, Honduras, Nicaragua, Uganda), and four will actually be paying more (Mali, Niger, Sierra Leone and Zambia). This is a key issue for two types of debtors: those which were not paying various (especially non-OECD government) creditors, or had received extremely concessional treatment from the Paris Club, and now have to pay service to these creditors; and, those which had mobilised donors to pay a considerable amount of their debt service to multilateral institutions before HIPC, and therefore had a lower amount of debt service to pay out of their own budget revenues – but whose donor contributions fell sharply once "debt sustainability" was reached.

Second, the debt relief savings themselves may not actually be spent on poverty reduction. Use of the savings is subject to negotiation with the BWIs and, in a few countries, they are being used to reduce budget deficits or domestic debt, or to resolve financial sector problems. These alternative uses, while highly desirable in some cases – not least for their positive effects on private sector activity and counter-inflation strategies – have not generally been subject to transparent public debate.

Independent reports by NGOs and the US General Accounting Office indicate that debt relief on its own will increase HIPCs' social spending by only 20 percent. However, the BWIs (IMF/World Bank, 2002c) indicate that social spending as a percentage of GDP has risen by half during 1999-2002. This seems to show that even if HIPC relief has not freed huge amounts of funding for poverty reduction, poverty reduction spending has increased dramatically due to the combined effects of HIPC relief, new money and the PRSP process.

However, focusing on traditional social sectors – health and education – leaves us short of measuring anti-poverty expenditures needed across the range of Millennium Development Goal needs (water and sanitation, feeder roads, rural electrification, smallholder agriculture, microcredit, gender programmes, population and social welfare).

Some have argued that data and methodological problems make it virtually impossible to cost the spending needs to attain the Millennium Development Goals. However, HIPCs themselves, independent analysts and UN agencies have developed many methods for such costings. These are based on either a macroeconomic framework, using poverty reduction or GDP growth elasticities derived from national poverty surveys, and then modeling sources and components of growth and the government expenditure necessary to reach public investment levels; or a more micro framework, which takes the individual sectoral MDGs (such as child vaccination), most of which are relatively easy to cost, and aggregates their budget spending needs. This is by no means a simple process, but has produced defensible estimates, which indicate that poverty reduction expenditure based on HIPC debt relief will be woefully insufficient to reach the MDGs.[5]

Under HIPC I, targets set for poverty reduction were strongly linked to the amount of debt relief and aid available. The most indebted eligible HIPCs targeted the fastest poverty reduction, and ineligible HIPCs or non-HIPC poor countries risked losing funds as aid was diverted to eligible HIPCs to supplement inadequate debt relief. This distortion has been reduced by HIPC II, because almost all HIPCs are eligible for relief, and can make some progress to the Millennium Development Goals. But poverty reduction targets have still often been based on available debt relief and aid, with insufficient efforts to mobilise additional aid, especially for those HIPCs which are not "favourites" of like-minded donor countries who are increasing aid.

As a result, it is obvious that many HIPCs (notably those in Francophone Africa) are not even aiming to reach the MDGs by 2015 in their HIPC and PRGF programmes; and additional resources for poverty reduction have been allocated largely to those IDA-only countries which are most indebted – rather than on the basis of current poverty indicators or government commitment to poverty reduction.

There is no excuse for not trying to quantify MDG costs and financing needs in PRSPs and then to mobilise the necessary financing, and simply abandoning the goal of reaching the MDGs on the basis that costings are not 100 percent accurate or that funding

5 For similar views, see EURODAD (2002) and Sachs (2002).

might not be able to be mobilised. HIPCs strongly advocate that all PRSPs should analyse the financing and growth needed to attain the MDGs, and the potential sources of the financing, and that the IMF must thereafter ensure that all its PRGF scenarios project the attainment of the MDGs.

The HIPC Initiative does nothing to fund poverty reduction in non-HIPCs. Debt relief could and should fund the MDGs in a much wider range of countries, given debt relief's superior qualities in financing poverty reduction (see Debate 7 below). This justifies annual examination of the debt sustainability of all PRGF-eligible/IDA-only countries by the countries themselves, in cooperation with the BWIs, to see whether all of the most-indebted countries are receiving the maximum possible debt relief. On this basis, countries which might benefit from substantial debt reduction, based on low income and high debt burdens, would include Afghanistan, Bangladesh, Cambodia, Haiti, Indonesia, Iraq, Kyrgyz, Moldova, Nigeria, Pakistan and Turkmenistan. On their reintegration into the international community, Cuba and Zimbabwe would also deserve analysis. The recent introduction by the Paris Club of the "Evian Terms" (which open the door to debt cancellation for more countries but on a vague basis, subject to analysis conducted by the IMF), are a small step in the right direction.

Summarising, the HIPC Initiative was primarily designed to reduce the debt burden of a group of countries where it was seen as excessive and hindering growth. It was only from 1999 that the funds freed by HIPC II were explicitly targeted for spending on poverty reduction. However, the current design of HIPC relief does not maximise its contribution to poverty reduction spending; nor is it surrounded by other funding which would ensure that all HIPCs reach the MDGs, or by measures to ensure that debt relief makes the maximum contribution to the MDGs in all low-income countries.

Debate 6: HIPC Conditionality Will/Will Not Accelerate the MDGs

The more important issue is whether HIPC-related development policies are allowing countries to make rapid enough progress to the Millennium Development Goals. According to proponents, the Poverty Reduction Strategy Papers which define the policy actions needed to receive debt relief under HIPC II, provide enormous potential for growth, poverty reduction and sustainable development. They represent a fundamental shift away from the pre-HIPC period in which debt relief was linked to conditionality that was too often pre-designed by external funders, agreed by recipient governments with virtually no popular consultation, and paying little attention to poverty reduction. Under HIPC II, in theory, conditionality is merely a reflection of national development strategies which are focused on poverty reduction, and designed through participatory consultation of the poor in each country, so that debt relief goes to countries which are most serious in designing and implementing their own poverty reduction strategies. Critics of HIPC II and PRSPs argue that externally-designed conditionality continues to be imposed on HIPCs, overriding all popular consultation, and preventing and delaying poverty reduction, growth or sustainable development.

HIPC ministers are becoming increasingly strident in their concern about delay in reaching the decision and completion points at which HIPC relief respectively begins and is finalised. As of January 2004, 28 countries had begun to benefit from HIPC relief and 10 had reached completion point – but nearly all of this progress occurred in the second half of 2000 when 16 countries reached decision point. Since then only 5 countries have reached decision point and 9 completion point. All of the rest have had decision and completion points delayed, by an average of 17 months, and the momentum of 2000 is disappearing.

What is the cause of this delay? The popular perception – caused by the welcome vociferousness of HIPC country civil societies and international NGOs – has been that relief is being delayed by the design and execution of new participatory processes to design poverty reduction strategies – leading to much discussion of the "trade-off" or "tension" between rapid HIPC and slow PRSPs. PRSPs have generally taken longer than expected to finalise. However, recent discussions with and publications by Bretton Woods staff confirm what HIPC Ministers have been saying for two years – that traditional conditionality rather than PRSP processes are causing almost all the delay. Only 4 of the 15 African HIPCs have been able to implement their PRGF macroeconomic and structural conditions on schedule. Five have had PRGF delays of 0-6 months, three of 6-12 months, two of 12-24 months and two of more than 24 months. As a result, a maximum of four African HIPCs are having completion points delayed by PRSPs, as opposed to eleven where delay is due to PRGFs.

Some within the BWIs argue that this delay is justified – i.e. that relief is being delayed by failure of HIPCs to implement agreed policies. A few suggest that the "stampede" of decision points at the end of 2000 was bad because it undermined country seriousness in programme implementation. However, HIPCs and the international community generally believe that traditional conditionality has been rigid and unsuccessful, and that delay in programme implementation has reflected three factors. First, over-rigid fiscal and macroeconomic frameworks to reach lower inflation targets even in "post-stabilisation" countries with inflation around 5 percent. This results in overambitious targets for expenditure containment and revenue mobilisation, causing expenditure overruns and revenue shortfalls for eleven countries. Second, insistence on executing "left-over" structural conditions from past ESAF/PRGFs (regardless of whether these will reduce poverty). Delays in executing such conditions have delayed PRGFs in at least eleven countries; and third, the proliferation of new poverty reduction performance criteria, especially for those countries which reached decision points before the fourth quarter of 2001 when the BWI staff began to reverse such proliferation. As the latest BWI Board paper indicates, such conditions may become problems for progress in future.

There has been some recent progress to reduce conditionality: (i) recent PRGFs have streamlined conditionality, limiting conditions more to macro issues – but with some structural conditions moving from IMF to World Bank programmes; (ii) an agreement in March 2002 that the period of execution of a full PRSP could be less than one year if this will cause major problems for funding; (iii) very limited evidence of more flexibility on the macro framework for those countries with inflation below 5 percent, with more stress being placed on growth and anti-poverty spending than on further reducing inflation and deficits; and (iv) a recent IMF paper (2003b) has indicated that for countries which are "post-stabilisation", the Fund could reduce its lending role, and move to a system of surveillance in which more flexibility in the macro framework would be allowed.

However, it is easy to exaggerate the change of conditions. Ministers and senior officials of 34 HIPCs indicate that most of them have seen little sign of flexibility either in letting them design their own alternative macroeconomic frameworks or in interpreting their compliance with conditions.

The following measures are essential to ensure that conditionality promotes rather than impedes the attainment of the MDGs:

- Continued progress to streamline the number of conditionalities across the programmes of all multilateral and bilateral organisations;
- Elimination of all structural conditions which have not been analysed to be essential to growth and poverty reduction, and especially of all micro-management of their economies.
- Poverty and Social Impact Analysis of macroeconomic frameworks in all PRGF programmes;
- More flexible macroeconomic frameworks in all PRGFs for post-stabilisation countries;
- Explicit presentation in all PRGF documents of alternative macroeconomic scenarios which show the growth and inflation trade-offs examined.
- Flexibility in interpreting compliance with poverty reduction criteria for countries which suffered from excessive proliferation in 1999-2001.
- Rapid definition of more precise circumstances under which the IMF would reduce its lending role and move to surveillance for "post-stabilisation" nations.
- Comprehensive programmes to build the capacity of governments and civil societies in African countries to design and analyse the potential and actual impact of macroeconomic and structural policies on poverty reduction.
- A comprehensive annual review of PRSPs, PRGFs and PRSCs, to ensure they are streamlining conditionality and promoting poverty reduction.

The delay in completion points is of growing concern because it can result in the cancellation or expiry of debt relief. Three countries have already reached their limits for IDA interim relief, three have had IMF interim relief suspended due to falling off-track with their Fund programmes, and five countries had run out of interim relief from the African Development Bank by the end of 2003. The Paris Club has also been threatening to suspend relief for countries which are off-track with Fund programmes. Suspension of relief – combined with suspension of aid – is disastrous for any country, providing an immediate "shock" to the economy, and should be assiduously avoided except in extreme circumstances. The IMF, IDA, the other multilateral development banks and the Paris Club need urgently to design rules for extending interim relief (providing the same percentage of debt service reduction as in previous years) in all circumstances except complete rupture of relations with a country.

Countries coming from conflict situations or governance problems that have excluded them from international support, earlier encountered lengthy delays in entering the HIPC Initiative (see, Serieux, 2002). Though recent measures have accelerated their initial integration into HIPC, they need much stronger early interventions for conflict prevention and resolution (which HIPC and the BWIs are not best placed to handle), and flexibility in the macro framework to allow more rapid post-war reconstruction and supply response (which is the responsibility of the BWIs), if they are to progress in the HIPC framework. The fragility of peace and reconciliation in most of these countries (as well as conflict-affected neighbours) requires us to deliver HIPC relief very rapidly, with heavy frontloading to reduce debt service ratios immediately and free funds for reconstruction.

Debate 7: Debt Relief Is/Is Not Preferable to Other Financing

Advocates of debt relief have stated that debt relief is morally and economically preferable, but others have suggested that it is no better than other forms of development finance.

Detailed analysis has concluded that debt relief is more desirable because:[6]

- Debt relief has greater political resonance in OECD countries than new aid.
- Debt relief is much more stable, predictable and counter-cyclical than other sources of financing, unless it is tied too tightly to IMF programmes.
- Under the new PRSP framework, debt relief could be less conditional than other finance and therefore increase developing country ownership.
- Aid, NGO flows and debt relief are by far the cheapest flows, preferable to FDI, portfolio investment and hard-window official lending.

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6 This section summarises earlier analysis in Martin (2002a). See also Birdsall and Williamson (2002) for similar views.

- Untied debt relief and aid have much greater value for money in financing development than other flows.
- The transaction costs of debt relief are much lower than those of project aid, FDI or other project-specific financing.
- HIPC debt relief absorbs more payment capacity, exchange rate and intest rate risk than all flows except grants.
- HIPC debt relief aims to reduce poverty directly, whereas much non-HIPC debt relief, aid and private flows do not target poverty reduction.
- HIPC debt relief has had a positive effect on private capital flows,[7] aid flows and domestic private savings and investment, whereas the evidence on positive linkages among other flows, and domestic investment, is much weaker.[8]
- Debt relief, increases in anti-poverty spending and improved fiscal management have encouraged donors to provide more aid – and in more flexible forms such as multiyear coordinated budget support.

For all the above reasons, debt relief is the preferable form of external financing.[9] A dollar of debt relief is much more valuable – especially if frontloaded – because it is more stable and predictable, counter-cyclical, has no cost, is high value for money, and (if PRSPs meet their promises) promotes ownership and poverty reduction.

However, these arguments should not be pushed too far:

- If HIPC stalls, it can suspend fast-disbursing programme aid and debt relief which is linked rigidly to its progress. The growing alignment of donors behind Fund conditionality makes flows highly vulnerable to suspension of Fund assistance. As long as Fund conditionality remains too stringent, this is unacceptable. To avoid this, donors need to keep their programme aid dis-

7 See Government of Tanzania (2001); Government of Uganda (2002).

8 See Elbadawi and Gelb (2002) on aid.

9 Most HIPCs would rather rely on domestic financing. But in many countries the current scale and potential for domestic financing is limited, and domestic debt is much more expensive than external financing. HIPC ministers have therefore stressed the need to provide free access to developed country markets, increase the value added of their exports, and procure aid-financed goods from other HIPCs. They have also suggested that much can be done at the micro level to provide external capital in ways which complement domestic savings. For more on domestic financing, see AERC (1998 and 2001); and Martin (1999b) and Johnson (2000).

bursement decisions independent of HIPC/PRGF processes and retain the flexibility to support recipient country policies and have a policy dialogue based on overall progress towards the MDGs, maximising recipient choice of how to fund poverty reduction.

- The amount of debt relief (and additional and higher-quality new finance) is not related to MDG or anti-poverty performance by individual developing countries, or to the levels of poverty or finance required to halve them. It continues to depend on the composition of each country's donor group and historical/strategic relations between donors and the country. For example, Mozambique receives 75 percent of its aid as grants and 35 percent as programme aid, but Mali receives only 35 percent as grants and 15 percent as programme aid, when both are regarded as high performers in terms of poverty reduction policy.
- Countries which had made huge efforts to mobilise additional funds before HIPC (e.g. Rwanda) or which had large amounts of arrears which they are now having to repay (e.g. DRC) have lost money since HIPC arrived.
- In addition, even if Monterrey promises produce large increases in aid, increased flows to HIPCs mean a diversion from non-HIPCs, and the majority of poor people live in non-HIPCs (though, as already discussed, many of them could also benefit from debt relief).
- Potential debt relief, equivalent to fine a 100 percent cancellation of debt, exceeds aid flows in only ten HIPCs, and averages only 10 percent of exports. So potential gains from each percentage increase in aid and especially trade are much greater than those from additional debt relief.
- In the current international political climate, given that international civil society pressure for debt relief has waned, there is more consensus behind increasing aid flows to countries which are performing best in poverty reduction – some of which may not be the most indebted – than there is behind more debt relief.

In addition, aid donors and providers of private capital flows could also do a great deal more to improve the quality and value for money of their funding for development. Developing country governments and private sectors could also do more to monitor, negotiate and coordinate such flows, and all sides could do more to generate domestic savings and tax revenues (Martin, 2002a; Martin and Rose-Innes, 2003; Martin, Johnson and Aguilar, 2003). These measures would have much greater effects on the quality of sustainable development funding.

Extra debt relief could be funded from many sources, including part of the Monterrey pledges and the proposed International Financing Facility; gold reinvestment or sales, or issuance and reallocations of SDRs by the IMF – which remains the only "off-budget" source of funds available for development, and could easily be transferred to fund debt relief by other creditors; and limited multilateral development bank reserves, capital and provisions.

Summarising, debt relief is in principle the best way to fund poverty reduction in developing countries – but HIPC relief needs to be complemented by relief for other countries and by large amounts of new official and private financing, and measures to enhance trade access (especially for exports with higher added value), and to promote domestic savings and investment, in order to attain the MDGs. In addition, unless HIPC is reformed in the ways suggested in this chapter, especially with regard to PRGF conditionality, HIPC governments would prefer programme aid which is managed more flexibly and not so tightly linked to PRGFs.

2 What Could HIPC Achieve ?

Advocates and critics of the HIPC Initiative are both correct. HIPC has made major progress in advocating debt sustainability, broadening burden-sharing among creditors, mobilising additional funding for development, and changing the focus of Bretton Woods conditionality towards poverty reduction. However, it remains inadequate to fulfil its own aims, let alone the wider goal of financing poverty reduction to reach the Millennium Development Goals. If the international community is serious about the MDGs, HIPC needs to achieve much more, by improving its own design, and by being complemented by wider measures to guarantee long-term debt sustainability.

Improving HIPC

HIPC could aim to provide genuine *debt sustainability* at completion point by: (i) abandoning the concept of present value and returning to using debt stock and debt service as the measures of debt burden;

(ii) if PV is retained, ensuring that it really measures the time cost of debt service for developing countries by linking it to their earnings on reserves, and reducing the PV/budget revenue threshold to 150 percent; (iii) analysing government domestic and total (external and domestic) debt burdens and reducing them where necessary using non-HIPC resources; (iv) monitoring and analyzing private sector debt, and assisting the private sector to obtain less expensive and more stable financing, to ensure that private debts do not become government liabilities; (v) continuing to include all (explicitly or implicitly) government guaranteed debt in debt sustainability analysis; (vi) focusing sustainability on attaining a debt service/budget revenue ratio below 10 percent from the decision point, and on maximising freeing of funds for poverty reduction in the early years of relief.

HIPC could *maximise burden-sharing* by all creditors, by (i) encouraging multilateral institutions to fund more of their HIPC relief from their own resources, and to move to total cancellation of multilateral debt; (ii) widening the use of the IDA commercial debt reduction facility to cover non-OECD commercial creditors, and creating a Trust Fund to relieve HIPC debts to creditors which have themselves received debt cancellation; (iii) combating lawsuits against HIPCs by putting them at the centre of discussions on international debt "standstill" procedures, ensuring that international arbitration fora and debtor and creditor jurisdictions forestall such suits, and providing rapid response legal technical assistance to debtors where necessary; and (iv) counting 100 percent debt cancellations by some Paris Club creditors as fully additional, and ensuring that all such cancellations are genuinely freeing debtor resources, thereby forcing all creditors to share the burden of HIPC.

HIPC could *accelerate the delivery of relief* and avoid its suspension, by streamlining conditionality far more dramatically, across the programmes of all multilateral and bilateral aid organisations; eliminating all structural and micro-conditions which are not demonstrated to be essential to having a major impact on growth and poverty reduction; interpreting compliance with conditions based on overall efforts and outcomes, rather than implementation of individual criteria; designing more flexible growth-oriented macroeconomic frameworks in all PRGFs, which present alternative macroeconomic scenarios and growth-inflation tradeoffs; comprehensive Poverty and Social Impact Analysis (PSIA) of all con-

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ditionalities, especially the macroeconomic framework of PRGFs, conducted by countries with independent third-party assistance; defining rapidly the precise circumstances in which the IMF will reduce its lending role and move to surveillance for "post-stabilisation" nations; establishing comprehensive programmes to build the capacity of low-income country governments and civil societies to design and analyse the potential and actual impact of macroeconomic and structural policies on poverty reduction; a comprehensive annual review of PRSPs, PRGFs and PRSCs, to ensure they are promoting poverty reduction in the above ways; avoiding relief suspension except in cases of complete breakdown of discussions with the international community; and, accelerating debt relief measures for conflict-affected countries to free funds for reconstruction and reconciliation.

Complementary Measures

Given debt relief's superiority in principle as a form of development financing, HIPC-style relief could be expanded beyond HIPCs by first, immediately (and annually) analysing the debt sustainability of all IDA-only moderately- or severely-indebted countries so as to judge whether debt relief should part-fund their progress towards the MDGs; and second, implementing the Paris Club's new Evian terms and ensuring that debt relief measures for other (e.g. middle-income) countries also maximise liquidity relief in order to fund the MDGs.

However, debt relief cannot be large, additional or well-distributed enough to finance the MDGs in all developing countries. Many measures to increase (and improve the quality of) net official and private flows are therefore vital (for long lists of these, see Elbadawi and Gelb, 2002; Martin, 2002a; Martin and Rose-Innes, 2003; Martin, Johnson and Aguilar, 2003). PRSPs need also to focus much more on increasing the value-added of exports and their access to developed country markets, and on promoting domestic savings, investment and tax revenues, in order to reduce long-term aid dependency.

In particular, new external financing needs to avoid recreating an unsustainable debt burden. This can be done in two ways, first by ending irresponsible lending by creditors, who should avoid all non-concessional loans to the public sector in HIPCs, assure themselves that all finance provided is for priority PRSP projects to avoid funding white elephants, and improve the quality of all their financing to provide better "development value" for each dollar spent; and second, by improving debt management to end irresponsible borrowing in developing countries. The HIPC Capacity-Building Programme, run by Debt Relief International and its partner institutions (BEAC/BCEAO Pôle-Dette, CEMLA, MEFMI and WAIFEM) will be building capacity in 34 HIPCs on all external financing in the next two years, encouraging them to assess the progress of each major creditor or donor, in providing sustainable finance for poverty reduction. A similar programme, the Foreign Private Capital Capacity-Building Programme, will be assisting 14 countries to monitor and analyse private capital flows.

A key first step to mobilising all types of financing is to analyse in all PRSPs the financing and growth needed to attain the MDGs, and the potential sources of the financing. Though there are important data and methodological constraints to these calculations, many of the costs of the MDGs are quantifiable and growth/poverty reduction elasticities are calculable. There is no excuse for not even trying to quantify MDG financing needs in PRSPs. The IMF must thereafter ensure that all its PRGF scenarios project the attainment of the MDGs, rather than abandoning them due to anticipated lack of financing.

Thereafter, the single largest factor keeping countries on course to the MDGs (apart from their own economic policy and political stability) will be protecting them against "external shocks". More flexible debt relief could help by reassessing sustainability annually and augmenting relief if necessary to reduce PV burdens. However, genuine protection requires more comprehensive mechanisms, including: making projections in HIPC and PRGF programmes more realistic, by including all 'likely shocks' (HIV/AIDs, regular natural disasters, commodity price volatility and aid shortfalls) in their baseline scenarios; focusing in PRSPs on realistic measures to reduce vulnerability to shocks, e.g. commodity hedging, export diversification into higher value-added products, opening OECD markets for such products, and providing disaster insurance; Including contingency measures in PRSPs, by quantifying financing implications of possible shocks, and mobilising up-front pledges of contingency budget support which can be disbursed to offset shocks immediately; and, making aid more predictable and stable, via flexible multi-donor budget support.

Finally, to implement the above reforms, two sets of voices need to be heard more loudly in international discussions: it is vital that HIPCs and low-income countries are better represented in international fora, in order to assert their own views on the HIPC Initiative and their wider needs for financing poverty reduction. Most existing international groupings do not provide them with sufficient representation for this purpose, because they are dominated by larger developing countries or creditors. This is why HIPCs have pursued a dialogue with the heads of the Bretton Woods institutions and G-7 governments by creating their own Ministerial Network. Furthermore, HIPC II was created by the energy and commitment of international civil society campaigners (especially Jubilee, 2000), together with open-minded leadership by some policymakers in G-7 and HIPC governments and international financial institutions, and the technical expertise of some of their officials. OECD governments must maintain the funding of international civil society advocates, especially those from HIPCs themselves, and expand it into building civil society capacity on macroeconomic policy issues.

The international financial community faces an unique opportunity to achieve massive poverty reduction in the poorest countries. The HIPC Initiative and Poverty Reduction Strategies have played a large part in inspiring the international community to believe that all poor countries which are committed to reducing poverty can reach the Millennium Development Goals. Results can match these expectations only if we ensure HIPC reaches its full potential.

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3

HIPC Debt Relief and Poverty Reduction Strategies: Uganda's Experience

Florence N. Kuteesa and Rosetti Nabbumba

In this chapter, we highlight the main issues relating to Uganda's experience in debt stock management and debt relief, explore the benefits of the HIPC Initiative, and conclude by looking at the relationship between the HIPC resources, debt sustainability and poverty reduction. The additional resources from the HIPC Initiative have been instrumental in reducing poverty but have not resulted in debt sustainability as expected.

1 Debt Relief Before and After HIPC

Uganda's debt burden in nominal terms rose from $172 million in 1970 to $3.6 billion in 1998, the year in which it first received debt relief under the HIPC Initiative. The country's external debt had increased over the decades because of arrears accumulation as a result of successive governments defaulting on debt obligations, deteriorating terms of trade, expansionary fiscal policies and heavy borrowing for economic recovery and stabilisation programmes.

Historically, the country had been contracting medium to long-term loans, short-term credits having ceased in the 1970s. The proportion of concessional debt to total debt rose steadily in the 1980s and 1990s, exceeding 70 percent by the mid-1990s in line with the country's borrowing guidelines.

From: HIPC Debt Relief - Myths and Reality
FONDAD, February 2004, www.fondad.org

Table 1 Uganda's Debt Relief Experiences

	Year
Paris Club	
• Toronto terms	1989
• London terms	1992
• Naples terms	1995
• Lyon terms (HIPC I)	1998
• Cologne terms (HIPC II)	1999
Commercial Debt Buyback	1992
Multilateral Debt Fund (Uganda)	1992-95
HIPC	1998
Enhanced HIPC	2000

Debt relief is not a new phenomenon in the case of Uganda. The country has benefited from debt relief reschedulings from the international community since the mid-1980s. However, apart from an IDA-funded commercial debt buyback in 1992, until the late 1990s only bilateral Paris Club creditors were willing to offer debt relief. Unfortunately, their relief only had a limited impact on Uganda's overall debt position, mainly because by 1994, 70 percent of Uganda's debt was owed to multilateral creditors. A number of bilateral donors therefore set up a Multilateral Debt Fund, into which they paid funds in order to help Uganda repay its debt obligations to multilateral creditors. This initiative was a precursor to the HIPC Initiative which engaged the multilateral lending institutions in direct negotiations on debt relief for the first time.

Uganda's experience with the HIPC Initiative has been broadly positive. Uganda was the first country to qualify for debt relief under both the first HIPC and the Enhanced HIPC Initiative in April 1998 and April 2000, respectively. The speed with which Uganda qualified, without having to go through a standard six-year qualifying period, was a reflection of the country's exemplary record of macroeconomic reform and a proven commitment to poverty reduction. In total, as a result of both initiatives, Uganda was granted debt relief amounting to \$1 billion[1] in NPV terms to be delivered over a period of twenty years. As a consequence, Uganda has

[1] This figure assumed full delivery of HIPC debt relief by all creditors, including those bilateral creditors who had refused the commercial debt buy-back in 1992 and non-OECD bilateral creditors who were not members of the Bretton Woods institutions.

received substantial cash savings, averaging $60 million per annum over the past 4 years, accounting for almost a quarter of the total budget support over the period. This figure has risen now to approximately $90 million per annum in debt relief and is set to rise further in the medium term.

2 Poverty Reduction

Prior to the HIPC Initiative, Uganda had adopted a national strategy for poverty eradication, the Poverty Eradication Action Plan (PEAP), which guides policy formulation and public spending over the medium term. As a way of protecting funds going specifically to poverty eradication programmes from budgetary cuts, the government formed the Poverty Action Fund (PAF) as an integral part of the government's budget. The PAF is a virtual fund within the budget that is funded by HIPC savings, "earmarked" donor funds, and government revenues. The trends in HIPC savings and PAF expenditures are shown in Figure 1, while the increase in budgets for PAF expenditure areas are shown in Figure 2.

Figure 1 HIPC Savings and Poverty Expenditures
(in millions of dollars and percentage of total budget)

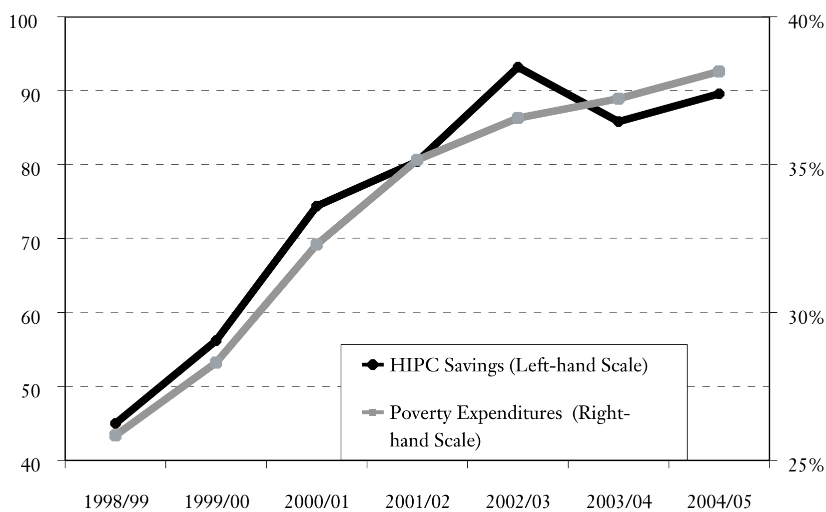
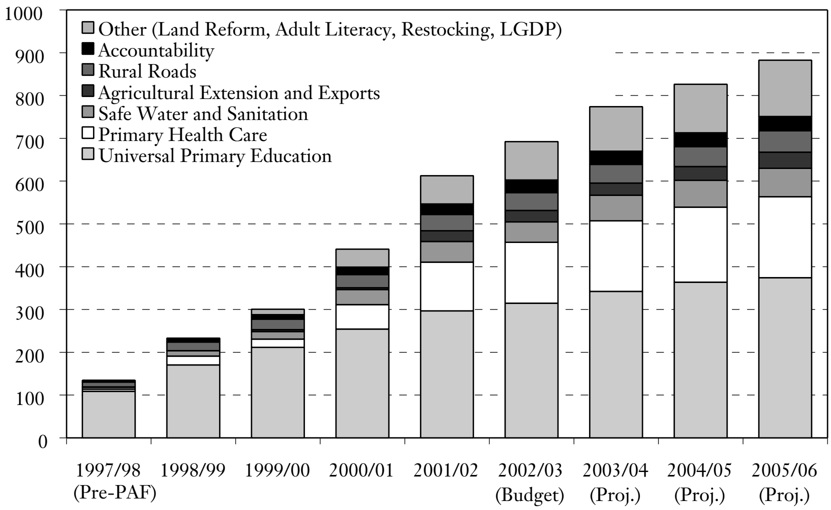


Figure 2 Expenditures on Poverty Reduction Areas
(in billions of Ugandian shillings)



The resources saved from HIPC debt relief that were purposively channeled to the PAF allowed Uganda to increase the budget for the most critical areas such as primary education, primary health care, rural roads, safe water and sanitation, and agriculture.

Over the past four years, annual expenditures on education increased by 9 percent. Yearly growth for health expenditures was 20 percent. There have also been substantial increases in spending on water, rural roads, gender, HIV/AIDS, justice, law and order, and on environmental spending. Throughout the 1990s, social service delivery improved significantly and poverty declined noticeably, as a result of increased budgets for poverty reduction, as shown in Table 2. These achievements are in line with the fulfilment of the Millennium Development Goals (MDGs) since there is a substantial overlap between the Poverty Eradication Action Plan and MDG targets:

- *Education*: Uganda's Universal Primary Education policy, initiated in 1997, has led to an upsurge in gross primary enrolment from 2.6 million to 7.3 million pupils in 2002. The gender gap at the primary level has been closed. However, pupil retention, the quality of education and increased access to post-primary schooling still needs to be improved.

Table 2 Development Indicators, Uganda, 1991–2000

Indicator	1991	1995	2000	Target	Year
Poverty and Inequality					
Poverty Level (%)	56	44	35	10	2017
Gini Coefficient (inequality)	0.364	0.366	0.384		
Demographic indicators					
Total Population (millions)	16.7	19.3	22.2		
Population Growth Rate (%)	2.5		2.9		
Macroeconomic Indicators					
GDP ($ billion)		5.5	6.2		
GDP per capita ($)		285	280		
Government Expenditure (% GDP)		17.2	21		
Government Revenue (% of GDP)		11.1	11.3		
Budget Deficit (% GDP, excl. grants)		6.4	11.5		
Education and Literacy					
Gross Primary Enrolment (millions)	2.3	2.6	6.8		
Net Primary Enrolment (%)		84	77	100	2003
Ratio of girls enrolment to boys (%)		95	99		
Pupil-Teacher Ratio			65:1	49:1	2005
Adult Literacy Rate (%)	54	62	68	85	2005
Health and Nutrition					
Infant Mortality (per 1,000 live births)	122	81	88.4	68	2005
Children Underweight (weight-for-age)		25.5	22.5		
Immunisation (DPT3) (%)		61	48	60	2005
Malaria (proportional morbidity) (%)		25	37		
HIV/AIDS Prevalence (%)		14	6.1	5	2005
Fertility Rate (children per woman)		6.9	6.9		
Water and Sanitation					
Rural access to safe drinking water (%)		39	53	65	2005
Urban access to safe drinking water(%)			62	80	2005
Households with latrine or toilet (%)		79.9	82.3		

Sources: Uganda, Ministry of Health, *Uganda Demographic and Health Survey*, 1995, 2000-2001; Ministry of Finance, *Uganda PRSP*, March 2002; Ministry of Water, Lands and Environment, *Uganda Poverty Status Reports*, 2001, 2003; Appleton,S., L. Song, "Income and Human Development at the Household Level", 1999; IMF and World Bank, "PRSP – Progress in Implementation", IMF, 2002.

- *HIV/AIDS*: prevalence rates have fallen considerably from 14 percent in the mid-1990s to 6.5 percent during 2001-2002.
- *Roads*: the share of the rural road network being maintained regularly has increased from 20 percent in 1997-98 to 60 percent in 2000.
- *Water and Sanitation*: access to water has improved nationally from 40 percent in 1997 to 52 percent in 2001. Sanitation, however, remains a problematic area.
- *Health*: improving the health status of the Ugandan populations remains a major challenge. There is still too little progress in reducing infant, child and maternal mortality rates and increasing immunisation rates.
- *Poverty*: incidence fell dramatically from 56 percent in 1992 to 35 percent in 2000, but has since risen again to 38 percent in 2002. As seen above, the Poverty Action Fund significantly improved social service delivery and its impact. However, less investment has gone to the productive sectors, particularly agriculture, where the majority of the poor derive their livelihood and hence the observed rise in poverty. Inequalities between socio-economic groups and regions also persist.

The Medium-Term Expenditure Framework and the newly created Long-Term Expenditure Framework are being re-oriented to address these new challenges so as to enhance the poverty focus of public spending. The government is committed to increase the share of the budget spent on PAF, which has risen from 18 percent in 1997-98 to 35 percent in 2001-02, and protect PAF expenditures from within-year budget cuts arising from the cash-management system.

3 HIPC and Debt Sustainability

The combined debt relief given to Uganda under HIPC I and II was supposed to enable Uganda to remain on a sustainable debt path for the foreseeable future, as measured by a continuing NPV debt-to-exports ratio of below 150 percent, thus delivering total exit from debt rescheduling. However, results of two debt sustainability analyses (DSA) conducted in 2002 showed a rise in Uganda's debt-to-exports ratio over the 18 months since the Enhanced HIPC completion point to almost 200 percent. Calculations made by the

Ministry of Finance, Planning and Economic Development at the end of 2003 suggest that this ratio has since risen further, to 307 percent as at end of June 2003. This ratio is fifty percentage points higher than Uganda's NPV debt-to-exports level prior to accessing HIPC I.

It should be noted from the outset that the rapid rise in the unsustainability levels of the debt is not a result of poor macroeconomic management: inflation remains at an average level of 5 percent, the government is currently pursuing a fiscal strategy of deficit reduction to enhance private sector development and emphasis is being placed on efficiency rather than volume of public spending. Rather, there are four main reasons explaining the rise in Uganda's debt-to-exports ratio.

First, the terms of trade deteriorated for Uganda's major exports, due to the fall in global commodity prices. For example, at the Enhanced HIPC decision point, the three-year average value of Uganda's export earnings for the year ending 2002-03 was projected at $1,007 million but the actual value turned out to be $726 million, reflecting a fall of 28 percent.

Second, at the Enhanced HIPC decision point, estimates for new financing in the macroeconomic framework and balance of payments were not fully incorporated in the Debt Sustainability Analysis. Uganda has borrowed $1 billion since reaching HIPC completion point, and although these new borrowings, which were primarily from the multilateral development institutions, have been on highly concessional terms,[2] they have led the nominal debt stock to increase from $3.2 billion at the time of Enhanced HIPC to $4.2 billion as at end of June 2003.

Third, not all creditors have been willing to deliver debt relief under the HIPC Initiative, as had been assumed. In particular, commercial creditors who refused the 1992 debt buyback and non-OECD bilateral creditors have been unwilling to extend relief, leading to arrears accumulation, which has contributed to the rise in the debt stock. As at end June 2003, arrears amounted to 7 percent of the total debt stock.

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[2] Uganda's National Debt Strategy stipulates that all new borrowings must have a minimum grant element of 78 percent, and/or have equivalent concessionality to IDA lending.

Fourth, low global interest rates have increased the present value of Uganda's debt and reduced the concessionality of IDA lending terms. Given prevailing market interest rates, IDA lending is only 55 percent concessional, a decline of almost twenty percentage points since HIPC completion.

Other unforeseen challenges relate to the fact that not all creditors have been willing to participate in equal burden-sharing and some have outright rejected participation in the HIPC initiative. A number of creditors have taken Uganda to court, suing it for the payment of their debts in full, plus compensation. To date, four cases have been successful, although one is currently on appeal, and Uganda has been forced to pay over $20 million in recompense so far. This amounts to almost a quarter of this year's HIPC relief savings.

Uganda has adopted a three-pronged strategy for maintaining debt sustainability in the future: ensuring all new borrowings continue to be highly concessional; reducing the country's fiscal deficit in the medium term; and implementing of growth-enhancing policy reforms that expand and diversify export production, thus minimising shocks to the economy.

However, the international community needs to do more in helping Uganda achieve and maintain debt sustainability in the future. First, Uganda has been unduly penalised by virtue of the fact that it was the first country to access the HIPC debt relief initiative. Errors made in the calculation of HIPC debt relief to Uganda have been corrected for subsequent countries. Moreover, subsequent countries accessing the Initiative have had their exports valued at the prevailing lower global commodity prices, which means they have been given relatively more relief to enable them to arrive at the same PV debt-to-exports ratio. There is therefore a strong case for additional relief to be extended to Uganda to rectify these inequalities and to help improve its debt sustainability indicators. Second, Uganda has not received all the relief it expected, as a result of the non-participation of a number of creditors. Further international debt relief would also help to ease the financial impact on Uganda of this unforeseen non-participation. Third, the international community can help reduce Uganda's future debt burden by giving more aid in the form of grants, rather than loans, thus reducing Uganda's future borrowings from multilateral development institutions.

4 Challenges for the Future

Key challenges to be addressed now and in the medium term are: the unsustainability of Uganda's current debt despite the HIPC Initiative; the slow implementation of pay reform; the tensions between fiscal decentralisation and capacity at local government level; the fiduciary issues associated with budget support; and the need to reduce Uganda's fiscal deficit.

Macroeconomic policies can contribute directly to poverty reduction by delivering stability and growth. However, in the short run there is a trade-off between strong growth in budget expenditure funded by donor aid, on the one hand, and macroeconomic stability, on the other. This is because large donor-funded expenditures have a macroeconomic impact, which needs to be 'neutralised' by a stronger exchange rate or higher interest rates to enable inflation to remain under control. A stronger exchange rate hurts export production, while high interest rates discourage private sector investment. This trade-off can be partially avoided by integrating donor projects into the budget so as to allow sectors to shift from project to budget support, thus reducing inefficient project spending funded by donor loans and grants, and increasing the efficiency of budget allocations and expenditures. A lower fiscal deficit should also enable Uganda to slowly bring its debt back to sustainable levels. Conversely, the macroeconomic impacts of aid-financed budget expenditures can also be mitigated if more aid is given as debt relief, rather than in the form of new concessional loans.

4

Lessons from Eastern and Southern Africa

Mothae Maruping

The initial reactions to the advent of the HIPC Initiative in 1996 was that it was a comprehensive and concerted programme that marked a total break with past piece-meal external debt relief. However, it soon became apparent that the Initiative's delivery of debt relief would not only be fairly slow and inflexible, but also that its impact on debt and poverty would be less than expected. Public pressure prompted IMF and World Bank-led reviews of the Initiative, which culminated in the significant enhancements at the turn of the millennium.

Notwithstanding the improvements in the Enhanced HIPC Initiative, it has not been able to speedily and fully achieve its objective of restoring external debt sustainability among the world's 42 HIPCs, of which 34 are African. The persistence of external debt problems in the first countries that reached the HIPC completion point clearly demonstrates that "we aren't out of the woods yet". This begs the question of how to further enhance the speed and depth of debt relief, to ensure a lasting impact on debt sustainability.

It is against this background and the concerns about the effectiveness of HIPC relief raised at various high-level *fora* that this chapter is revisiting the Initiative. The aim is to provoke additional thinking on which further improvements could be brought to bear on the Initiative to reinforce it into a re-enhanced HIPC Initiative.

Also, in recognition of the widely held view that the Enhanced HIPC Initiative will not be a panacea for attaining either long-term

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external debt sustainability or the Millennium Development Goals (MDGs),[1] I will discuss other national and international options for addressing long-term post-HIPC debt sustainability and, more broadly, the financing of development. In this regard, HIPC resources should be seen for what they are: they are one source of financial resources in addition to several others that must be explored.

1 The HIPC Initiative and Other Debt Initiatives in Africa

Debt Relief Measures Up to the HIPC Initiative

Since its inception, the Paris Club, as an informal grouping of mainly OECD countries chaired by the French Treasury, has attempted to address external debt problems by offering successively improved debt reorganisation terms, including among others: standard terms; Houston (1990); Toronto (1988); London (1991); Naples (1994); Lyon (1996); and Cologne (1999) terms or accords.

Historically, Paris Club arrangements have suffered mainly from lack of legal enforceability of its equitable burden-sharing principle outside the Club's membership. In spite of the Club's insistence on non-payment of debt service to non-compliant non-Club creditors, a number of non-OECD countries and some commercial creditors declined to be bound by the Club's principles. In some cases, the creditors have opted for litigation, much to the detriment of the debtor countries concerned.

Another historical setback to adequate Paris Club debt relief has been the limited eligibility of external debts for restructuring. The fixing of Paris Club debts' cutoff dates, excluding new debts from the restructuring process, blocked a more pragmatically addressing of more recently acquired but often equally heavy bilateral debt burdens. The Paris Club contends that maintaining fixed cutoff dates would avoid deterring creditors from advancing critical new lending to the HIPCs.

Prior to the HIPC Initiative, multilateral creditors, though not

[1] The MDGs seek to address extreme poverty eradication; universal primary education; gender inequality; child mortality, maternal health; HIV/AIDS; environmental sustainability and global partnership for development by 2015.

directly writing off their claims, also participated in ameliorating external debt problems in other ways, on a case-by-case basis. This has included the IDA's Debt Reduction and Debt Service Facility (often also co-funded by some bilateral donors) that has provided grants to repurchase some handsomely discounted external bilateral and commercial debts. New concessional financing has been another multilateral instrument.

Debt restructuring under the London Club, which successfully dealt with mostly Latin American commercial debts, has not significantly benefited African countries. The core external debt problems of the latter have been in the official category. Similar to the Paris Club, the London Club is also informal. Its composition and chair varies by debtor country, depending on the degree of exposure. On a case-by-case basis, the bank with the highest exposure would normally chair the restructuring process, which only reschedules principal. It also provides a variety of refinancing bonds, alongside market-based instruments, such as debt conversions and buy-backs, which would seek to meet the burden-sharing clause of the Paris Club.

Current Debt Relief Measures: The Enhanced HIPC Initiative

The Paris Club's Naples, Lyon and Cologne terms have been included in the overall framework of the HIPC Initiative. By targeting lower and sustainable thresholds of external debt ratios through concerted efforts from all creditors, the Enhanced HIPC Initiative has attempted to address the issue of inclusiveness that has bedeviled the Paris Club. It has sought to be more comprehensive and concerted in providing sustainability-linked levels of external debt relief from all creditors concerned, on an equitable burden-sharing basis. The question is: has this been adequate? Was the *modus operandi* adopted sufficient?

Assessment of HIPC

The objectives of the Enhanced HIPC Initiative were to achieve deeper, wider and faster debt relief; to promote economic growth and to ensure release of financial resources for increased social spending aimed at reducing poverty.

After completion point, HIPCs' debt levels remains precarious.

In other words, post-completion point is not yet synonymous with post-HIPC status, because debt relief has been too superficial.

There has been high-level recognition of the potential positive contributions of the Enhanced HIPC Initiative in Africa in as far as it helps reduce external debt burdens and unlocks aid for development.[2] It has increased the attention being paid to poverty reduction resources, their spending and monitoring, and linkages to debt, macroeconomic and social policies, including good governance and improved aid accountability.

There has been high-level concern, however, with the limited consultation of HIPCs in the design of the Initiative. In spite of the fact that external and domestic debt both constrain poverty reduction expenditure, domestic public debt has been left out of the core-HIPC Debt Sustainability Analysis (DSA), partly as a result of this limited consultation. This has constrained the Initiative to only a partial solution to the debt problem. In addition, delivery of debt relief has also been rather slow, while the risk of failed objectives and targets has remained high.

The Initiative also has a heavy baggage of rigid conditionalities that have become serious hurdles towards accessing relief for HIPCs. The overall effect has been that high expectations have been raised, but have not been matched by real and timely action, as well as attainment of effective results on the ground. This could jeopardise the credibility of the Initiative.

The above-mentioned concerns, however, need not detract attention from the significant improvements in the Enhanced HIPC Initiative. Noteworthy among these are the enhanced prospects for broader participation brought about by the lowering of thresholds of eligibility indicators, front-loading of interim debt relief; flexibility in the timeframe through use of floating completion points, and a greater link between debt relief and poverty reduction.

However, in spite of these steps forward, experience from Eastern and Southern Africa indicate that the HIPC process is still rather slow and remains inadequate in delivering sufficient and

[2] HIPC Finance Ministers' Perspectives expressed at Commonwealth HIPC Forum, February 20, 2000, Lilongwe, Malawi is one example. Further HIPC views have been expressed at other international *fora* such as the Commonwealth HIPC Review meetings held in London over the last few years, and the March 2002 international Conference on Financing for Development held in Monterrey, Mexico.

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urgently required debt relief. Added to that, non-compliance from some non-OECD creditors is a real problem for the HIPCs in the sub-region. Ideally, debt relief should be flowing from *all* creditors. This includes the difficult issue of inter-HIPC debt relief.

Experiences of Eastern and Southern African Countries

Initially six of the eleven member countries of the Macroeconomic and Financial Management Institute of Eastern and Southern Africa (MEFMI), have been identified as HIPCs.

After recent World Bank and IMF evaluations, it was established that Angola's and Kenya's external debt were sustainable through the application of traditional relief mechanisms like rescheduling. The four remaining MEFMI countries eligible for HIPC debt relief are Uganda, Tanzania, Malawi and Zambia. As of January 2004, only Uganda and Tanzania had reached HIPC completion point. However, they cannot be considered to have permanently exited into a long-term sustainable debt realm. They remain vulnerable to exogenous shocks, such as adverse weather and deteriorating terms of trade, given their undiversified narrow-based export sector.[3] Uganda has been particularly adversely affected by a significant deterioration in market prices of her key exports.

Completion points for the two other cases (Malawi and Zambia) are still pending, owing largely to governance considerations. However, both have been recently disaster-stricken from severe drought later followed by floods that threatens to reverse poverty reduction efforts. For Zambia, the prospects have been further dampened by the problems in the mining sector. Export shortfalls relative to initial projections for years 2000-01 were considerable for Zambia, much as for Uganda.[4]

The situation of these countries clearly signals a glaring need for a review of the HIPC Initiative. What is needed is a more urgent and realistic approach that would lead to accelerated debt relief

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[3] The percentage share in exports for three main products for the four MEFMI eligible HIPCs ranged from 63% for Uganda; 67% for Zambia; 40% for Tanzania; to as high as 75% for Malawi, as at 1999.

[4] In fact, the IMF (April 2002) indicated that 16 out of 24 HIPCs experienced lower than projected exports in 2000-2001, raising questions about the realism of projections.

alongside emergency aid and increased official development assistance (ODA). Further delays in obtaining the requisite external financing would only tend to worsen debt sustainability at completion point. Also, under current circumstances, pressure to resort to domestic public debt financing could quickly build up, thus further exacerbating the already strained overall fiscal sustainability.

Angola, which is just emerging from armed conflict, has been treated as ineligible for HIPC relief so far. This is because it is considered to be sustainable once traditional debt relief measures are fully implemented and, also, due to the favourable price of oil exports. The country's situation however warrants close monitoring, and a flexible application of HIPC eligibility indicators, macro-economic and social conditionality and external financing requirements for post-conflict reconstruction and poverty reduction.

As one would expect, resources from HIPC debt relief, while important for short to medium-term debt sustainability, will only constitute a small fraction of what the HIPCs actually need to cut poverty in half, consistent with the 2015 Millennium Development Goals. A poverty-reduction deficit seems imminent under the current approach.

It is of utmost importance that the HIPC Initiative be re-enhanced to, as far as possible, increase the amount and efficiency of HIPC resources that would be freed and channeled into poverty-reducing spending. The risk and costs of exogenous shocks need to be addressed, including the circumstances of countries in, emerging from or affected by armed conflict. Other extra-HIPC national and international development financing should be increased and used more efficiently.

Proposed HIPC Reinforcement Measures

As the foregoing review demonstrates, the international community is still in a learning process regarding how to provide debt relief that leads to debt sustainability and poverty reduction. While recognising the significant enhancements incorporated into HIPC II and accepting the fact that HIPC will not necessarily be a panacea for poverty eradication or development financing, the experiences with the Initiative to date suggest that there is ample room for further improvements. These could pave way for a re-enhanced HIPC Initiative. There are three areas that require further innovations: burden-sharing and funding, speed and formula of debt relief, and post-completion point debt sustainability.

Burden Sharing and Overall HIPC Funding

The HIPC Initiative is not legally binding or enforceable. HIPC burden-sharing could be improved by systematically addressing the negotiation problems of non-OECDs and inter-HIPC or, more broadly, inter-low-income country debt relief. To deepen debt relief, the Paris Club cutoff dates should be re-examined wherever warranted. Bilateral debt cancellations beyond the minimum HIPC requirements could also be intensified and widened to provide additional debt relief.

The same goes for ensuring adequate funding of the HIPC Initiative by all creditors. This could be achieved through concerted dialogue among creditors and through instituting legally binding arrangements. In this regard, international proposals for debt restructuring mechanisms need to be examined. These would bring about a more orderly legal process for debt restructuring.

A way of assisting HIPCs with legal expertise to discourage litigation should be devised. A soft facility should be created, or existing soft facilities could be extended and replenished, to be used by HIPCs in case they lose litigation. Meanwhile, the practice of publicising non-compliant creditors, as a deterrent against litigation, should be continued.

Speed and Formula for Debt Relief

Considering the human costs of delays in delivering debt relief, providing overall debt relief should be speeded up. Partly, this could be achieved through re-enhanced front-loading of future debt relief, in support of the attainment of the 2015 Millennium Development Goals, and the acceleration of assistance to post-conflict HIPCs. These measures should be synchronised with parallel higher development financing, which would take into account countries' absorptive capacities for maximum impact.

The formula for computing debt relief to be provided to the HIPCs has important implications for the actual quantum of debt relief each HIPC will ultimately obtain. In view of the unmitigated short and long-term risks of exogenous shocks on the HIPCs, the eligibility ratios, including related benchmarks and projections, need to be re-examined. Contingency provisions for additional funding in the event of significant impact from purely exogenous shocks should therefore be systematically built into the Initiative. The amount that would be set aside in this respect could be based on historical experiences, on a case-by-case basis.

In this regard, it is proposed to adjust the export data used to calculate PV debt-to-exports and debt service-to-exports ratios. Export earnings could be discounted with expenditures on essential imports (e.g. critical food and health related imports, capital goods and related supplies and raw materials, especially for the production of export products), minimum required foreign exchange reserves and offshore export earnings.

For pre-decision point countries, there is still an opportunity to use this suggested methodology when they do reach decision point, together with more realistic forecasts. For post-decision and post-completion point countries, this methodology can still be applied retroactively together with actual figures (outturn instead of forecasts). The results could then be used to determine minimum top-up debt relief for the period going back to the decision point. This would contribute towards making topping-up more objective and transparent. For current and future topping-up, this improved methodology using realistic forecasts and meticulous analysis of scenarios would suffice.

In broad terms, these proposals point to the need to increasingly focus on the external sector of the HIPCs for debt sustainability indicators. Experience shows that the dampening of the effects of the HIPC Initiative emanate from the external sector.

It would be of interest to see how else export revenue losses from exogenous shocks could be catered for. External factors that are to be addressed include effects of global economic slow-down, deteriorating terms of trade, protection and subsidies in developed industrial countries which tend to reduce external market access, costs of aid disbursement delays, etc.

Similar considerations could also be explored for the PV debt-to-revenue ratio. For instance, global economic slow-down, adverse terms of trade and protectionism all affect government budget revenues in different ways that constrain economic growth and trade. These in turn are key determinants of budget revenue performance. This is especially important in view of the usual heavy reliance by HIPCs and developing countries in general on indirect taxes, such as value-added tax or sales tax and external tariffs, for the bulk of their domestic budget revenues.

It is necessary to explore the possibility of shifting the HIPC objective from merely restoring external debt sustainability to achieving fiscal sustainability of total public debt. The latter would target the PV ratio of total public (domestic and external) debt in relation to appropriately adjusted domestic budget revenues. Domestic debt should be addressed, which does not necessarily implicate that it should be relieved from HIPC funds.

Finally, it is essential that debt sustainability leads to fiscal sustainability. Including both domestic and external debt in debt sustainability analyses would reflect the true picture of the burden on the fiscus. Countries are urged to adopt a risk-based sovereign balance sheet management approach. Mushrooming domestic debt is a matter of concern calling for full attention.

Long-Term Post-Completion Point Debt Sustainability

Several national, regional and international measures could be considered to assist in preventing HIPCs from slipping back into unsustainable levels of indebtedness, while ensuring that efforts to attain international development goals are not being compromised.

Sovereign debt has to be managed competently, efficiently and transparently, leading to a comprehensive, meticulous and preventive control of public debt. That would call for providing adequate funding to relevant regional organisations engaged in building sustainable debt management capacity and emphasising retention of well-trained staff. In this regard, consideration could be given to allocating part of HIPC debt relief for the strengthening of debt management capacity and closely related functions in the HIPCs. If this would 'crowd out' poverty reduction spending, then additional grant resources could be provided for capacity building in debt management in HIPCs and non-HIPCs as well.

Financing any gap above the annual sustainable financing levels should be restricted to grant financing, assuming that the decline in ODA would be arrested and reversed. Positive net resource flows should be at least maintained and preferably increased. Net new concessional debt accumulation should not exceed annual debt relief, in PV terms. The excess needs to be provided as grants, to avoid a net re-build-up of external debt over time, thus causing a relapse. Any exceptions to the rule would need to be justified and would need to take place only on a limited scale.

Creditors and borrowers jointly should seek ways of enforcing sustainability-linked external borrowing ceilings (for both amounts and terms) that would keep external debts within sustainable levels. In this way, they would stimulate a serious consideration of the costs, risks and returns for debt-financed activities, through monitoring and sharing of information on the uses of borrowed funds. Additional debt relief could be provided as a reward for channeling new debt into agreed social priorities and productive sectors, particularly in the export sector.

The aim would be to avoid post-HIPC debt re-building up beyond sustainable levels, thus causing a relapse into HIPC status. This, together with realistic sovereign credit ratings, would assist debtor countries to restore their international creditworthiness, thereby paving the way for accessing of capital markets and attracting foreign investment.

Although the HIPC Initiative will release only a small fraction of the required development financing, all avenues to increase the amount should be exhaustively explored. In particular, innovative measures need to be devised to enhance and accelerate the front-loading and topping-up of total debt relief, in a truly additional manner (e.g. a mix of debt moratoria and better-than-current HIPC debt cancellations). This is most pressing for countries that are experiencing pre and post-completion point shocks and for post-conflict HIPCs. These proposals may have higher cost implications for the HIPC Initiative. However, if this would solve this persisting debt problem, it would be worthwhile and pay-off to all down the line in the future.

2 Broader National and International Development

Over and above measures to re-enhance the HIPC Initiative, there are a number of public and private sector options that can be pursued at the national, regional and international levels by both developing countries and international development partners.

National

It is reasonable to anticipate that, beyond HIPC debt relief, the HIPCs themselves will have a more important role to play in ensuring long-term debt sustainability. Already, there are growing calls for them to make effective use of any new official and private development financing. Therefore, a comprehensive and integrated risk-based approach to the monitoring of capital flows and management of entire public assets and liabilities is critical.

In addition, HIPCs and, indeed, all other low-income developing countries, need to foster sustainable growth for the purpose of poverty reduction and overall development. They should maintain course on necessary structural and environmental reforms, focusing on the development and diversification of competitive export sectors to broaden the export base and to make them more resilient to shocks. At the same time, this economic growth should be participatory, pro-poor and environmentally friendly.

To ensure growing and more stable government revenues the tax base should be broadened and the tax collection be improved. Similarly, the quality of public expenditure needs to be improved, with a fair share for social pro-poor programmes.

Developing the financial sector is important to enable economic growth. Mobilising domestic savings will make them available as credit and equity financing for the public and private sector entities. Primary and secondary domestic financial markets should develop into deeper, more active and stable low-risk and low-cost sources of additional development financing. Governance and institutional capacity should be reformed to enhance the competence, efficiency and stability of the financial sector. Financial sector surveillance should be strengthened to reduce the frequency and impact of financial crises and the need for government bail-outs for financial sector players. Monitoring private capital flows enables well-timed policies to ward-off financial crisis.

To encourage small and medium enterprises and integrate the informal sector, targeted sectoral policies and financing are required, e.g. through the provision of micro-finance at lower costs and less stringent or government-assisted collateral and guarantees.

To attract higher and stable external finance and investment an enabling political, macroeconomic, institutional and regulatory environment should be created. Carefully calculated and cautiously approached capital account liberalisation should be pursued as part of the enabling environment. A development-friendly legal framework should be put in place. Elimination of corruption and bureaucratic excesses would need to be addressed decisively, by taking measures that meet domestic and international standards and expectations in the areas of efficiency, accountability, consistency, transparency and absorptive capacity.

Investing in infrastructure and human resources, including addressing health and education requirements is important, not only to achieve economic growth. In this regard, funding for combating HIV/AIDS and malaria is urgently needed.

Finally, capacity building is needed to encourage and consolidate ownership of macroeconomic and social policies, to achieve stronger economic growth and policies that are more effective.

Regional

In the last two decades, regionalisation attempts have almost stalled in Africa. Very little progress is being made in exploiting benefits of symbiosis and synergies. There is need to re-invigorate regional integration and harmonisation of socio-economic, political and legal systems and standards, in line with adopted regional principles, e.g. African Union's New Partnership for Africa's Development (NEPAD),[5] SADC, etc. This could help to achieve sound public and corporate governance and stimulate cross-border trade, finance, and payments systems.

International

The international community should improve opportunities for increased market access for HIPC exports through transparent and equitable trade liberalisation and trade negotiations that take the special needs of the less developed countries into account. Initiatives such as the USA's Africa Growth Opportunity Act (AGOA) and

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[5] NEPAD envisages attracting financing from capital flows (domestic resource mobilisation; debt relief, ODA reforms and private capital flows) and external market access for diversified exports (from mainly private sector-led growth and trade liberalisation) and global partnerships with industrialised countries and international financial institutions.

other direct export financing and guaranteeing facilities need to be expanded. These could be channeled through regional development banks. Trade will profit from mitigating international financial instability and cushioning its adverse effects.

The international community should ensure increased provision of predictable and appropriately concessional external financing for the attainment of the Millennium Development Goals, without contributing to debt unsustainability. In this regard, the UN target for ODA of 0.7 percent of the GNPs of developed countries needs to be followed up with concrete action in a truly additional way. The generous aid efforts of the Nordic countries and the Netherlands are worth emulating in this regard, while the recent announcements by some donors of their intention to increase aid resources are commendable and need to be followed up with concrete action. The international community should seriously consider arresting and reversing the declining trend of ODA in a financially and politically stable global environment.

Bilateral and multilateral donors should harmonise aid procedures and streamline conditionality, including untying aid and channeling aid through government budgets, especially in countries where accountability is guaranteed. They could promote more innovative financing arrangements, targeted particularly at boosting of export diversification, to mitigate the effects of financial volatility and shocks from changes in volume and terms of trade, aid financing and natural conditions.

The HIPC Initiative shows the need for legal mechanisms for orderly international debt restructuring and mediation.

3 Building Capacity for Debt Management

It should be reiterated that it is essential to manage sovereign debt competently, efficiently and transparently. To do this, human and institutional capacity should be built and maintained. HIPCs should not relapse back into unsustainability of debt after completion point just because of poor debt management. Non-HIPC low-income developing countries should not slip into HIPC status simply because of weak debt management.

Capacity building has been found to be superior to technical assistance. History has shown that technical assistance tends to perpetuate dependence. Capacity building tends to successfully wean the country off technical assistance addiction.

Experiences with the pervasiveness and urgency of the external debt problem, lately coupled with mushrooming domestic public debt, have heightened the need to put in place best practices in debt management in HIPCs and non-HIPCs alike. In 1994, these experiences culminated in a pilot project of Eastern and Southern African countries, to strengthen external debt management capacity in the sub-region. The project, then called the Eastern and Southern African Initiative in Debt and Reserves Management (ESAIDARM), prioritised capacity building in the area of external debt management. The management of the meagre external foreign exchange reserves was also prioritised in order to link the external debt liabilities to sovereign external assets.

With time, and as capacity to manage external debt improved in tandem with HIPC external debt relief efforts, it became imperative to introduce a more holistic and risk-based approach to the management of the entire sovereign balance sheet.

In pursuit of these broad objectives, ESAIDARM was transformed into the Macroeconomic and Financial Management Institute of Eastern and Southern Africa (MEFMI) in 1997. Since its launch, MEFMI has contributed to capacity improvements, especially in the area of debt and aid management. These efforts have not been confined to HIPCs, but have included non-HIPCs as well. Current endeavours are geared at assisting HIPCs in obtaining debt relief while strengthening capacity to prevent non-HIPCs from falling into the debt trap.

The ultimate objective remains that of attaining best practice in all aspects of debt management, consistent with sound macroeconomic and financial management in the region. With unwavering support for the region's efforts from international development and technical partners, this objective will not be out of reach for HIPCs and non-HIPCs alike, within a reasonable timeframe.

4 Conclusion

The Enhanced HIPC Initiative has been beneficial to HIPCs. It has not, however, attained its objectives. Post-completion point HIPCs are still in a precarious position regarding external debt sustainability. Economic growth remains low to moderate in most post-completion point countries. Poverty reduction remains a monumental challenge.

Perhaps it should be noted that it has always been clear from the beginning that, given the demands and costs, the HIPC Initiative in its present, or hopefully re-enhanced, form would still not necessarily become a panacea for financing poverty eradication, including the attainment of the international development goals (see Chapter 6).

However, everything possible should be done to ensure that the Initiative at least realises its primary objective of restoring HIPCs' debt sustainability, thereby also enhancing their economic growth opportunities. In this regard, it needs to be emphasised that the export sector is key. Focus should fall on that sector when seeking to reinforce or re-enhance the HIPC Initiative. Both developing countries and international development partners need to be encouraged to each play their part in this respect.

Beyond the provision of HIPC debt relief, additional options should be explored to raise the necessary development financing that would be critical to the halving of world poverty by the year 2015 in keeping with the MDGs. Hopefully, goal posts will not have to be shifted for lack of sufficient mobilised financial resources and slow progress in achieving set objectives.

The HIPC Initiative, as pointed out at the beginning, is not, and was not intended to be panacea for all woes facing HIPCs. Other measures still have to come into play to ensure enduring debt sustainability, strong and sustained growth as well as poverty reduction. In the same spirit, dire assistance needs of non-HIPC low-income developing countries should not be forgotten and ignored. They too need meaningful assistance and reinforcement in their development effort.

Poverty is not mere statistics. It means actual suffering of a large part of humanity. The 1999-2001 momentum and enthusiasm, which were the result of pressure exerted by the new millennium related civil organisations, have lost steam. There is need to rekindle and maintain keen global interest in this important issue. The HIPC Initiative should be improved and decisively pursued to its logical conclusion.

5

Achievements to Date and Challenges Ahead: A View from the IMF

Martin Gilman and Wayne Mitchell[1]

This chapter is intended as background for facilitating an understanding of the objectives of the Enhanced HIPC (Heavily Indebted Poor Countries) Initiative and the progress made to date. It summarises the key features of the Initiative and spells out the context for assessing progress in its implementation. It reviews the status of and the challenges facing countries during their interim period, the impact of the Initiative on debt stocks, debt service, and poverty-reducing expenditures, as well as the status of creditor participation, and culminates with a summary of the main challenges ahead for the Initiative. Lastly, the chapter provides an assessment of HIPCs' external debt outlook and outlines the key responsibilities of governments and creditors in facilitating the achievement of long-term debt sustainability in HIPCs.

Since the 1980s, there have been various efforts by members of the international community to alleviate the debt burden of low-income countries. In the late 1980s, industrial countries, primarily members of the Paris Club, first agreed to reschedule low-income countries' debts on concessional terms in the context of the so-called Toronto[2] terms. By the mid-1990s, there was a general recognition

1 The views expressed in this chapter are those of the authors and should not be interpreted as those of the International Monetary Fund.

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FONDAD, February 2004, www.fondad.org

that the debt problems of the low-income countries were more structural and permanent in nature than it was initially thought. Consequently, under what came to be known as Naples terms,[2] Paris Club creditors were forgiving two-thirds of low-income countries' eligible debts. Despite these efforts, some low-income countries, especially those in sub-Saharan Africa, continued to face heavy external debt burdens and difficulties in servicing them, sometimes repeatedly resorting to debt rescheduling. This often reflected a combination of factors, including a lack of perseverance with structural and economic reform programmes, a deterioration in their terms of trade, poor governance, civil unrest, and also a willingness of creditors to continue to provide new loans.

In September 1996, the IMF and the World Bank launched the HIPC Initiative. The Initiative marked a significant shift in the development finance regime, as the supporting framework sought to resolve the persisting debt crises in a sustainable way by linking debt relief with the policy environment, conditionality with ownership, and social impacts of macroeconomic policy reforms with public expenditure prioritisation. A stated key objective of the HIPC Initiative was to reduce the overall external debt burdens of eligible countries to sustainable levels.[3] To this end, target levels in the range of 200 to 250 percent for the net present value (NPV) of debt-to-export ratio and 280 percent of NPV for the debt-to-revenue ratio was established as thresholds for debt sustainability. Unlike traditional debt reduction mechanisms the Initiative involved, for the first time, debt relief from multilateral financial institutions.

The 1996 Initiative was enhanced following extensive consultations with interested parties from civil society and the Group of Seven (G-7) countries. The Enhanced HIPC Initiative launched in late 1999 by the IMF and World Bank Executive Boards, aimed to provide broader, faster, and deeper debt relief to a larger number of countries. Consequently, the targets established under the original HIPC Initiative in 1996 were lowered to 150 percent of a country's

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[2] The Toronto terms were granted in October 1988. They provide for a concessional rescheduling with a reduction in the net present value (NPV) of eligible debt of up to one-third of debt. The Naples terms, granted from January 1995, effect a two-thirds reduction in the NPV of eligible debt.

[3] See IMF and World Bank, "Modifications to the Heavily Indebted Poor Countries (HIPC) Initiative", IMF, Washington D.C., July 23, 1999, (http://www.imf.org/external/np/hipc/modify/hipc.htm).

exports (or 250 percent of government revenues) at a given point in time.[4] This enabled a broader group of countries to benefit under the Initiative; earlier assistance was provided through interim relief from creditors; and floating completion points were initiated, enabling countries to benefit faster and more effectively from debt relief. In line with these objectives, those HIPCs committed to achieving and maintaining macroeconomic stability, and pursuing reforms aimed at improving governance, stimulating growth, and reducing poverty have benefited from substantial debt relief.

1 Key Features of the HIPC Initiative

The design of the Initiative provides a way forward for HIPCs to effectively use the resources released from lower debt service payments toward poverty-reducing expenditures. Given that the countries targeted are among the poorest in the world, considerations influencing its architecture have centred on its ability to make a substantial contribution to poverty reduction. In this context it is important to note that recent historical gross resource flows to HIPCs were three and a half times the level of debt service payments made. But while the contribution of the HIPC Initiative is important, in terms of these countries' future resource needs to support their poverty reduction strategies (PRSPs), much broader international support is needed. Experience has shown that external support can only be effective if it reinforces sound policies implemented by HIPCs themselves.

Debt relief under the HIPC Initiative is provided in two stages (Figure 1).[5] In the first stage, the debtor country needs to demonstrate the capacity to use prudently whatever debt relief is granted by adhering to IMF and World Bank supported economic adjustment programmes. During this period, the country will receive

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4 Under the Enhanced HIPC Initiative, the external debt burden of a poor country is deemed sustainable if the net present value of debt does not exceed 150 percent of exports or 250 percent of fiscal revenue. Eligibility for assistance under the fiscal window is subject to thresholds for the openness of an economy (export-to-GDP ratio) of 30 percent and for the revenue effort (revenue-to-GDP ratio) of 15 percent.

5 Ross, Doris C., R. Harmsen *et al.*, *Official Financing for Developing Countries*, World Economic and Financial Surveys Series, IMF, Washington D.C., 2001.

debt relief from Paris Club creditors under traditional mechanisms (usually a flow rescheduling on Naples terms) and concessional financing from the multilateral institutions and bilateral donors. At the beginning of the second stage, when the decision point under the Initiative is reached, the Executive Boards of the IMF and World Bank determine whether the full application of traditional debt relief mechanisms would be sufficient for the country to reach sustainable levels of external debt, or whether additional assistance would be required under the Initiative. In the latter case, the IMF and the World Bank would commit to granting debt relief, provided the country continues implementing macroeconomic reforms and structural adjustment policies, including strengthened social policies aimed at reducing poverty. At the same time, Paris Club creditors provide additional debt relief through a flow rescheduling, and commit to providing at the end of the second stage, when the completion point has been reached, a stock-of-debt operation. The full amount of debt relief by the IMF and the World Bank will be provided at the completion point as well, on the condition that other creditors (including multilateral development banks, commercial creditors and non-Paris Club official bilateral creditors) participate in the debt relief operation on comparable terms.

Expectations raised by the HIPC Initiative among stakeholders and development partners are understandably high and at times, the Initiative has been criticised for not achieving results beyond its intended scope. Some facts are emphasised below for setting the context for assessing achievements to date and understanding the role and scope of the Enhanced HIPC Initiative. First, it builds on traditional external debt reduction mechanisms over the last two decades, to provide additional external debt relief from the wider international community to countries requiring HIPC relief. Consequently, the external debt of these countries following suitable policies will be significantly reduced when traditional and HIPC relief is combined over time. Second, it provides a solid basis for HIPCs to achieve debt sustainability and to exit the rescheduling cycle. This is a major achievement, but maintaining debt at sustainable levels over time is a more complex undertaking – which requires efforts both by debtors, on the one hand, and creditors and donors, on the other. For this, it is essential that debtors pursue sound economic policies, including good debt management. It is also essential that creditors/donors are ready to support HIPCs by

Figure 1 Enhanced HIPC Initiative Flow Chart

First Stage

- Country establishes three-year track record of good performance and develops together with civil society a Poverty Reduction Strategy Paper (PRSP); in early cases, an interim PRSP may be sufficient to reach the decision point.
- Paris Club provides flow rescheduling on Naples terms, i.e. rescheduling of debt service on eligible debt falling due (up to 67 percent reduction on a net present value basis).
- Other bilateral and commercial creditors provide at least comparable treatment (recognising the need for flexibility in exceptional cases).
- Multilateral institutions continue to provide adjustment support in the framework of World Bank- and IMF-supported adjustment programmes.

Decision Point

Either

Paris Club stock-of-debt operation under Naples terms and comparable treatment by other bilateral and commercial creditors

is adequate

for the country to reach external debt sustainability

========> **Exit**
(Country does not qualify for HIPC Initiative assistance)

Or

Paris Club stock-of-debt operation under Naples terms and comparable treatment by other bilateral and commercial creditors

is not sufficient

for the country to reach external debt sustainability.

========> **World Bank and IMF** Boards determine eligibility for assistance

All creditors (multilateral, bilateral, and commercial) commit debt relief to be delivered at the floating completion point. The amount of assistance depends on the need to bring the debt to a sustainable level. This is calculated based on latest available data at the decision point.

Figure 1 (Continued)

Second Stage

- Country establishes a second track record by implementing the policies determined at the decision point (which are triggers to reaching the floating completion point) and linked to the (Interim) PRSP.
- World Bank and IMF provide interim assistance.
- Paris Club provides flow rescheduling on Cologne Terms (90 percent debt reduction on NPV basis or higher if needed)
- Other bilateral and commercial creditors provide debt relief on comparable terms.*
- Other multilateral creditors provide interim debt relief at their discretion.
- All creditors continue to provide support within the framework of a comprehensive poverty reduction strategy designed by governments, with broad participation of civil society and donor community.

"Floating" Completion Point

- Timing of completion point for nonretroactive HIPCs (i.e., those countries that did not qualify for treatment under the original HIPC Initiative) is tied to at least one full year of the implementation of a comprehensive poverty reduction strategy, including macroeconomic stabilisation policies and structural adjustment. For retroactive HIPCs (those countries that did qualify under the original HIPC Initiative), the timing of the completion point is tied to the adoption of a complete PRSP.
- All creditors provide the assistance determined at the decision point; interim debt relief provided between decision and completion points counts toward this assistance.
- All groups of creditors provide equal reduction (in NPV terms) on their claims as determined by the sustainability target. This debt relief is provided with no further policy conditionality.
- Paris Club provides stock-of-debt reduction on Cologne terms (90 percent NPV reduction or higher if needed) on eligible debt.
- Other bilateral and commercial creditors provide at least comparable treatment on stock of debt.*
- Multilateral institutions provide debt relief, each choosing from a menu of options, and ensuring broad and equitable participation by all creditors involved.

* Recognising the need for flexibility in exceptional cases.

providing adequate resources on appropriately concessional terms. Third, HIPC relief is provided on a voluntary basis and depends on the concern and goodwill of each participating creditor for these heavily indebted poor countries. Some non-Paris Club and commercial creditors have chosen not to provide debt relief. Making creditor participation mandatory would require the ratification of international agreements by each participating country. Fourth, it lowers debt service payments for decision point HIPCs on average to levels significantly below that paid by other developing countries. Lower debt service payments by HIPCs allow scope for higher social spending, which reached more than three times the level of debt service payments by 2002.

2 Progress in Implementation

Implementation Update

Since October 1999, 27 HIPCs (of a potential list of 38 countries) qualified for assistance under the HIPC Initiative or reached the decision point, the most recent being the Democratic Republic of Congo in July 2003. In net present value (NPV) terms, they account for 85 percent of the total expected relief for the 34 HIPCs for which data are available. By July 2003, eight of these HIPCs had reached the completion point and have received debt relief committed by the international community. The most recent of these has been Benin and Mali in March 2003.[6]

A number (ten) of other countries have been making progress towards the completion point by adopting programmes which will achieve macroeconomic stability, facilitate growth and help reduce poverty. To illustrate, as at July 2003, a number of countries between the decision point and completion point (the interim period) have satisfactory performance records in their macroeconomic programmes.

The remaining nine countries had either recently experienced problems in programme implementation or did not have an IMF-

[6] Guyana and Nicaragua have since reached the completion point in December 2003 and January 2004, respectively, bringing the total number of completion point countries to ten.

supported programme in place after protracted delays in establishing a satisfactory record of performance. Among the former, Cameroon, Ethiopia, The Gambia, Guinea, and Zambia are currently making efforts to implement measures that would facilitate programme continuation.[7]

Challenges in reaching the completion point reflect many factors. Some countries experience extended interruptions to PRGF programme implementation risking macroeconomic stability with fiscal policy slippages, primarily expenditure overruns, being the most common. Weak budget execution and poor policy implementation are often associated with limited institutional capacity, weak governance and deteriorating political and security conditions. Preparing fully participatory PRSPs has taken longer than expected, but on the other hand, most of the countries in the interim period have finalised them and will likely not be constrained by the one-year satisfactory implementation requirement from reaching the completion point in 2004. Many countries lack the institutional and human resource capacity in preparing timely PRSPs and underestimate the time and effort required to fully engage all stakeholders in a participatory process, collect and analyse data, establish priority objectives and sectoral strategies and undertake their costings. Progress in meeting the social and structural completion point triggers has generally been slower than envisaged but varies across countries in the interim period. In many cases, within specific sectors such as health and education, performance on most triggers has been satisfactory but one or more triggers may not have been met or insufficient information is available to make a determination. Difficulties with key triggers could prove to be obstacles to reaching the completion point in the future, though they have not been in the past.

Eleven countries have yet to reach the decision point. In most of these (Burundi, Central African Republic, Comoros, Côte d'Ivoire, Liberia, Myanmar and Somalia), continuing domestic conflict or unsettled transitions from post-conflict situations have hampered effective policy implementation and institution building. Domestic conditions need to stabilise and security conditions need to be maintained before these pre-decision point countries can move

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7 See IMF and World Bank, "Initiative for Heavily Indebted Poor Countries – Status of Implementation", IMF, Washington D.C., September 12, 2003, (http://www.imf.org/external/np/hipc/2003/status/091203.htm).

forward quickly toward the decision point. Another potential impediment to reaching the decision point is the settlement of protracted external payments arrears, including arrears to multilateral creditors. In several HIPCs, such as Liberia, Somalia and Sudan, a concerted international effort would be needed to resolve outstanding arrears.

Impact on Debt Stocks, Debt Service and Poverty Reducing Expenditures

The Initiative is projected to substantially lower debt indicators of participating HIPCs at the completion point to levels comparable to other developing and low-income countries (Table 1).[8] The weighted average NPV of the debt-to-exports ratio for the 27 decision point countries is projected to decline from almost 300 percent before HIPC relief at the decision point to 128 percent by 2005 when most HIPCs are expected to have reached their completion points. The weighted average NPV of the debt-to-GDP ratio is projected to decline from 60 percent before HIPC relief at the decision point to 30 percent in 2005. These projected levels are close to those of other low-income countries.

The HIPC relief committed as at July 2003 to the 27 countries that have reached their decision points, together with debt relief under the traditional debt relief mechanisms and additional bilateral debt forgiveness over and beyond the HIPC Initiative, represents a reduction in the outstanding debt stock of about $52 billion in NPV terms, or a two-thirds reduction of the overall debt stock of these countries (Figure 2).[9] In the eight countries that reached their

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[8] The comparability of NPV statistics derived from Global Development Finance (GDF) data (on developing countries) and HIPC documents and staff estimates (on HIPCs) is limited by the use of different methodologies to account for debt relief and differences in debt coverage. Debt relief is reflected in the GDF database only when actual debt relief agreements are signed, whereas debt relief estimates in HIPC country documents are based on the assumption of full creditor participation in the HIPC Initiative. Furthermore, debt indicators for HIPCs cover only public and public guaranteed debt whereas debt indicators for developing countries cover total public and private debt. GDF debt service data typically overstate debt service because grants associated with HIPC relief were accounted for separately until 2001.

[9] Traditional relief refers to Naples terms stock-of-debt operations, involving a 67 percent NPV reduction.

Table 1 Debt Indicators for Developing Countries and HIPCs
(in percent-weighted averages)

	Developing Countries		HIPC Countries[1]			
	Developing countries average 2001[2]	Non-HIPC low-income countries 2001	Before enhanced HIPC relief[3]	Debt indicators for 2001	Debt indicators for 2002	After enhanced HIPC relief at the completion point
NPV of debt-to-exports ratio[4]	120	143	274	275	214	128[5]
NPV of debt-to-GDP ratio	38	39	61	65	50	30[5]
Debt service-to-exports[6]	19	15	16[7]	10	10	8[5]

Notes:
Figures represent weighted averages. Serbia and Montenegro, Liberia, Somalia, and Turkmenistan have been excluded because of incomplete data.
1 HIPC countries refer to the 27 countries that had reached the decision point by the end of July 2003 under the enhanced HIPC Initiative.
2 Developing countries comprise low- and middle-income countries according to the World Bank income classification.
3 Debt stocks are after traditional Paris Club relief before the decision point. Data refer mostly to end-1998 and end-1999; for the Democratic Republic of Congo, data refer to end-June, 2002.
4 Exports are defined as the three-year average exports of goods and services up to the date specified.
5 Data are for 2005. Since the Democratic Republic of Congo is expected to reach its completion point only in 2006, the NPV of debt after enhanced HIPC relief assumed committed unconditionally is used.
6 Exports are defined as exports of goods and services in the current year.
7 Average over 1998 and 1999.
Sources: Global Development Finance (GDF), World Bank (2003); HIPC country documents; and staff estimates.

Figure 2 NPV of Debt for the 27 Decision Point Countries
(in billions of dollars, in 2002 NPV terms)

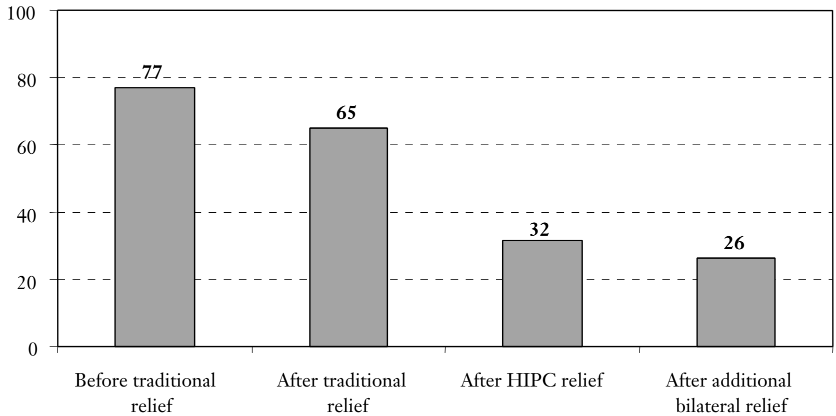
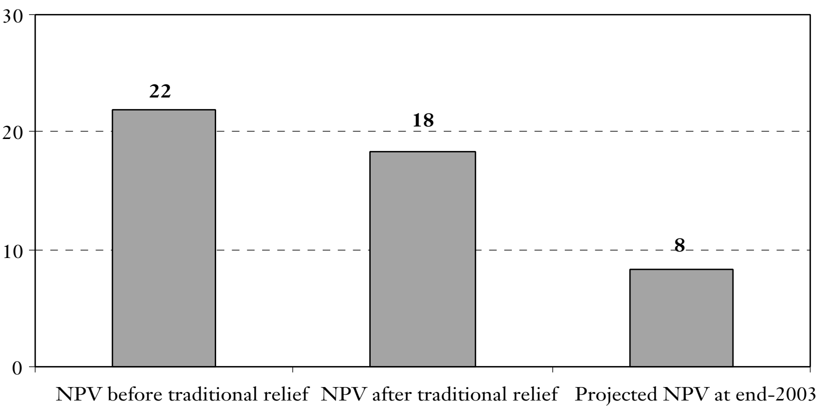


Figure 3 NPV of Debt for Completion Point Countries
(in billions of dollars, in 2002 NPV terms)



completion points, debt stock reduction averaged more than 60 percent in 2002 NPV terms (Figure 3).[10]

The HIPC Initiative continues to provide substantial savings in terms of debt service payments for HIPCs, notwithstanding the delay in bringing a number of them to their completion points. Significant

[10] The 2003 projections for the eight completion point countries are based on the assumption of full creditor participation. This assumption tends to overstate the achieved debt reduction, but financing assurances already obtained for these countries average approximately 90 percent of total required HIPC relief.

debt service reductions occur before countries reach the completion point due to the provision of interim relief by Paris Club and key multilateral creditors which eases the resource constraint of HIPCs and allows them to increase poverty reducing expenditures. Primarily because of interim relief, the average debt-service-to-exports ratio for HIPCs had already fallen to 9.9 percent by 2002 from an average of 16.9 percent in 1998, and is projected to fall to 8 percent by 2005. These debt service ratios are considerably below the corresponding 20 percent ratio in other low-income countries.[11] Similar improvements are also recorded in the other debt service capacity ratios such as debt-service-to-revenue and debt-service-to-GDP.

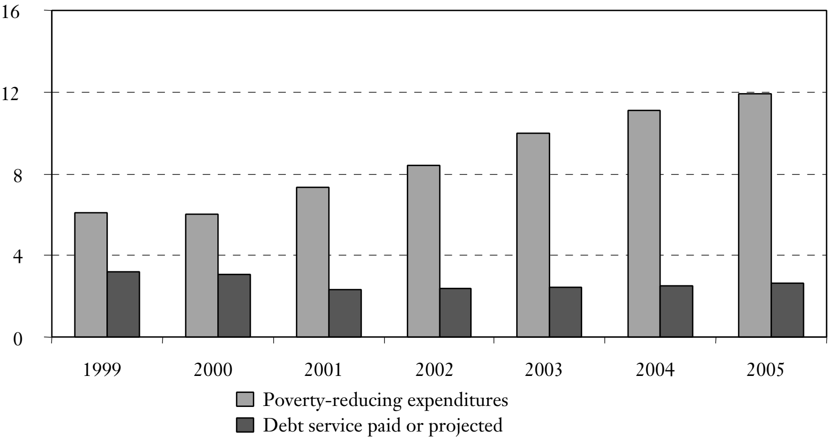
Poverty-reducing expenditures in the 27 countries that have reached the decision point were almost four times as great as debt service payments in 2002 (Figure 4).[12] Annual debt service by these countries is projected to be about 30 percent lower during 2001-2005 than in 1998 and 1999, freeing about $1.0 billion in annual debt service savings. Poverty-reducing expenditures, meanwhile, increased from about $6.1 billion in 1999 to $8.4 billion in 2002 and are projected by staffs to increase to $11.9 billion in 2005.[13] The amount of debt service savings and the related increase in poverty reducing expenditures in the near term vary across countries depending on their specific situations. Poverty-reducing spending is expected to increase in all countries that are on track in their economic reform programmes and implementing their PRSPs with financing from increased revenue and international support in the form of new aid flows and debt relief.

[11] An exception is the Democratic Republic of Congo, where debt service ratios rise significantly after the enhanced decision point. The increase is partly due to the resumption of debt service payments following the arrears clearance operation, as the Democratic Republic of Congo had not been servicing most of its debt in the previous period.

[12] The definition of poverty-reducing expenditures varies across countries although many countries include primary education and basic health as well as expenditures for rural development.

[13] Country authorities are putting in place public expenditure management systems that would ensure the efficiency of poverty-reducing expenditures. See IMF, "Actions to Strengthen the Tracking of Poverty Reducing Public Spending in Heavily Indebted Poor Countries (HIPCs)", IMF, Washington D.C., March 22, 2002, (http://www.imf.org/external/np/hipc/2002/track/032202.htm).

Figure 4 Poverty-Reducing Expenditures and External Debt Service in the 27 Decision Point Countries
(in billions of dollars)



Creditor Participation: Costs, Commitments and Delivery

The total cost of the HIPC Initiative for the 34 HIPCs for which external debt data is available is estimated at $39.4 billion in 2002 NPV terms.[14] In nominal terms, these costs represent about $51.1 billion in debt service relief over time. Of the total cost in 2002 NPV terms, $33.3 billion is associated with the countries that have reached the decision point. This estimate does not include the costs for Liberia, Somalia, Sudan, or Lao PDR because reliable data for these countries are not yet available.[15] Preliminary calculations suggest however, that including Sudan, Liberia, Somalia, and Lao PDR in the estimates could increase the cost of HIPC relief by more than 25 percent or $10.6 billion to $50.0 billion in 2002 NPV terms. Most of these additional costs are concentrated in Sudan.

[14] See IMF and World Bank, "Initiative for Heavily Indebted Poor Countries — Status of Implementation", IMF, Washington D.C., September 12, 2003, (http://www.imf.org/external/np/hipc/2003/status/091203.htm).

[15] The first three countries also have protracted arrears problems.

Multilateral Creditors

In NPV terms, multilateral creditors accounted for $19.0 billion, or 48 percent of total HIPC costs. Twenty-three of 30 multilateral creditors have indicated their intention to participate in the Initiative, representing more than 99 percent of the total debt relief required. The large multilateral creditors, including the IDA, the IMF, the African Development Bank (AfDB), the Inter-American Development Bank (IADB), the European Investment Bank/European Union (EIB/EU), and the Central American Bank for Economic Integration (CABEI) are providing relief to most countries in the interim period. In October 2002, the East African Development Bank agreed to participate in the HIPC Initiative and the Arab Monetary Fund reconfirmed its participation in early 2003. So far multilateral creditors have delivered more than $3.8 billion in relief.

Bilateral Creditors

Most of the costs attributable to official bilateral creditors are borne by members of the Paris Club which account for $15.2 billion of the total HIPC costs in 2002 NPV terms. All Paris Club creditors have committed to delivering their share of HIPC relief to the countries that have reached the decision point. Many Paris Club creditors are providing interim relief and relief over and above that required under the HIPC Initiative. Since September 2002, Paris Club creditors have agreed to a number of stock-of-debt operations on Cologne terms[16] for a number of countries going beyond the degree of concessionality generally provided by Naples terms, these include Benin and Mali at their completion points and flow reschedulings for Nicaragua and The Gambia at their decision points. The flow rescheduling on Naples terms for the Democratic Republic of Congo was instrumental in clearing arrears to external creditors. In addition, many Paris Club creditors offered terms for the arrears clearance that went beyond this. In addition the Paris Club has agreed to consider topping-up the Naples flow rescheduling amounts to Cologne terms once the Democratic Republic of Congo reaches the decision point,

[16] Cologne terms entail stock-of-debt operations, involving an 90 percent NPV reduction.

which would reduce the country's debt service obligations by another 70 percent.

The participation of non-Paris Club bilateral creditors has steadily improved. The 51 non-Paris Club official bilateral creditors account for $3.4 billion of HIPC relief costs in 2002 NPV terms, of which the costs for the 27 decision point countries represent $3.3 billion. In September 2002 Libya agreed to fully participate in the Initiative and deliver $225 million (in 2002 NPV terms) in HIPC relief to 16 countries.[17] In June 2003 India announced its decision to write off all claims on HIPCs, thereby benefiting Ghana, Guyana, Mozambique, Nicaragua, Tanzania, Uganda, and Zambia. Delivery of relief by non-Paris Club official bilateral creditors can only be fully measured after their debtors reach the completion point. Consequently, delivery of relief becomes an issue once countries to which they have outstanding loans reach the completion point. Thirteen non-Paris Club bilateral creditors have indicated commitments to deliver full debt relief under the HIPC Initiative framework and 14 have made commitments to deliver HIPC relief on some but not all claims on HIPCs. Twenty-four non-Paris Club creditor countries representing about 21 percent of the total cost attributable to this group have not yet agreed to deliver HIPC relief. In March 2003 the Boards of the Bank and the Fund reviewed measures to provide relief by HIPC creditors to HIPC debtors.[18] Based on the input received from the Board discussion staffs have been working with bilateral creditors and donors to further explore options to resolve this issue.

Commercial Creditors

The size of commercial debt owed by HIPCs has already been substantially reduced as a result of the Debt Reduction Facility for IDA-Only Countries and debt relief required from them accounts for about 5 percent of HIPC relief. In some HIPCs, however,

[17] Although Libya has agreed to participate in the HIPC Initiative it has yet to establish the legislative framework to facilitate this. Staffs estimate that traditional debt relief, i.e. a stock-of-debt operation on Naples terms, will cost around $900 million in 2002 NPV terms.

[18] See IMF and World Bank, "Enhanced HIPC Initiative – Creditor Participation Issues", IMF, Washington D.C., April 8, 2003, (http://www.imf.org/external/np/hipc/2003/creditor/040803.pdf).

commercial creditors account for a significant proportion of outstanding debt. Although the claims of commercial creditors are small in NPV terms, they are nevertheless a cause of concern. In nine countries commercial creditors and some non-Paris Club bilateral creditors have resorted litigation as a means of debt recovery. There are many cases where debtors have not remitted payments after creditors have received judgments, however, in some cases debtors have made payments in excess of that required had the creditor provided HIPC relief. Pending litigation and outstanding court judgments also prevent HIPCs from regularising financial relationships with the international community.

Challenges Ahead for the HIPC Initiative

For the countries in the interim period delays in reaching the completion point have been attributed to the challenge of maintaining macroeconomic stability, preparing and implementing poverty reduction strategies and meeting the social and structural completion point triggers. Although there is a strong desire to see more countries reach the completion point quickly, the Boards of both the IMF and the World Bank as well as development partners have stressed that ownership and quality in the PRGF programmes and PRSPs should not be sacrificed for speed.

Staffs of the Bank and the Fund have sought to provide support for countries which are experiencing difficulties in meeting the required conditions. Where PRGF programmes have either lapsed or been discontinued, IMF staff have sought to work with the respective country authorities to implement Staff Monitored Programmes that would facilitate the resumption of financial support from the international community. In principle therefore countries with protracted interruptions in their macroeconomic programmes could be back on track within a short period of time and reach the completion point provided other conditions are met. Additionally, IMF and World Bank and Fund staff have been working with others to alleviate constraints facing countries in PRSP design and implementation. In this regard the PRSP preparation status reports have also helped identify bottlenecks and the need for technical assistance.

The HIPC Initiative is open to all eligible countries that establish a performance record leading to the decision point by the end of

2004 when the sunset clause takes effect.[19] A critical challenge that lies ahead is to ensure that the remaining pre-decision point countries qualify for entry before this date is reached. The approach contained in the World Bank Task Force Report on Low-Income Countries Under Stress (LICUS) may be useful in supporting HIPCs that face conflict-related, governance or capacity obstacles to reaching decision points.[20]

Full participation in debt relief by all creditors poses another challenge. Such participation is essential in order to ensure that the debt stocks of HIPCs are reduced to sustainable levels. Such support is also critical for many countries in their interim periods which may take longer than anticipated to reach their completion points due to the need to develop their PRSPs and overcome difficulties in the implementation of their economic adjustment and reform programmes. The provision of interim assistance by major creditors during this period is critical as it supports the efforts of HIPCs, and lowers their near-term debt service costs substantially.

Non participation in the Initiative and in particular, creditor litigation against HIPCs, frustrates the achievement of these objectives. The latter diverts the HIPCs time and resources, is financially costly, undermines the burden-sharing principle underlying the Initiative. Given the voluntary nature of debt relief under the Initiative, moral suasion is the only approach pursued by the Fund and Bank staff in dealing with this issue. Encouraging commercial creditors to deliver HIPC relief, however, is complicated by their limited interaction with the World Bank and the IMF. Accordingly, the Fund and Bank will continue to (a) give extensive publicity to the problems arising from the sale of HIPC debt in the secondary market and to known litigation cases in the semi-annual HIPC Initiative implementation reports and (b) contact the authorities of creditor countries and multilateral creditors about their expected participation as HIPCs reach critical points under the

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[19] The sunset clause stems from the 1996 Programme of Action which established a time limit in order to prevent the HIPC Initiative from becoming a permanent facility and to encourage HIPCs to adopt adjustment programmes that could be supported by the IMF and IDA. The Boards subsequently agreed to two-year extensions in 1998, 2000, and 2002.

[20] See World Bank, "World Bank Group Work in Low-Income Countries Under Stress: A Task Force Report", World Bank, Washington D.C., September 2002, (http://www1.worldbank.org/operations/licus).

Initiative;[21] and (c) encourage the debtor countries to take an active and constructive role in seeking debt relief from their non-Paris Club official bilateral and commercial creditors.

3 Debt Sustainability in HIPCs

Review of Debt Sustainability

The global economic slowdown in 2001, together with a significant decline in many primary commodity prices, led to a deterioration of external debt indicators in many HIPCs and fears that some countries could have debt ratios exceeding the HIPC threshold ratios at the completion point. These concerns prompted public officials, academics, and non-governmental organisations (NGOs) to call for a better understanding of the causes and nature of the recent changes and to propose actions to ensure that the objectives of the HIPC Initiative are achieved.

An IMF and World Bank staff review in August 2002[22] confirmed that (i) for the group of HIPCs whose debt indicators worsened in 2001, the principal source of the deterioration was lower exports owing mainly to declining commodity prices;[23] and (ii) while the world economy is recovering slowly, the prices of key export commodities of HIPCs continue to be depressed and were not expected to recover quickly. When compared to projections made at the decision point, the NPV of debt-to-exports ratios in 2001 are estimated to have been higher in 15 out of the 24 countries including completion point countries for which data are available (Table 2).[24]

[21] Contacts are limited with Iraq, North Korea, and Taiwan Province of China; the latter two are not Fund members.

[22] See IMF and World Bank, "Heavily Indebted Poor Countries Initiative – Status of Implementation", IMF, Washington D.C., August 16, 2002, (http://www.imf.org/external/np/hipc/2002/status/092302.htm).

[23] This primarily reflects exports in countries with a narrow resource base and heavily concentrated in primary commodities such as, coffee, cotton, cashews, fish, and copper. The world price for coffee, the main export crop in five HIPCs, fell by 35 percent in 2001. Cotton, the main export in three HIPCs, fell by 19 percent. Other commodities that constitute the primary export of at least one HIPC saw large price declines: cashews (a decline in prices of 69 percent), fish (21 percent), and copper (13 percent).

[24] Ghana and Sierra Leone both reached their decision points in 2002 and thus are not included in the comparison of 2001 outturns vs. decision point projections.

Table 2 Updated NPV of Debt-to-Export Ratios at end 2001 Compared with Ratios Projected at their Decision Points
(in percentage points)

	Percentage Points Difference NPV of Debt-to-Export-Ratio	Effect of NPV of Debt (Numerator) [1]	Effect of Exports (Denominator)
15 Countries with Worsened Debt Ratios			
Benin	82	70	11
Burkina-Faso	88	57	30
Chad	. . .[2]	. . .[2]	4
Gambia, The	21	6	15
Guinea	. . .[2]	. . .[2]	25
Guinea-Bissau	. . .[2]	. . .[2]	99
Guyana	55	49	5
Honduras	. . .[2]	. . .[2]	12
Malawi	. . .[2]	. . .[2]	9
Mauritania	75	37	38
Nicaragua	11	-47	59
São Tomé and Principe	. . .[2]	. . .[2]	45
Senegal	. . .[2]	. . .[2]	33
Uganda	44	19	25
Zambia	58	1	57
9 Countries with Improved/ Unchanged Ratios			
Bolivia	-36	-33	-4
Cameroon	-1	-2	1
Madagascar	-31	-7	-25
Mali	-8	10	-18
Mozambique	-34	-7	-27
Niger	. . .[2]	. . .[2]	-11
Rwanda	-49	3	-51
Tanzania	-41	-22	-19

Note:
The decomposition of debt and export effects is derived as
$\Delta(D_t/X_t) = (D_{t-1}/X_t)*(\Delta D_t/D_{t-1} - \Delta X_t/X_{t-1})$
where D is the NPV of the debt, X is exports, and Δ is the first difference operator.

1 Includes new borrowing and revisions in the outstanding stock of debt. In the case of Benin, Burkina Faso, and Guyana, the higher NPV of debt is largely due to delays in reaching completion points.

2 Insufficient information on the NPV of debt was available to make a complete assessment of the NPV debt-to-exports ratio. The estimated effect of exports (3rd column) shows the change in the ratio assuming the NPV of debt was as predicated in the Decision Point.

Sources: Decision Point documents, and World Bank and Fund staff estimates.

Revisions to the debt stock at the decision point and delays in reaching the completion point compared with decision point projections also raised the debt ratios in several countries.[25] In some cases higher borrowing than projected at the decision point as well as changes to discount and exchange rate assumptions also contributed to the deterioration of debt ratios.

The structural characteristics of these economies show that, on average, the countries with worsened debt indicators have a slightly higher export commodity dependence and a much greater volatility in historical exports, as compared to other HIPCs. These structural characteristics, together with the type of commodities they produce and export, were a contributing factor determining performance in 2001. Thus assessing debt sustainability in HIPCs must take account of each country's specific situation and requires that a fuller discussion of the relative roles of domestic policies versus exogenous factors and judgment on whether the changes are temporary or permanent.

The current framework of the HIPC Initiative has the flexibility to respond to a deterioration of the debt sustainability outlook for countries that have yet to reach their completion point. This approach was endorsed by the IMF and World Bank Boards in September 2001 and an operational framework for providing such additional assistance or "topping up" at the completion point beyond that committed at the decision point was established.[26 27] Central to the approach is a comprehensive assessment based on actual debt and other economic data available at the completion point, on whether a country's economic circumstances have been fundamentally changed due to exogenous developments. The IMF and World Bank staffs will continue to be involved with HIPC authorities not only in the context of their respective programmes and PRSPs but also in

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25 The full impact of debt relief on debt stocks is projected at the decision point for provision at the completion point. However the delivery of debt relief does not occur as projected when countries are delayed in reaching the completion point. This results in an increase in debt levels relative to projections at the decision point.

26 See IMF and World Bank, "The Enhanced HIPC Initiative – Completion Point Considerations", IMF, Washington D.C., August 21, 2001, (http://www.imf.org/external/np/hipc/2001/cpd/cpd.pdf).

27 To date, Burkina Faso is the only country that has benefited from this flexibility.

provided them with assistance to update their DSA, strengthen debt management capacity, including new borrowing policies, and increasing the effectiveness in the use of foreign aid.

Maintaining Debt Sustainability Beyond the HIPC Initiative

The level of relief provided under the HIPC Initiative should be sufficient for HIPCs to embark on a path of sustainable debt – excluding shocks that fundamentally change these countries' macroeconomic conditions for a prolonged period of time.[28] The challenge for HIPCs however, is to remain on such a path. Long-term debt sustainability depends not only on (i) the existing stock of debt and its associated debt service but also on (ii) the evolution of a countries' fiscal and external repayment capacity, as well as on (iii) the growth and terms of new borrowing. The HIPC Initiative deals only with the first of these elements by providing a one-time debt reduction, but this is not an ongoing guarantee of debt sustainability. The other two elements fall beyond the Initiative's scope and more under the responsibility of HIPC governments and their creditors.

To maintain debt sustainability, HIPCs have a responsibility to adhere to sound macroeconomic policies and implement structural reforms to diversify their production and export base away from commodity dependence, and to strengthen growth and export performance overall. They should utilise their Poverty Reduction Strategy Papers (PRSPs) as the main vehicles for addressing these tasks by taking the central role in diagnosing country-specific challenges, deepening ownership of economic development strategies, and improving governance and institutions and, hence, the effectiveness with which they utilise resources, including foreign aid. In this regard, it is important that HIPCs continue to improve their public expenditure management systems, building on the progress made in this area under the HIPC Initiative.[29]

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[28] See IMF and World Bank, "Heavily Indebted Poor Countries Initiative – Status of Implementation", IMF, Washington D.C., September 23, 2002, (http://www.imf.org/external/np/hipc/2002/status/092302.htm); and, Doris Ross and Lisandro Abrego, "Debt Relief Under the HIPC Initiative: Context and Outlook for Debt Sustainability and Resource Flow", IMF Working Paper WP/01/144, IMF, Washington D.C., 2001. This subsection draws substantially on these papers.

[29] For progress in improving the tracking of poverty-reducing public expenditure

In addition to ensuring improvements in a country's repayment capacity, strengthened debt management is important in improving debt sustainability prospects (see Box 1). Irrespective of export performance, HIPCs undertaking new borrowing should aim to adhere to the following key principles: limiting or avoiding non-concessional borrowing; integrating plans for new borrowing with the broader macroeconomic and fiscal framework and tailoring new borrowing to a country's debt servicing capacity; following best practices in debt management; and ensuring a productive use of funds to assure sufficient returns to repay future obligations.

On the donor/creditor side, responsibility lies in providing adequate external financing on sufficiently concessional terms in support of HIPCs' poverty-reduction and growth strategies without jeopardising their external debt sustainability. This includes an increase in grant financing from both bilateral and multilateral development partners. The recently concluded 13th IDA replenishment agreement to provide a proportion of IDA resources in the form of grants to particularly vulnerable low-income countries will be an important step forward in this regard (see Box 2). The effect on the debt ratios of a substitution of part of HIPCs' new borrowing with grants would be small in the short term, but the cumulative impact could be significant over the longer term. More concessional financing from the international community would help ensure that new external financing is consistent with the payments capacity in countries that are particularly vulnerable. Over the longer term, however, the international community must help these countries to regain their creditworthiness and reduce their reliance on grants. Further support from the international community to increase the access of low-income countries to global markets would allow the latter better opportunities for growth and export diversification and enhance their capacity to service their debt obligations.

Looking ahead, IMF and World Bank staffs are currently working on developing a forward-looking framework for assessing debt sustainability in a post-HIPC world while making judgments about financing, borrowing, and debt management strategies. The

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and public expenditure management system in PRSP countries, see IMF and World Bank, "Poverty Reduction Strategy Papers – Progress in Implementation", IMF, Washington D.C., September 11, 2002, (http://www.imf.org/external/np/prspgen/2002/eng/091102.htm).

Box 1 Strengthening Debt Management Capacity in HIPCs

Following a 2001 survey and the presentation of the March 2002 report to the World Bank and IMF Boards,[1] Executive Directors recommended that staffs explore proactive measures to improve the coordination of donors, technical assistance providers, HIPCs and multilateral institutions so as to strengthen debt management capacity in HIPCs. The survey also revealed substantial demand by HIPCs for improvement in information sharing among HIPC debt management agencies, and for support from technical assistance providers to strengthen cooperation and coordination. Staffs have continued to work with donors, technical assistance providers and HIPCs in order to strengthen the mechanisms for improving debt management capacity.

Recognising the importance of debt management capacity building, staffs are currently evaluating potential measures to: (i) strengthen the linkages between HIPC country level debt management and broader country economic management; (ii) establish a stronger communication link between agencies as a means of collaborating on capacity-building measures; and improve efficiency by reducing duplication and strengthening complementarities; (iii) improve country ownership of debt management; and (iv) establish a set of HIPC debt management standards. A number of measures could be implemented without delay:

- As part of a comprehensive approach to strengthen HIPCs' debt sustainability prospects, with the assistance of their development partners, HIPCs are expected to prepare and update their own DSA regularly as they reach the completion point. Uganda's recent DSA provides a good example. This could be part of the macroeconomic framework defined in the PRSP and be followed up in subsequent PRSP progress reports.
- Stronger monitoring of new borrowing both by debtors and creditors is also key to maintaining such sustainability. Domestic debt should be included as part of a systematic and regular monitoring of overall public debt. Moreover, creditors should take on increasing responsibility for disclosure of the terms and conditions of outstanding credits.
- A key measure for maintaining long-term external debt sustainability is an institutionalised periodic review of the effectiveness of external financing by HIPCs themselves. This could be done as part of periodic public expenditure review or review of the public investment programme.

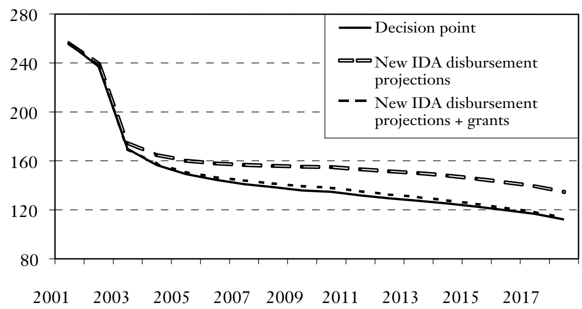
1 See IMF and World Bank, "External Debt Management in HIPCs", SM/02/92, March 22, 2002 (http://www.imf.org/external/np/hipc/2002/edm/032102.htm).

objective is to allow low-income countries to take maximum advantage of resource flows to promote growth and reduce poverty while minimising the risk of future "debt distress" and, in particular, ensuring that progress towards sustainability arising from HIPC relief is not undermined. The framework will be based on several

Box 2 The Impact of an Increase in IDA Grants on HIPCs' Debt Sustainability

Over the past two years, IDA lending to the ten countries that were projected in the HIPC progress report of spring 2003 to have their NPV of debt-to-exports ratios above the HIPC threshold at the completion point[1] has been slightly greater than was anticipated in the decision point documents and future lending is also programmed at higher levels in many cases. As a result, the NPV of debt-to-exports ratios in these countries may therefore increase beyond the levels previously projected. At the same time, IDA donors have recently agreed that up to 40 percent of financial support to HIPCs under the thirteenth replenishment of IDA resources (IDA-13) may be furnished in the form of grants.

Chart 1 Weighted Average of the Debt-To-Exports Ratio for the Ten Countries
(in percentages)



As a result of increases since decision point in projected IDA disbursements, the NPV of debt-to-exports for the ten countries is projected to average 155 percent in 2010 compared with 135 percent projected in the decision point documents. By 2018, the average ratio is now projected at 135 percent compared with the previous estimate of only 112 percent.
If the ten countries would qualify to obtain 40 percent of IDA resources in the form of grants, the likely impact would be to offset almost completely by 2018 the effect on the debt-to-exports ratio of larger-than-anticipated IDA lending. With 40 percent of new IDA financing being furnished in grant form, the NPV of debt-to-exports ratio would average 114 percent in 2018, which is very close to that projected in the decision point documents.
It is clear that the beneficial impact on HIPCs' long-term debt sustainability outlooks of shifting IDA lending toward partial grants can be magnified if other creditors followed suit to adjust their financing terms to increase their concessionality.

Note:
[1] Benin, Burkina Faso, Chad, Ethiopia, Gambia, Guinea-Bissau, Malawi, Rwanda, Senegal, and Zambia. Burkina Faso reached its completion point subsequently in April 2002.

indicators that relate prudent debt bearing capacity to country-specific factors mentioned above, i.e. the quality of a country's policies and institutions, its past and prospective growth performance, the degree of openness of the economy, the volatility of revenues and exports, and its vulnerability to shocks. To date extensive consultations have been held with stakeholders, in a number of workshops around the world, with a view to gaining support for and refining this new approach. The latest of these has been the October 2003 meeting of the multilateral development banks in Vienna. The IMF and World Bank Executive Boards review of this framework is envisaged in early 2004.

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From Debt Relief to Achieving the Millennium Development Goals

Amar Bhattacharya[1]

Dealing with the debt difficulties of the poorest countries has been an important element of the development agenda of the 1990s. While the initial thrust was on reducing the debt overhang of the heavily indebted poor countries, the focus has shifted to achieving sustained growth and poverty reduction while preserving long-term debt sustainability. I will argue that while debt relief is a necessary first step towards these development objectives, a more comprehensive and concerted approach is needed to accelerate progress towards the Millennium Development Goals (MDGs) in these countries.

The next section reviews the status of implementation of the Heavily Indebted Poor Countries (HIPC) Initiative and assesses what the Initiative can and cannot do in the pursuit of different development objectives. Section 2 sets out an agenda to accelerate progress towards the MDGs, building on the foundations laid in the HIPC Initiative, and mindful of the need to preserve debt sustainability. Section 3 concludes.

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[1] Revised version of a paper presented by the author at the Annual Bank Conference on Development Economics – Europe held in Paris on 15-16 May 2003. The views expressed are those of the author and do not necessarily represent those of the World Bank.

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1 Implementation of the HIPC Initiative and What It Can(not) Yield

The HIPC Initiative was launched in 1996 following extensive debate[2] and deliberations provoked to a large extent by strong advocacy on the part of key non-governmental organisations. The Initiative was modified in 1999 to encompass, in addition to the original objective of "removing the debt overhang", the additional objectives of debt sustainability through a "permanent exit from rescheduling" and poverty reduction by "[freeing] up resources for higher social spending … to the extent that cash debt service payments are reduced."[3]

Forty-two countries have been identified as HIPCs[4] accounting for 14 percent of the developing world's population and 5 percent of GNI. Their share of developing country debt is only 8 percent but large relative to their own economies. Relative to other low-income countries, their debt burdens increased sharply during the 1980s and the early 1990s (Table 1). The main factors behind the build-up of debt were: adverse shocks and secular deterioration in terms of trade; sustained macroeconomic imbalances and weak policies and institutions; non-concessional lending and refinancing policies of creditors; inadequate debt management; and civil strife and political upheavals (Brooks *et al.*, 1998).

Table 1 External Debt as Percentage of GDP
(period average)

Category	1980–1984	1985–1989	1990–1994	1995–2000
HIPC	38	70	120	103
Other IDA countries	21	33	38	33
Other LMI* countries	22	30	27	26

Note:
* Lower-middle-income.

Source: World Bank, *Global Development Finance*, 2002, and World Bank, *World Development Indicators*, 2002.

2 Several FONDAD publications provided key information for the debate that preceded the HIPC Initiative.
3 For a comprehensive review and assessment of the Initiative see OED, 2003.
4 Including four countries that are potentially sustainable without HIPC assistance (Angola, Kenya, Vietnam and Yemen), see Table 2.

Table 2 Status of the 42 Eligible HIPCs
(as of January 2004)

Reached completion point	Benin, Bolivia, Burkina Faso, Guyana, Mali, Mauritania, Mozambique, Nicaragua, Tanzania, Uganda
Reached decision point and receiving interim relief	Cameroon, Chad, Democratic Republic of Congo*, Ethiopia, The Gambia, Ghana, Guinea, Guinea-Bissau*, Honduras, Madagascar, Malawi, Niger, Rwanda*, São Tomé and Príncipe, Senegal, Sierra Leone*, Zambia
Not yet at decision point	Burundi*, Central African Republic*, Comoros, Republic of Congo*, Côte d'Ivoire, Lao P.D.R., Liberia*, Myanmar*, Somalia*, Sudan*, and Togo
Potentially sustainable without HIPC assistance	Angola*, Kenya, Vietnam, Yemen

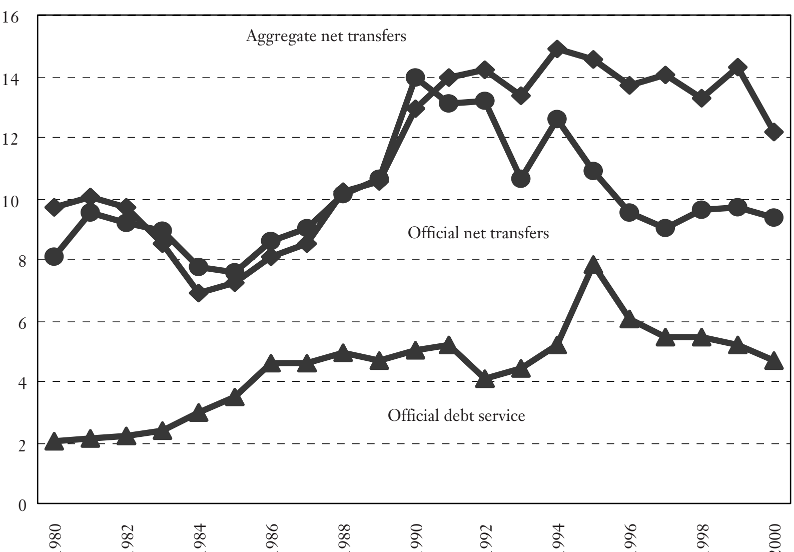
Note:
*Conflict-affected countries.

Implementation is progressing steadily but more slowly than anticipated. Of the 42 HIPCs, 27 have reached decision point under the enhanced framework, and ten have reached their completion point including Mali and Benin in March 2003, and Guyana and Nicaragua in December 2003 and January 2004, respectively (Table 2). Four countries are considered to have sustainable debt burdens without debt relief. Among the 11 countries still to reach decision point, most are conflict affected. Côte d'Ivoire was about to reach decision point but the HIPC process was derailed by sudden domestic conflict. And in the case of the Central African Republic, preparation of the HIPC preliminary documents was interrupted by an upsurge in civil strife. The Democratic Republic of Congo has reached its decision point in July 2003.

The HIPC programme can be considered to bring debt levels of HIPC countries to the same level as other poor countries and to eliminate the excessive debt overhang that posed a constraint to growth and poverty reduction. Although the reduction of the debt burden under the HIPC Initiative reduces the debt burden significantly, it cannot guarantee a net increase in external financing. As shown in Figure 1, aggregate official inflows to HIPCs have exceeded debt service. But official net transfers trended down in the second half of the 1990s, although there has been considerable variation in the pattern of net transfers to individual HIPCs. Aggregate net transfers have fallen from a peak of $14 billion in the early 1990s to less than $10 billion in 2000. This is a larger decline than the savings in debt service due to the implementation of the HIPC Initiative. This trend underscores the importance of additional financing to support the development objectives of the HIPC countries. While net transfers to HIPCs have declined it is worth noting that they have received an increasing share of aggregate net transfers to developing countries. This is both because of a shift in official development assistance (ODA) to HIPCs and the increased concessionality of flows to these countries.

The aim of the HIPC Initiative is to reduce the debt burden to a reasonable level at exit, but it cannot ensure debt sustainability of HIPC graduates in the long term. Uganda's debt-to-exports ratio, for example, was brought down to the targeted 150 percent at completion point, but a downturn in export earnings and higher than anticipated new borrowings led to an increase in the ratio to

Figure 1 Net Resource Transfers to HIPCs
(in billions of dollars, in 2002 NPV terms)



Source: World Bank, *Global Development Finance*, 2002.

171 percent in 2001, 43 percent higher than the ratio of 128 percent projected at decision point. Increased levels of borrowing and poorer than expected export performance were also responsible for increases in debt-to-exports ratios in the case of Burkina Faso and Mauritania. Bolivia, Tanzania and Mozambique have remained below the target largely as a result of low borrowing. So while a reduction in debt stocks can help restore debt sustainability at a point in time, long-term debt sustainability depends crucially on export performance and on the amounts and terms of new financing.

In parallel with debt relief, the HIPC Initiative is aimed at supporting policy and institutional reforms that can lay the basis for sustained growth and accelerated poverty reduction. There is an *ex ante* requirement of the establishment of a strong policy track record for a country to reach the decision point. While such a track record was binding in the case of the initial entrants, this requirement was eased during 2000 in order to allow more countries to join the Initiative. In order to reach the completion point, a HIPC has to fulfil three requirements: (i) staying on track with the IMF's PRGF macroeconomic stabilisation and reform programme; (ii) the development and implementation (for at least one year) of a full PRSP; and (iii) performance criteria focused on public expenditure reform, governance and increased and improved social expenditures.

The improvements in policies and institutions that have begun to take hold in many though not all the 26 countries that reached decision point has been reflected in improved growth performance. Fourteen of the 26 countries that have reached decision point recorded annual GDP growth rates in excess of 4 percent since 1995. Countries that have already reached completion point show the strongest performance reflecting more sustained policy and institutional improvements. In addition to stronger growth, HIPCs have been increasing social spending as part of enhanced poverty reduction efforts.

Despite this encouraging progress, none of the HIPCs are on track to meet a majority of the MDGs. HIPCs appear best positioned on access to safe water where 9 out of the 24 countries with available data appear on track to meet the goal by 2015. In contrast, only 1 out of the 37 HIPCs with available data are likely to meet the goal on child mortality, and none of the 28 HIPCs with data are likely on the basis of current trends to meet the primary school enrolment goal.

2 Achieving the MDGs

Three developments have generated a new dynamism in the global efforts to accelerate development and fight poverty. First, the Millennium Summit and the adoption of the MDGs marks an important milestone in the global commitment to development. The MDGs recognise the multi-dimensionality of poverty and set international benchmarks to focus and measure the effectiveness of the collective efforts of the international community. Second, the Poverty Reduction Strategy Paper for low-income countries has gained wide acceptance as a new approach to development at the country level – based on principles of country ownership and participation, of a comprehensive and long-term approach, and of partnership and alignment. Third, the Monterrey Conference on Financing for Development (in conjunction with Doha and Johannesburg) has generated a "consensus" on the way forward to meet the MDGs and broader development goals. Developing countries committed to sound policies and good governance, and the rich countries committed to provide market access, debt relief and more and better aid.

There is also agreement, or at least less disagreement than appears to be sometimes the case, on the development framework to achieve the MDGs. First, there can be no disagreement that progress on MDGs hinges critically on sustained economic growth. Indeed, there is no country that has made rapid progress on the MDGs without robust growth. Second, we also know that countries' ability to translate growth into progress on poverty reduction and other development goals varies widely depending on their policy orientation. Third, while growth is critical, in many poor countries it is unlikely to generate sufficient domestic resources to finance the attainment of all of the MDGs. To take an example, Ethiopia currently spends $74 million per year on primary education, or less than $14 per student. Only 25 percent of children complete primary school and only about 60 percent of children are even enrolled. To reach the 2015 target, expenditures would need to double, reforms in the quality and delivery of schooling would be required, and $200 million in annual external financing would be needed to bridge the expected financing gap. If Ethiopia were to rely solely on its own domestic resources, the goal of 100 percent primary school completion would not be reached before 2050. In the area of health, expenditure needs are even greater and the sums expended even lower. And this does not take into account the direct and indirect costs of HIV/AIDS, of the environment, of investments in infrastructure.

Hence for the poorest countries the MDGs can only be met with substantial increases in external financing. But such external assistance will only be effective if it is based on a framework of measurable results – based on sound country strategies, on good governance and public financial management and effective service delivery. These foundations will necessarily take time. But the international community can and must provide assistance where there are reasonable foundations in place and clear commitments that can provide the basis for scaling-up actions by the countries and matching support by the international community. The challenge now is how to translate these principles into concrete actions and to accelerated progress on the development goals.

In response to a request from the Development Committee, Bank and Fund staff have proposed a framework for monitoring of policies and actions – by developing countries and by their international partners – needed to implement the Monterrey consensus and achieve the MDGs, to complement the work of the UN on monitoring progress on the MDGs. The aim of this framework is to enhance transparency and accountability and allow the international community to focus on those priority areas of attention needed to maintain momentum on the development agenda. It is only through the combined actions of developing countries themselves and complementary actions on the part of their development partners will poor countries be able to lay the foundations for sustained growth and invest in their poor.

The initial assessment that was carried out shows that there is encouraging progress, but much more is needed. On the part of developing countries, there has been a clear improvement in policies and institutions. The Country Policy and Institutional Assessments carried out by Bank staff reflect this progress, with the greatest improvements in macroeconomic management and trade policies. The area that is most lagging is public sector management and governance, and there remains a wide dispersion in performance across countries.

The trend for HIPC countries is similar but not as strong. While performance of the countries that have reached completion points have been strong and sustained, there have been slippages in some countries that are between their decision and completion points. Performance on public sector management and governance is a particular concern in many HIPCs. An assessment of public expenditure systems in HIPCs carried out by Bank and Fund staff last year shows that benchmarks for budget formulation, execution and reporting were not met by most HIPCs. Without a strong public expenditure management system, it will be difficult for HIPCs to ensure that resources that are freed up by debt relief, or new aid resources, are effectively deployed. Hence strengthening public expenditure management and governance is a critical need if countries are to be successful in scaling up their efforts to meet the MDGs. HIPCs also need to take complementary actions to strengthen service delivery mechanisms.

These efforts of the HIPC countries will only be successful if there are commensurate efforts on the part of developed countries. Monterrey underscored the critical importance of trade to the attainment of the MDGs. The three core development issues in the Doha agenda – agriculture, TRIPS and medicines and special and differential treatment – are of particular relevance to the HIPCs. Market restrictions and subsidies in agriculture are the single most important external impediment to development in HIPC countries given that they are mainly commodity exporters. Many HIPCs suffer disproportionately from HIV/AIDS and would stand to gain from an accord on medicines. And HIPCs could benefit from targeted special and differential treatment as they integrate with the global economy.

The second requirement from rich countries is to meet their commitment on debt relief. The G-8 and other industrial countries have reaffirmed this commitment, demonstrated most recently in the replenishment of the HIPC Trust Fund. The goals of the HIPC Initiative and the attainment of the MDGs can only be met if developed countries are able to raise the quantity and quality of aid. The HIPC Initiative will reduce the average debt servicing burden to less than 2 percent of GDP by 2005. But on average, HIPCs will need 10 percent of GDP or more in net transfers if they are to lay the foundations for sustained growth and accelerate progress towards the MDGs. When the debt service burden was in excess of 5 percent as it was before the launch of the Initiative, debt and debt service reduction was the first priority. Looking ahead, it will be additional financing in suitable terms and form that will be key.

Leading up to and since Monterrey developed countries have announced commitments, that if implemented could increase ODA by some $16 billion. The immediate challenge is to ensure that these commitments are translated into actual outlays. Although these new commitments fall short of the total aid that is estimated to be needed to reach the MDGs, HIPCs could benefit greatly if these new commitments and existing aid programmes are more effectively deployed than the past.

In particular, efforts to target aid to the poorest countries and those with credible reform programmes, to make aid more predictable, to make it more fungible including for recurrent cost financing, to harmonise and simplify donor practices as was committed at the Rome High Level Forum and to untie aid could ensure that there is true additionality to debt relief and that the HIPCs have adequate resources to meet the MDGs. Of critical importance to HIPCs also is that this aid be provided on terms that assures long-term debt sustainability.

Long-term debt sustainability depends primarily on growth and export prospects, on vulnerability to shocks, and on the magnitude and terms of new financing. The ability of the government to mobilise resources will additionally determine the sustainability of the government's own finances. This assessment has necessarily to be done on a case-by-case basis. There are a few HIPCs where growth prospects and government finances have strengthened to the point and where the export base has developed and diversified sufficiently to warrant borrowing that could take the NPV debt-to-exports ratio above the 150 percent target adopted by the HIPC Initiative. But for most HIPCs the magnitude of net external financing needed and the high degree of vulnerability warrants a very cautious approach to new borrowing. For some time, the bulk of the financing needs of HIPCs must be provided by grants. While HIPCs can also rely on the concessional lending by IDA, for some the ability to utilise their full allocations of IDA will be constrained without increasing the grant element for these countries. The decision to allow up to 40 percent grants for the most vulnerable countries in IDA-13 was an important step in this regard.

There are two important policy challenges ahead therefore for the HIPC countries and for the international community. The first is to be able to curb inappropriate borrowing. Experience has shown that HIPCs can quickly build up their debt to cope with shocks or to finance increased public investments through borrowing. HIPC countries need to have rigorous debt management systems in place to avoid any borrowing that can threaten long-term debt sustainability. Where warranted, the international community needs to be able to help meet exceptional financing needs with grants or concessional loans so as to prevent a recurrence of debt overhangs. A second challenge is to ensure that HIPCs can have long-term access to external financing in suitable amounts and concessionality. As HIPCs undertake policy and institutional reforms to accelerate progress towards the MDGs the international community needs to be prepared to step up its external financing. As the experience of the Education Fast Track Initiative shows the international architecture is not yet in place to ensure that such matching support will be available when needed. While some HIPCs will be able to absorb some amounts of new borrowing, for most HIPCs the bulk of such financing has to be provided on grant terms.

3 Conclusion

The HIPC Initiative, when fully implemented, will reduce the debt burden of HIPC countries to levels comparable to other low-income countries. The HIPC process will also have set in motion the strengthening of policies, governance and institutions in HIPC countries that can pave the way for accelerated growth and faster progress towards the MDGs. But none of the HIPCs will reach a majority of the MDGs without scaling up their own efforts and without complementary support from the international community. In addition to steps to improve market access and elimination of subsidies in agriculture, more and better aid is a critical priority for HIPC countries. As a group, they will remain more dependent on new external financing than any other group and such financing has to be provided on grant or highly concessional terms. Without concerted and comprehensive actions on the part of both the HIPC countries and the international community, the benefits of the debt relief effort of the 1990s will not endure and the HIPC group will be the most at risk in not reaching the MDGs.

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7

Debt Relief from a Donor Perspective: The Case of the Netherlands

Geske Dijkstra[1]

The Netherlands recognised relatively early that the debts of the international financial institutions (IFIs) were a heavy burden on developing countries. Loans from the IFIs were not only part of the solution, but also part of the problem. Out of the 1.6 billion Euros that the Netherlands spent on debt relief between 1990 and 1999, an increasing share was spent on multilateral debts. Multilateral debt relief included contributions to the "Fifth Dimension" of IDA (providing funds to repay earlier non-concessional IBRD loans to enable IDA-only countries to repay past IBRD loans), to Multilateral Debt Funds under supervision of the debtor country from which multilateral debt service was paid, and more recently to the HIPC Trust Fund.

From 1995 on, the Dutch government also played an active role in promoting the creation of the Enhanced HIPC Initiative in 1999. The Dutch Minister for Development Cooperation supported, for

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[1] This chapter is largely based on an evaluation of debt relief carried out for the Policy and Operations Evaluation Department (IOB) of the Ministry of Foreign Affairs of the Netherlands. The text draws heavily on the second synthesis report of that study, *Results of International Debt Relief* (IOB, 2003), written by the author, but also on the first synthesis report, *Dutch Debt Relief Policy* (IOB, 2002, only available in Dutch), written by Dick van der Hoek, IOB Inspector and responsible for the overall study.

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example, the Jubilee 2000 activities for putting pressure on the G-7 meeting in Cologne, where the principal decision in favour of Enhanced HIPC Initiative was made (IOB, 2002). Once the Enhanced HIPC Initiative had been approved in the Annual Board Meetings of the World Bank and the IMF in September 1999, the Dutch officials expressed themselves firmly in favour of the Initiative. The Netherlands immediately began providing resources to the HIPC Trust Fund managed by the World Bank, and urged other donors to do the same. The Dutch view was that multilateral debt relief and debt relief from the IMF should be financed as much from bilateral contributions as possible, in order to not reduce the IFIs' lending capacity for the poorest countries. Furthermore, these contributions should be in addition to the regular foreign aid flows from bilateral donors. By August 2001, the Netherlands was the biggest contributor to the HIPC Trust Fund in terms of actual disbursements, bypassing much larger countries like the US, Japan and the UK (IOB, 2002).

The Dutch government also strongly supported the conditions for the HIPC Initiative. It expected that the requirement of elaborating a PRSP with participation of civil society would bring an end to the traditional form of policy conditionality by the IFIs, leading to more "ownership" of the receiving country. In addition, it would enhance participation and democracy, and favour increased donor coordination in aid. PRSPs also became the leading device for Dutch bilateral development cooperation policy in general.

In sum, the Netherlands embraced the HIPC Initiative as an ideal solution to the debt problems of the poor countries, and appears to be the ideal donor in relation to this HIPC Initiative. This chapter aims to add some question-marks to each of these statements. It brings to the fore some problematic aspects of the HIPC Initiative, aspects related to the international decisionmaking processes on debt and debt relief and to the financing of debt relief, in particular: (i) the role of donors and creditors in perpetuating debt problems by providing (the means for) new loans, thus raising the question of the coherence of debt relief policies; (ii) the lack of additionality of debt relief; and (iii) the problematic consequences of setting conditions for debt relief.

These three issues are discussed in the following sections, and where possible illustrated for the case of the Netherlands. Whether debt relief is additional to other aid flows may vary from donor to donor, and therefore this is examined extensively for the Netherlands. The last section summarises the changes that should be made around HIPC debt relief and around aid in general.

The analysis in this chapter is largely based on an evaluation of debt relief carried out for the Policy and Operations Evaluation Department (IOB) of the Ministry of Foreign Affairs of the Netherlands. This evaluation comprised a study of Dutch debt relief policies, a literature review and econometric study, and eight country studies: Bolivia, Jamaica, Mozambique, Nicaragua, Peru, Tanzania, Uganda and Zambia, out of which three were field studies (Mozambique, Nicaragua and Tanzania).

1 The Role of Donors in Perpetuating Debt Problems

One of the characteristics of current debt problems of the poorest countries is that they have persisted for such a long time, despite successive rounds of debt relief. Today's heavily indebted poor countries have, on average, experienced low growth rates in the past 20 years, and they still need more debt relief. Two different conclusions can be drawn: (i) some argue that the international community has done far too little in alleviating the debt burden of poor countries, giving them debt relief just sufficient to enable them to pay their primary creditors, but not enough to allow their economies to grow, let alone to reduce poverty (Hanlon, 2000; Sachs, 2002); (ii) others conclude that too much relief has already been given, and that more debt relief is likely to perpetuate bad policies (Easterly, 2002).

Thus, the primary question is whether the HIPC Initiative will be no more than just another round of rescheduling, unable to end the debt burden and stop low growth in poor countries, either because it delivers too little debt relief or because it delivers debt relief leading to a continuation of bad policies. Many authors (also in this book) have already pointed to the optimistic GDP and export growth projections in the Debt Sustainability Analyses (DSAs) made for HIPC countries at decision point, which suggest that future debt sustainability is unlikely. But much less attention has been given to the numerator of the debt sustainability ratios, in other words, the creditor side of the loan relationships. All DSAs project large amounts of new loans. Although these loans are expected to be mostly concessional (that is, on soft conditions), the past ten to fifteen years have shown that this is no guarantee for the ability to repay these debts.

The IOB evaluation of the results of international debt relief efforts in the 1990s has shown that the volume of new loans to the eight countries involved in the study exceeded debt forgiveness during the 1990s. Eighty per cent of the new loans to governments originated from the international financial institutions.[2] The share of multilateral debts in total debts increased during the 1990s, and since multilateral creditors are preferred creditors, the actual debt service paid did not decrease. The large volume of new loans was one of the reasons for the limited effectiveness of debt relief. Long-run debt sustainability analysis shows that continuation of the trends of the 1990s with respect to new loans and export growth will quickly make debts unsustainable again (IOB, 2003).

Why was there so much new lending to these countries during the 1990s? The most general reason is that the international community apparently posed the wrong diagnosis of the debt problems in the early 1990s. It acted as if countries had a temporary liquidity problem. The response to a temporary liquidity problem was to grant debt reschedulings and to extend new loans and grants, so that countries could grow out of their debt problems. However, these countries in fact had a solvency problem.

This wrong diagnosis was very much related to the fact that the creditors were official governments and multilateral agencies, and not private institutions. During the 1980s, the debt crisis was primarily a problem of private creditors, mainly big US and European banks. They began to withdraw from the debtor countries, no longer providing them with new money and writing down on the old loans. Yet, and partly due to large incoming official flows, they managed to get large flows of debt service out of these countries (Dooley, 1994). Official creditors, on the other hand, never wrote down on their dubious loans. There are no agencies enforcing them to do so, so both the bilateral export credit agencies (ECAs) and the multilateral institutions always maintained the fiction that they would receive the full value of their claims. Since the IFIs are preferred creditors, they indeed received most of their debt service in time, but these were often paid for from bilateral

2 Only in Nicaragua this figure was lower, at about 60 percent.

grants to these countries. While during the 1980s official creditors bailed out private creditors, during the 1990s and especially in low-income countries, bilateral creditors and donors bailed out multilateral creditors. This implies that the IFIs experienced moral hazard. They could continue their imprudent lending behaviour much longer than if they had had to suffer the consequences of non-repayment themselves.

The bailing-out of the IFIs, thus allowing moral hazard, is only one of the ways in which bilateral donors helped to maintain this flow of new loans and, as a consequence, the debt problems. The bilateral donors also made these loans possible. In fact, bilateral donors and creditors paid in three different ways for the concessional loans of the IFIs. First, they contributed to the special funds of the IFIs that provide the interest subsidies or other means to make these concessional loans possible. Bilateral donors like the Netherlands spend part of their development grants as contributions to the ESAF Trust Fund of the IMF, to the IDA Replenishment Fund and to similar funds of the regional multilateral development banks, such as the Fund for Special Operations of the IADB. Second, the preferential status of the IFI loans reduced the value of bilateral debt claims, making more bilateral debt relief necessary than otherwise would be the case. Third, bilateral donors provided debtor countries with programme aid or even direct debt relief on multilateral debt service so that these countries can pay the multilateral creditors.[3] This is not an efficient use of aid money. Although most bilateral donors themselves only provide grants to these heavily indebted countries, they perpetuate debt problems indirectly through these three mechanisms. In a way, they throw "good money" after "bad money".

Over the course of the 1990s, Dutch contributions to the IDA Replenishment Fund amounted to 1.6 billion euros (IOB, 2002, p. 112), or about equal the entire amount of Dutch debt relief in the same period. The Netherlands also contributed substantially to the subsidy account of the Enhanced Structural Adjustment Facility (ESAF) of the IMF. With the creation of the original HIPC Initiative in 1996, and since debt relief granted by the IMF had to be financed partly from this Trust, its name was changed into an ESAF-HIPC Trust in 1996, and later into the PRGF-HIPC Trust. In 1996,

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[3] In the context of the HIPC Initiative, they contribute to the HIPC Trust Fund.

the Dutch Minister of Finance announced another large contribution to this Trust, making the Netherlands the largest donor. In 1999, when the Enhanced HIPC Initiative was launched, the Netherlands immediately became the biggest contributor to the HIPC Trust Fund of the World Bank – at least, in terms of actual disbursements. The Netherlands had disbursed $138 million, plus $34 million through the European Union (IOB, 2002, p. 111). The US had disbursed $122 million, Canada 114 and the UK 90 million.

Will these debt dynamics change with the HIPC Initiative? At first glance, there is a change. With the HIPC Initiative, the IFIs bear part of the costs of debt relief for the first time. Further consideration of the financing of debt relief on multilateral debt, however, reveals that bilateral contributions are still essential. As regards the World Bank, IBRD profits only provide for $2.15 billion of the expected total costs of $8.1 billion. The remaining $5.95 billion will have to be met from bilateral contributions in the framework of the 14th IDA Replenishment, planned for 2005 (IMF and IDA, 2002b). If that additional money is not forthcoming, debt relief will be at the expense of new World Bank loans to the poorest countries.[4] So far, bilateral donors have pledged more than $2.5 billion to the HIPC Trust Fund, but that money is used to finance debt relief for other multilateral development banks.

The costs of the HIPC Initiative for the IMF are estimated at $2.7 billion (SDR 2.2 billion), a large part of which will have to be met from the IMF's own resources. At first, the IMF planned to sell part of its gold reserves for the purpose, but the major gold-producing countries objected to this. The IMF then proceeded to 'off-market' gold sales, meaning that a quantity of gold is to be sold symbolically and then bought back in the framework of a transaction with a member state. This 'paper' sale and repurchase of gold enables its book value to be upgraded. The investment income on the proceeds of this upgrading, to the amount of SDR 1.8 billion, is then used for the HIPC Initiative. The disadvantage of using the bookkeeping profit of symbolic gold sales is that a slightly larger part of IMF's capital becomes illiquid (Felgenhauer, 2000), thus reducing the basis for future loans. To restore this lending capacity,

[4] If the funds do become available, it will probably be at the expense of bilateral grants (see the remarks on additionality in the next section).

the IMF would have to appeal to its shareholders, i.e. the bilateral donors.

Given that bilateral donors are expected to finance part of the relief given on IFI debts, moral hazard can continue. It is already clear that multilateral institutions continue to provide new loans to countries that have reached their decision point of the HIPC Initiative. Although these loans are concessional and have a grace period of 10 years (World Bank and other development banks) or five years (IMF), they will eventually increase debt service. If problems should re-appear regarding debt sustainability, and debtor countries are again unable to pay off their debts, it is likely that the multilateral institutions will again be preferred creditors and that bilateral donors once again will have to step in with relief on multilateral debt service.[5]

In sum, the success of the HIPC Initiative requires that the volume of new loans from the IFIs be reduced. A simple measure is to have the multilateral development banks extend only grants to these poor and heavily indebted countries, as the Meltzer commission has proposed for IDA (International Financial Institution Advisory Commission, 2000). Another measure to stop the IMF from long-term lending to poor countries, is to abolish the PRGF. This has also been proposed by the Meltzer commission, on the very justifiable grounds that these poor countries do not suffer from temporary liquidity or balance of payments problems, which was the original rationale for IMF borrowing. There are more reasons for abolishing the PRGF, and these will be discussed below.

2 The Lack of Additionality

Debt relief provided under the HIPC Initiative was meant to be additional to regular aid flows, so that debtor countries would experience an increase in net transfers. The HIPC Review of the Operations Evaluation Department (OED) of the World Bank, however, showed that net transfers to all HIPC countries between 1995 and 2000 were lower than between 1990 and 1995 (OED,

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[5] In two out of the four countries that had reached their completion points under the HIPC Initiative in 2000 and 2001, debt-to-export ratios had again become unsustainable in 2002 (IMF and IDA, 2002a).

2003, p. 53). The decline was even greater for all developing countries, indicating that there has been some redistribution from non-HIPC to HIPC countries in the second half of the 1990s, within a declining total aid budget. This redistribution seems to have continued in recent years: after 1998, the 26 HIPC countries that have reached their decision points in the HIPC Initiative, have experienced an increase of their relative share in total net transfers to developing countries (OED, 2003, p. 54). Nevertheless, these 26 countries received a smaller net transfer in 2000 than had been anticipated in the decision point documents.

Although the lack of additionality of HIPC debt relief is a cause for concern, it should be put in perspective and should not lead to the conclusion that the HIPC Initiative is not effective. I will argue, first, that there may be more additionality than the figures on aggregate net resource flows indicate. Second, even if there would be no additionality of debt relief, debt relief may have positive effects on the recipient countries. And third, even if debt relief to HIPC countries leads to a declining aid flow to other, less indebted countries, the effect on those less indebted countries may ultimately be positive. I first elaborate on these three issues and then look at the additionality of Dutch debt relief, in particular.

The first issue is that additionality may be greater than if we just look at the developments in net resource flows. What matters for the additionality issue is what would have happened to aid volumes in the absence of debt relief. In all eight countries of the IOB evaluation, debt relief of the 1990s was found to be additional to regular aid flows in the 1990s (IOB, 2003). As the OED review also observed, one reason may be that there has have been a redistribution of net flows from countries with low debts to countries with high debts (see also below). Another reason is that debt relief is not financed from aid budgets and there are two possibilities here.

First, creditors that were no longer donors, such as Russia or some OPEC countries, granted a large amount of debt relief. Debtor countries were usually not paying on these debts since they were not getting new resources from these creditors. The only way for the creditors to see at least part of their money back, was to substantially reduce the debt stocks. These debt stock reductions are not included in the OED data on net resource flows, thus reducing registered debt relief.

Second, creditors that are still donors may provide part of debt relief from budgets other than their aid budgets. There are again two possibilities here. Some modalities of debt relief do not qualify as net Official Development Assistance (ODA) according to the definition of the Development Assistance Committee (DAC),[6] and are by definition additional. The other possibility is that debt relief does qualify as ODA, but that institutional arrangements within donor countries imply that it is financed from other budgets than the aid budget. In this case, debt relief is also additional since the net ODA flow from the donor country is larger than if only the foreign aid budget would be taken into account. This may be different from country to country and we therefore examine the additionality of debt relief for the case of the Netherlands in the next section.

The second issue is that debt relief may also have a positive influence on economic growth and, ultimately, poverty reduction for other reasons than its effect on the reduction of the debt service flow. Most publications only pay attention to a possible "flow effect" of debt relief. However, the reduction in the debt stock may also be important. A lower debt stock may lift the "debt overhang" that hampers private investment and may also prevent good government policies. Debt relief on a debt that was unpaid before is not leading to additional resources, but may be very positive if it reduces the debt overhang. This argument has recently also been brought forward by Birdsall and Williamson (Birdsall and Williamson, 2002).

Third, there is the issue of the redistribution between recipient countries. To the extent that debt relief is financed from aid budgets and does substitute for other ODA flows, this may imply redistribution from countries with low debts to countries with higher debts. This appears to have been the case in the 1990s (Birdsall *et al.*, 2001; OED, 2003). To the extent that countries with higher debt levels had less adequate policies and governance – and the OED Review establishes this to be the case, using the "Country Policy and Institutional Assessment" measure of the World Bank – this points to adverse selection in the aid allocation: Countries with better policies and governance get less aid. However, rather than being concerned that a HIPC Initiative does not bring additional resources to the highly indebted poor countries, one could see this

[6] DAC is the Development Assistance Committee of the OECD, the Organisation for Economic Cooperation and Development.

particular lack of additionality at the country level also as a positive feature of the Initiative. In other words, even if all debt relief would be financed from aid budgets so that there is no aggregate additionality, it could still be beneficial for the less indebted countries if it brings an end to this adverse selection. Once the debt levels have been lowered, there is no longer any reason for the international community to support these highly indebted countries more than other countries. These other countries may suffer temporarily, but they may ultimately benefit. However, this pleads for granting debt relief in a once-and-for-all fashion. Since the financing of multilateral debt relief has not been secured yet, this is difficult to achieve in the current situation. According to current HIPC arrangements, that extend multilateral debt relief over fifteen to twenty years, this may reduce aid flows to other countries for a long period.

3 The Financing of Debt Relief in the Netherlands

The Netherlands has been active in alleviating all types of debt in developing countries: bilateral, multilateral and private. Debt relief on multilateral debt, via takeovers of debt service to the IFIs or via contributions to the HIPC Trust Fund of the World Bank, is included in the definition of ODA and has always been financed from the aid budget. The same holds for debt relief on private debts of developing countries, in particular the contributions to the World Bank "Debt Relief Facility" that financed debt buybacks of private debts. In these two cases there is no additionality. Yet, debt relief on private debts has been effective in decreasing debt stocks and in reducing the debt overhang of developing countries.

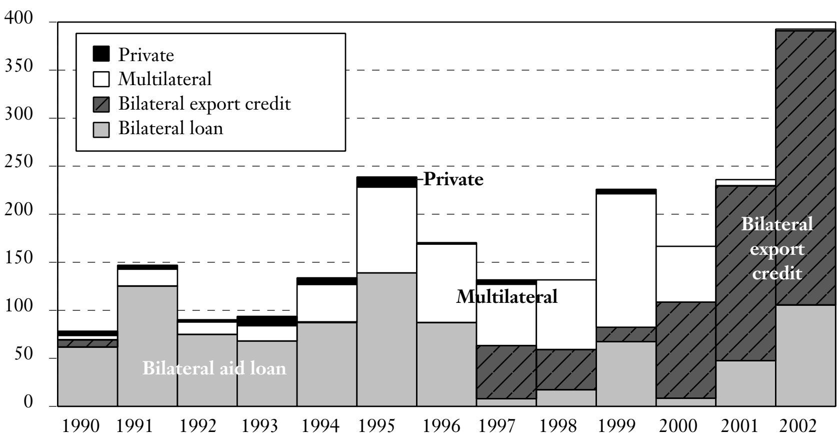
The case of relief on bilateral debt is more complicated. There are two types of bilateral debt: debts following from bilateral aid loans, and debts following from the state insurance of export deliveries from donor countries dealt with by export credit agencies (ECAs). With respect to alleviating the latter, the Netherlands followed international agreements in the Paris Club, the informal group of creditors dealing collectively with bilateral debts of developing countries. With respect to the former, the Netherlands has often gone beyond the agreements in the Paris Club.

Until 1997, the classification of what was aid in the Netherlands had no relationship with the international ODA definitions. In 1997, however, the institutional environment of Dutch aid policies changed drastically. The size of the Dutch aid budget became fixed as 0.8 percent of GNP and became fully linked to the official ODA definition. This change had substantial consequences for the amount of aid available apart from debt relief, i.e. for the additionality issue.

Dutch Export Credits

Until 1997, the forgiveness on export credits as agreed upon in the Paris Club (33 percent and later higher percentages of debt service due in a certain period) was financed from general budget resources,[7] and not from the budget for development cooperation – in spite of the fact that it classifies as ODA. This means that this debt relief, amounting to about 180 million Euros, was fully additional. After 1997, this forgiveness on commercial credits was financed from aid budgets, precisely because this modality of debt relief classifies as ODA and as a result of the changed determination of the Dutch aid budget.

Figure 1 Dutch Debt Relief Financed from the Aid Budget, by Type of Debt, 1990-2002
(millions of current euros)



Source: IOB Database debt relief, extended up to 2002.

7 With a small exception in 1990, as can be seen in Figure 1. See IOB, 2002.

Figure 1 shows that the amounts of debt relief for export credits became substantial from 1997 onwards. In the years 2000-2002, when the Enhanced HIPC Initiative began to be implemented, the volume exploded, leading to an all-time high of total debt relief in 2002. This means that much less money became available for regular aid.

The Dutch case raises the question to what extent the DAC is right in classifying all relief on export credits as ODA. Most debts began to be restructured in the 1980s or early 1990s. The part of debt service due that was not forgiven was rescheduled and capitalised so that it maintained its real value. However, the Dutch export credit agency, NCM, had to compensate the insured Dutch firm immediately for the full value of both the forgiven and the rescheduled parts of debt service due, and the Ministry of Finance in turn had to compensate the NCM. Given that the Netherlands had and still has a cash budget, this implies that debt relief has already been registered as expenditure. Nevertheless, the Dutch state maintained the full claim on the developing country for the rescheduled part of debt service due; there was no writing down or writing off – in spite of the fact that it could be foreseen at the time that the debtor country would never be able to repay the debt fully.

With the HIPC Initiative, creditor countries finally recognise that debts will not be repaid, and Paris Club creditors agreed to forgive about 90 percent of the remaining bilateral debt stocks. However, a large part of these debt stocks consists of earlier rescheduled and capitalised debt service due. In the Dutch case, this implies that at least part of the "debt relief" that is now granted just implies a compensation of the Dutch Ministry of Finance for expenses made a long time ago, namely when it had to compensate the NCM.

The IOB evaluation also brought to the fore that the Ministry of Finance even charges the aid budget for more than the amount paid to the NCM in the past (IOB, 2002). This is, first, because the bill includes the own risk of the exporting firms that the NCM never had to pay to the involved firms. Second, the Ministry of Finance does not subtract the insurance premiums paid to NCM by those firms from the amount charged to the aid budget. The bill presented by the Ministry of Finance includes the full nominal value of the debt – since that appears to be allowed by the DAC definition of ODA. These two issues in particular have raised a lot of attention in

Dutch press and in Parliament. In response, the government wrote a letter to the DAC asking for clarification of the ODA definition on this point. In the expectation of a reply from the DAC, members of parliament have not pushed the government yet to make an end to this hollowing out of the aid budget on the basis of what could be considered a weird application of the DAC definition.[8] More in general, one can wonder whether debt relief should be classified as ODA if it concerns debts that, in the absence of debt relief, should have been written down a long time ago, namely, when it was clear that it would never be paid fully. Birdsall and Williamson have also made this argument (2002). Furthermore, and more fundamentally, one can question whether the Ministry of Finance should bail out the NCM in the first place. As Jubilee Netherlands has pointed out time and again, this bailing-out is in contradiction with an EU directive which states that all national export credit agencies (ECAs) should be self-supporting. This directive obviously aims to avoid unfair competition between firms from different European countries, and implies that ECAs should finance their unrecoverable claims from the premiums received and not from government (aid) budgets.

Bilateral Aid Loans

With respect to the Dutch relief on bilateral aid loans, the situation is almost the reverse since this forgiveness is treated differently in the DAC definition of ODA. The forgiveness of interest on aid loans classifies as net ODA. The forgiveness of amortisation on aid loans classifies as *gross* ODA, but there has to be an imaginary compensating flow so that registered *net* ODA is not increased. Otherwise, the same aid loan would be registered as ODA twice: first when the original concessional loan is extended, and then when it is forgiven. However, in the absence of this forgiveness and assuming the debt service would be paid, there would be an amortisation flow from debtor to creditor so that net ODA would be lower. Therefore, net ODA is higher with debt relief than without, *if* the amortisation due would be paid (Renard and Cassimon, 2000). In sum, forgiveness on both interest and on amortisation lead to

8 In November 2003, a parliamentary motion to ask the government to end this practice of including own risks and premiums, has been kept on hold.

higher registered net ODA as compared to the case in which this debt service would have been paid. Conversely, if debt service would *not* have been paid in the absence of relief, this debt relief does *not* increase registered net ODA. This appears to be fully correct. The DAC definition of ODA, however, does not mention the case of forgiveness on principals, i.e. debt stocks that are not yet due. This means this forgiveness is *not* counted as ODA. If and to the extent that one assumes that donors forgive these principals only if they do not expect to be repaid, this accounting is consistent with the rules on forgiveness of debt service due.

In the Netherlands, until 1997 all forms of relief on bilateral debt were financed from the aid budget, despite the fact that part of it does not classify as ODA. The latter holds, in particular, for forgiveness on principals. After 1997, the forgiveness of remaining stocks of aid loans shrunk to almost zero, because paying this from the aid budget would have reduced the budget to below the fixed norm of 0.8 percent GNP. Forgiveness of debt service on aid loans continued after 1997.[9] Yet, the share of forgiveness on aid loans decreased as of 1997 (Figure 1).

In the context of the HIPC Initiative, creditor countries have promised to forgive 90 percent of remaining stocks of bilateral aid loans. The Dutch Minister for Development Cooperation has announced the intention to grant forgiveness on the full stock of bilateral aid loans in these HIPC countries. For some countries (the – so far – nineteen countries that have a special status within Dutch development cooperation), this is done at decision point; for the other HIPCs, this is done at completion point. Since this stock forgiveness does not classify as ODA, the costs involved are financed from the general budget, and this debt relief has thus become additional to regular aid. This debt relief is not included in Figure 1, but the amounts are much smaller than the amounts involved in forgiveness on export credits. Many aid loans had already been forgiven before 1999.

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[9] In practice, the annual development cooperation budget of 0.8 percent GNP is topped up by the amortisation payments due. If these payments are forgiven, these amounts are not forthcoming and the actual budget remains at the 0.8 percent. According to the DAC rules, gross ODA is then increased by the forgiven amortisation amounts and this is corrected by a counteracting flow so that in the end net ODA is again equal to 0.8 percent of GNP.

From: HIPC Debt Relief - Myths and Reality
FONDAD, February 2004, www.fondad.org

The – generous – Dutch contributions to the HIPC Trust Fund have been presented by the Dutch government as "additional" to regular aid flows and as helping to guarantee additionality of multilateral debt relief. The – then – Dutch Minister for Development Cooperation even urged other bilateral donors to also make their contributions to the HIPC Initiative "additional". However, since the Dutch contributions have been financed from the aid budget, they can only be called additional by changing the usual definition of that concept. In practice, the Dutch government defended its position by pointing to the growing aid budget during those years (1999-2001) since it was fixed as 0.8 percent of GNP, and GNP was growing. However, contributions to the HIPC Trust Fund have reduced the amount of aid that would have been available for other destinations in the absence of these contributions. This policy probably contributed to the observed redistribution of flows among recipient countries from low-debt countries to high-debt countries. In addition, this policy implies a redistribution of flows between donors, in the form of a re-allocation of aid money from the bilateral channel to the multilateral channel. The Dutch effort to guarantee "additionality" of debt relief of the IFIs in fact boils down to maintaining the regular lending volume of the IFIs while reducing the bilateral grant volume. This is another way in which donors contribute to the maintenance of debt problems and does not seem to be an appropriate use of aid money.

In sum, it is important that official creditors are also forced to write down and eventually write off their bad loans, and that the costs involved should not be charged to aid budgets. The case of the Netherlands shows that this could be achieved by changing the ODA definition: debt relief on export credits of countries that are suffering from debt problems already for a long time, evidenced in series of debt reschedulings, should not be registered as ODA. These debts should be written down at the moment that countries are unable to pay and can be expected not to pay the full value of their debt service due.

4 Adverse Effects of Conditionality

The last problematic issue of the HIPC Initiative is its conditionality. Before the HIPC Initiative, the most important condition for debt relief was that there should be an agreement with the IMF regarding structural adjustment. The original HIPC Initiative required countries to have successfully completed an IMF programme for three years in order to reach the decision point, and to do so for another three years to reach the completion point. Basically, the first HIPC Initiative evaluated past performance. With the Enhanced HIPC Initiative, however, an additional condition was set for reaching the decision point. Countries had to elaborate a strategy for reducing poverty (Poverty Reduction Strategy Paper, PRSP) and had to do so with civil society participation. Furthermore, countries must begin to implement the strategy in the "interim period" (between the decision and completion points of the HIPC Initiative), to be evidenced by Progress Reports, so that the international community can be sure that debt relief given in this period is used to implement the PRSP. The interim period is no longer fixed at three years, but became "floating", depending on the country meeting the conditions for it. Apart from implementing the PRSP, the country must also execute a number of more conventional reforms and must be on track with an IMF agreement. The conditions for debt relief are thus more comprehensive than in the 1990s and also far more elaborate than those of the original HIPC framework.

Strangely enough, in roughly the same period, broad consensus was reached in academic circles (Collier *et al.*, 1997; Killick, 1998) that it was useless to draw up conditions ex ante because they were ineffective. Governments generally implement policies only if they had already intended to do so. The broad acceptance of the increased ex ante conditionality for the Enhanced HIPC Initiative can therefore be considered as inconsistent with this academic consensus. In fact, policymakers also broadly accepted the ineffectiveness of policy conditions. The case of the Netherlands illustrates this.

In 1998, the Dutch Minister for Development Cooperation embraced the Assessing Aid Report of the World Bank (World Bank, 1998), which was another study concluding that ex ante policy conditionality was ineffective. The report became the basis for a far-reaching change in bilateral aid policy. From then on, Dutch bilateral aid would be focused on those countries that had demonstrated to be able to carry out good policies and to maintain good governance in the past. Aid would thus become more selective.

Despite this, the Dutch government welcomed the requirement of a PRSP and its accompanying required participatory processes as additional ex ante condition for the Enhanced HIPC Initiative. Not long after that, PRSPs even became the basis for Dutch bilateral development cooperation in general.

Basically, there are three arguments against setting conditions for debt relief to the poorest countries. A first and important reason is that debt relief does not always provide additional resources to the recipient countries. On top of the substitution for regular aid that may be involved, even debt relief itself does not always free resources as compared with the situation without debt relief. If debt relief concerns debts that were not paid before, the country does not receive additional money. As the IOB evaluation concludes, a large part of relief from the Paris Club in the past concerned debt service that would not have been paid in the absence of this relief (IOB, 2003). This may still hold for part of the Paris Club relief under the Enhanced HIPC Initiative.

The HIPC Initiative may even lead to increased debt service actually paid to particular creditors, for example, if because of the comprehensiveness of the Initiative creditors must now be paid that were not paid before, or if bilateral grants to take over debt service to the IFIs are no longer forthcoming (and not replaced by budget support). Debt service may also increase due to the particular scheduling of multilateral debt service. The HIPC relief on multilateral debts is computed as a fixed percentage of debt service due; if debt service due increases, for example because the loan volume from development banks increased ten years before,[10] the debt service that must annually be paid also increases.

In all of these cases, debt relief does not free resources and the requirement to "spend" these resources for poverty reduction policies may imply higher government expenditure and a higher deficit, possibly (depending on how the deficit is financed) provoking higher inflation, or may be at the cost of other government expenditure. This may also occur in countries that have expended little on the social sectors so far (Berthelemy, 2001). The

10 Soft loans from multilateral banks have a ten-year grace period, so debt service payments begin after that period. In Nicaragua, for example, loans from the IFIs were vetoed by the US between 1983 and 1990, and their volume almost annually increased since 1990. This implies that debt service due increases almost every year during 2000-2010.

HIPC Initiative forces such countries to spend more on social projects from their tax income, possibly at the risk of a greater deficit or at the cost of expenditure that would have had more effect on economic growth.

A second reason is that setting conditions for debt relief could be termed bad donor governance since it implies the "double tying" of aid[11] – a practice that has been condemned by donors in the context of the Special Programme of Assistance to Africa (SPA). In the case of debt relief, conditions are first set for the original (aid) loan, either in the form of policy conditions but more likely in the form of particular projects to be carried out, or of particular goods to be purchased from the donor country. Recipient countries are then unable to repay these loans. This points to donors and creditors having made the wrong lending decision: their expectations may have been too optimistic or perhaps they recommended inappropriate destinations (projects or supplies) for the use of this money. Instead of accepting their incorrect expectations or mistakes and taking their losses, donors and creditors now pose new conditions to the relief on these same loans. This is double tying of the same aid money, and can therefore be termed bad donor practice. Even worse, there is no guarantee that the mistakes of the past will be avoided: are donors sure that conditions will have beneficial effects this time?

The third argument against conditions for debt relief is that the setting of conditions to aid in general is ineffective, as already discussed above. Furthermore, the setting of conditions for debt relief may even have perverse effects. Earlier research demonstrated that two factors are responsible for the fact that setting conditions has little effect. One is that governments are not likely to carry out policies if they are not convinced themselves that these are the right policies, and second is that the donors seldom impose real sanctions on lack of performance. These two factors probably still hold for the PRSP process.

As for the first, it has been shown that domestic political factors are most important in determining government policies (Dollar and

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[11] Double tying means that donors set conditions for the same amount of aid money twice. For example, a donor provides foreign exchange with which the country must purchase donor countries' export goods. The recipient government must sell these goods in the local market, and the donor then requires that the proceeds in local currency be used for particular projects.

Svensson, 1998). If countries are under severe pressure to reach an agreement with IMF and World Bank, for example because of a high debt, conditions may be implemented but often only cosmetically or partially, or additional measures may be taken to undo the effects of these earlier measures, for example, by granting many exemptions to trade liberalisation. The Enhanced HIPC Initiative required governments to elaborate a PRSP and to do so with participation of civil society. The idea was that countries would write and own their own strategies. For this reason, PRSPs would only have to be "endorsed" by staffs of the IFIs, not "approved". In practice, however, recipient countries did not observe any difference in endorsement and approval. The three field studies carried out for the IOB evaluation showed that the fact that strategies had to be approved detracted from their degree of ownership, and also reduced the chances for real participation (IOB, 2003). NGOs in the three investigated countries felt that they had not been given a real chance to influence the strategy, and that they had not had much actual influence. In Mozambique, NGOs maintained that they were not really interested in influencing the strategy because it was also in their interest that the country would qualify for the Enhanced HIPC Initiative as soon as possible. Without country ownership, it is also less likely that strategies will be implemented. In two out of the three countries examined, differences were observed between what the government set out to do in the PRSP, and what the government actually did (IOB, 2003).

The second cause for the ineffectiveness of policy conditions according to earlier research is that actual sanctions are seldom imposed. They are not applied because of the conflicting interests of individual donors, who have an interest in continuing the aid relationship, or they have little effect because donors do not act collectively. The HIPC Initiative guarantees greater donor co-ordination, but it still seems difficult to impose sanctions that are effective. Partly owing to pressure brought to bear by international NGOs such as Jubilee 2000 and EURODAD, it is in the interest of the international community that many countries should be admitted to the HIPC Initiative. In December 2000 in particular, this led to the approval of PRSPs that did not really deserve it, or to the admission of countries that could only stay on track with the IMF with the aid of numerous artificial waivers. Later, in Nicaragua for example, the full PRSP was approved due to the political interests of one or two donors, although the donor community as a whole considered the government in power to be corrupt and not interested in the reduction of poverty (Dijkstra and Evans, 2003).

Therefore, although in theory the setting of conditions guarantees that countries receiving debt relief will "use" it to combat poverty, in practice this is not certain. Furthermore, as long as debt relief remains tied to policy conditions, it is unlikely that donors will apply greater selectivity. Debt relief is in itself so necessary and inevitable that even countries where corruption is rife, those with poor policies, and those where genuine participation does not exist, have received it or will eventually do so. Highly indebted countries will also continue to receive more aid than others do. Because countries are highly indebted, the cycle of debt relief, aid and new loans will continue, also in countries with bad policies and bad governance. Such adverse selection will only be put to an end if debt relief is no longer tied to conditions. Donors can then start to be really selective in the allocation of new foreign aid disbursements.[12]

The IMF plays a crucial role in maintaining this adverse selection. As a creditor, the IMF has an interest in reaching a new agreement with these countries. A new PRGF agreement brings a small new IMF loan, but more importantly, frees the way for debt relief and for other and much larger multilateral and bilateral programme aid, with which earlier IMF loans can be paid. The IMF is therefore at the same time gatekeeper for international finance, and beneficiary of such finance (White and Dijkstra, 2003). This implies that there is a conflict of interest. This conflict maintains the adverse selection in the aid allocation. Donors look at the IMF for giving a stamp of approval on countries that are performing well and thus deserve programme aid (debt relief and budget support), while the Fund is least likely to bring this selectivity into practice. This is another reason for proposing that the IMF no longer provides long-term concessional finance to poor countries.

[12] Donors can of course still support the poor people in these countries with bad policies and bad governance, but they will no longer support the governments of these countries.

5 Conclusions

This chapter has analysed three problematic aspects of the HIPC Initiative: the fact that donors continue to extend large amounts of loans, thereby perpetuating debt problems, the limited additionality of debt relief, and the conditionality associated with the HIPC Initiative. The first two imply that debt problems are not likely to be solved by the Initiative, the third implies that adverse selection in the aid allocation is likely to continue.

All of this points to a need to change international decision-making around the HIPC Initiative and around aid in general. In the preceding pages, some recommendations for changes have been made. These include:

- All IDA loans should become grants;
- The IMF should no longer provide long-term finance to the poorest countries;
- A mechanism must be created to ensure that official creditors, just like commercial creditors, write down on bad loans;
- The writing down on bad loans should not be charged to aid budgets;
- The debt relief on export credit debts that should long have been written off, no longer counts as ODA – in line with the DAC definition of ODA in the case of debt relief on bilateral aid loans;
- Debt relief to the poorest countries should be given without policy conditions.

Given that chances for success of the HIPC Initiative are grim as a result of the problems analysed in this chapter, we hope that donors and creditors begin to consider these possible changes seriously.

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HIPC Debt Relief: Myths and Reality

Edited by Jan Joost Teunissen and Age Akkerman

Will the HIPC debt relief initiative finally solve the debt problem that the Highly Indebted Poor Countries are facing since the 1980s? Is there any guarantee that a country's external debt remains sustainable after the completion of the HIPC programme?

Towards the end of the 1980s, concern about the rising debt problems of poor African countries prompted a few international experts to advocate effective debt relief to low-income countries. Early FONDAD publications contributed to putting pressure on western policymakers to consider substantial debt relief for poor countries.

In 1996, the international community introduced the Heavily Indebted Poor Countries Initiative to provide a permanent exit from the repeated debt reschedulings of HIPCs in the Paris Club and bring their external debts to sustainable levels. However, in 2004 the HIPC debt problem has still not been solved.

This book presents a thorough analysis of the successes and failures of the HIPC Initiative and provides a wide range of suggestions of what needs to be done.

Issues addressed include the question of whether debt relief should be linked to IMF conditionality, the need for including domestic debt in assessments of debt sustainability, the (mis)use of aid funds for debt relief and repayment of export credits, and the bailing-out of IMF loans by donor countries.

With a view to the future of low-income countries, the book relates the HIPC Initiative to the Millennium Development Goals and warns that debt relief can only provide a fraction of the funds required for reducing poverty and avoiding a new build-up of unsustainable debt.

The book spells out how genuine debt relief could contribute to poverty reduction and economic growth in poor developing countries.

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