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Assessing the HIPC Initiative: The Key Policy Debates

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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

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[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).

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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).

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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-

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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