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.

From: HIPC Debt Relief - Myths and Reality
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

---

[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

[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.

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

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

---

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

[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)

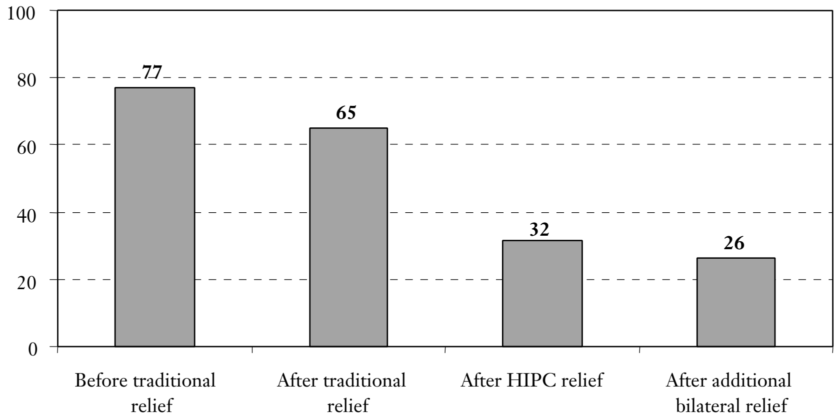
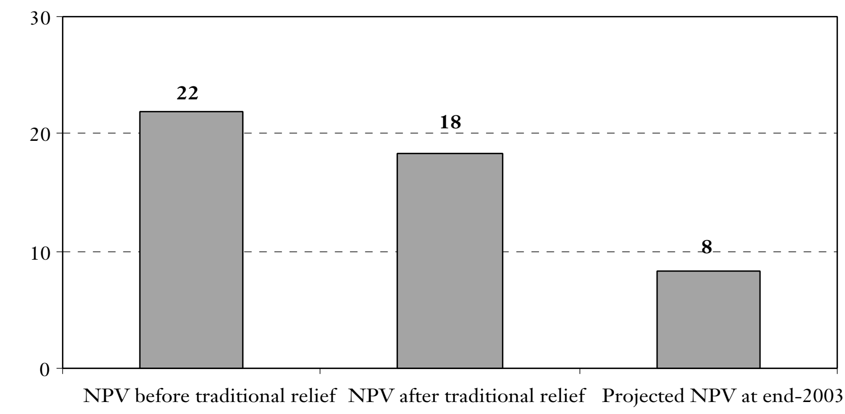


Figure 3 NPV of Debt for Completion Point Countries
(in billions of dollars, in 2002 NPV terms)



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.

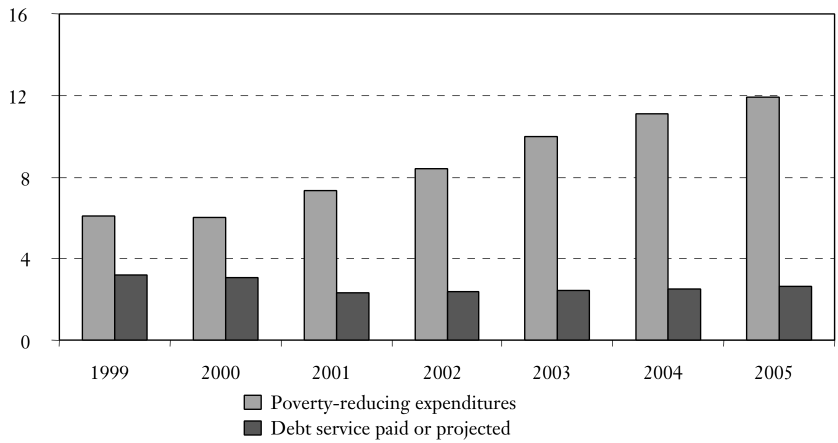
Poverty-reducing expenditures in the 27 countries that have reached the decision point were almost four times as great as debt service payments in 2002 (Figure 4).[12] Annual debt service by these countries is projected to be about 30 percent lower during 2001-2005 than in 1998 and 1999, freeing about $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

---

[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

---

[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]

---

[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

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.

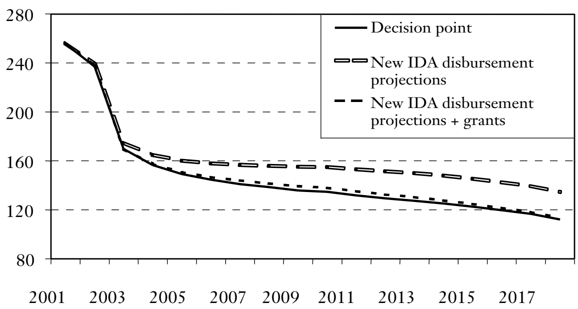
1 See IMF and World Bank, "External Debt Management in HIPCs", SM/02/92, March 22, 2002 (http://www.imf.org/external/np/hipc/2002/edm/032102.htm).

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.