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From Debt Relief to Achieving the Millennium Development Goals

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

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

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

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

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

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

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

Note:
* Lower-middle-income.

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

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

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

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

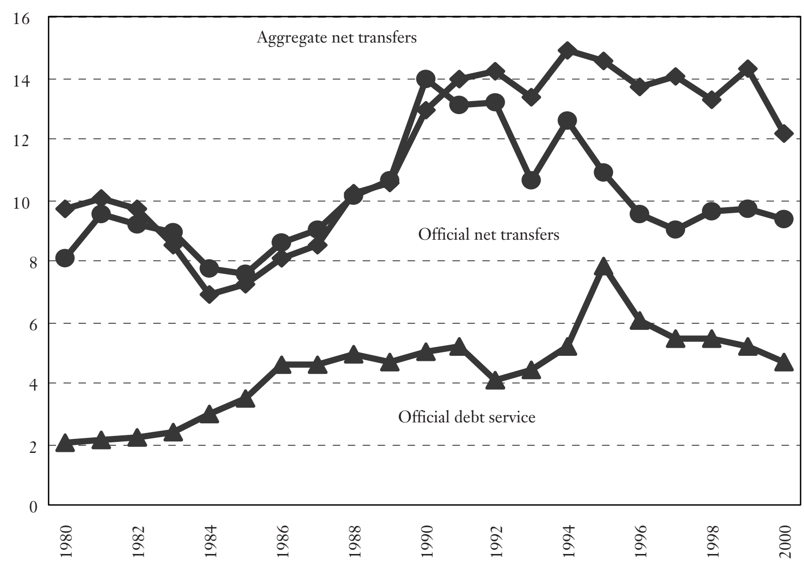
Note:
*Conflict-affected countries.

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

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

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

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



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

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

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

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

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

2 Achieving the MDGs

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

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

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

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

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

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

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

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

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

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

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

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

3 Conclusion

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

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