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New Proposals on Attaining Debt Sustainability after the HIPC Initiative

- While the Enhanced HIPC (Heavily Indebted Poor Countries) Initiative has served to substantially reduce debt burdens, some individual HIPC countries either continue to be highly indebted or have again reached high levels of debt.
- These high debt levels are due first to persistent structural problems in HIPC countries and second to exogenous shocks. Most low-income countries will for this reason be unable to generate, on their own, the financial resources they need to reduce poverty and to counter exogenous shocks.
- If the Millennium Development Goals (MDGs) are to be met by 2015, the low-income countries will need more external resources than they have been receiving. If the resources provided are loans, the objective of simultaneously reaching debt sustainability and the MDGs will be just about tantamount to squaring the circle.
- The ongoing debate on achieving debt sustainability centers on five proposals:

1. A framework developed by IMF and World Bank designed to ensure long-term debt sustainability in low-income countries.
2. A new US official proposal on 100% debt relief for the HIPC countries, to be provided by the multilateral financial institutions.
3. A new official UK proposal on 100% debt relief for low-income countries, to be provided by the multilateral financial institutions.
4. A new official UK proposal on financing the MDGs: the International Finance Facility (IFF). Under the IFF donors would issue bonds in international capital markets, i.e. themselves incur debt in favor of developing countries.
5. A new IMF financial instrument designed to mitigate exogenous shocks and containing an element of flexibility regarding repayment modalities for the case that exogenous shocks should occur.

The Present Debt Situation in the HIPC Countries

Viewed in terms of **debt stocks**, the HIPC Initiative has on the whole been very successful. According to IMF and World Bank estimates, the debt stocks of the 27 eligible HIPC countries is set to be reduced by roughly two thirds, measured in terms of Net Present Value (2003), from US$ 80 billion to US$ 26 billion. The most important indicator used for assessing debt sustainability in the framework of the Enhanced HIPC Initiative is a country's debt-to-exports ratio (in %); and it is essential that a figure of 150% will not be exceeded here. According to IMF and World Bank estimates, the corresponding figure for the HIPC countries was 274% prior to the Enhanced HIPC Initiative, and the figure is expected to have declined to 128% in 2005.

However, the results differ substantially for individual HIPC countries. On the one hand, the debt stocks of some countries have declined considerably in connection with the debt relief provided in the framework of the Initiative, and they are expected to remain low, as e.g. in the cases of Ghana, Madagascar, Mali, or Tanzania.

On the other hand, the debt-to exports ratio of other HIPC graduates either continues to be at or has once again reached levels of over 150%, and is thus in excess of the debt-sustainability limit set by IMF and World Bank in connection with the HIPC Initiative (see Table). Furthermore, IMF and World Bank estimates already indicate that seven of the 13 HIPC countries that have not yet graduated from the program will, in the medium-term, be faced again with a situation of unsustainable debt when they have completed the Initiative.

Table: Debt to exports ratio (Graduated HIPC Countries, in %)

	2000	2001	2002	2003	2004*	2005*	2006*
Ethiopia[1]	170	184	246	268	**277**[3]	291	
Bolivia[2]	199	**100**	120	133	147	153	160
Burkina Faso			170	**172**	178	159	152
Mozambique	270	**179**	187	208	173	171	
Nicaragua[2]			161	174	**187**	192	189
Uganda[1]	167	**185**	235	223	212	205	199

Source: IMF, various country reports

* Estimates

1 These data refer to years which begin in the mid of the year, e.g. 10 July 2000 to 9 July 2001.

2 Based on a three-year average of exports of goods and services on the previous year, e.g. export average over 2000-02 for the Net Present Value (NPV) of debt-to-exports ratio in 2002.

3 Bold numbers show that completion was reached in the respective year.

Debt-service payments (interest and redemption) as a share of exports, government revenues, or GDP are the best indicators to measure present debt burden. Since, however, many concessional loans provide for a redemption-free period of several years, debt-service payments reflect only present – not future – debt burdens. This indicator should therefore be used together with the above-mentioned indicator in conducting debt-sustainability analyses.

Viewed in terms of debt-to-exports ratios, the debt service of the HIPC countries declined on average from 16% to 10% between 1998/99 and 2003. In most HIPC countries the values for this indicator have declined substantially and continue to show a falling trend. Bolivia and Uganda must be seen as exceptional cases here. Debt service in relation to government revenues likewise declined substantially in the same period: from 24% to 15%.

Box: The HIPC Initiative

Following nearly two decades of repeated attempts to reduce the external debt burden of the world's poorest countries, the World Bank and the IMF launched the HIPC Initiative in 1996. In 1999 the heads of government of the G7 countries, meeting in Cologne, reached agreement on the Enhanced HIPC Initiative (HIPC II). Compared with the original initiative, HIPC II involves more countries by lowering eligibility thresholds, provides for more speedy implementation of the process, and establishes a closer link between poverty reduction and debt relief by requiring debtor countries to work out and present Poverty Reduction Strategies (PRS). The HIPC Initiative may thus be seen as the first systematic and coordinated procedure for low-income countries that involves all public and private creditors: For the first time in history multilateral donors are participating in a debt-relief procedure.

Their high foreign debt and their low incomes as well as their reformed economic policies and the Poverty Reduction Strategy Papers (PRSPs) they have presented thus far have qualified 27 countries for participation in HIPC Initiative, i.e. these countries have reached the so-called decision point. By September 2004 a total of 14 countries had concluded the Initiative, that is, they had reached the so-called completion point and were thus eligible for, and obtained, comprehensive debt relief. Apart from these 27 countries, there are 11 others that may be seen as potential candidates for the HIPC Initiative, although they have not yet qualified for the Initiative for reasons bound up with their political instability and inconsistencies in their PRSPs.

Causes of Debt

For one thing, persistent external debt with public-sector donors is due to the failure of the HIPC countries to mobilize sufficient own funds; the reason is that the internal conditions given at present – e.g. unstable macroeconomic frameworks, underdeveloped business and financial sectors, and deficits in good governance and rule of law – are unsuited to the purpose. Moreover, structural problems constitute to present an obstacle to attracting sufficient private foreign capital – in particular in the form of foreign direct investment.

For another, HIPC countries are often unable to meet their debt-service payments on external loans because their external repayment capacity is impaired by low export earnings. These low export earnings are due to structural problems in the HIPC countries themselves as well as to external shocks. Relatively underdiversified economic and export structures and a dominance of primary goods tend to raise these countries' vulnerability to exogenous shocks that may occur in the form of fluctuations in prices for raw materials, of natural disasters, or of currency and interest-rate shocks.

In 1999 nearly two thirds of graduate HIPC countries earned over 50% of their export revenues with three or fewer products. Moreover, in the later 1990s primary goods accounted for a share of 60% of total exports in least developed countries (LDCs). Most of these exports are agricultural goods and are thus vulnerable to natural disasters.

The HIPC Initiative's Contribution to Resolving Structural Problems

On the one hand, these structural problems cannot be eliminated with the aid of the HIPC Initiative over the short/medium-term; but on the other hand, by requiring HIPC countries to prepare PRSPs and to implement them for at least one year, the HIPC Initiative does offer a framework for the long-term resolution of these problems. Moreover, credits from the Poverty Reduction and Growth Facility (PRGF) are conditioned on reforms designed to ensure macroeconomic stability.

Furthermore, structural reforms are anchored both in the PRSP framework and in the so-called social and structural completion point triggers. These triggers are designed to promote pro-poor growth and to ensure that HIPC countries spend more on poverty-reduction measures. The triggers include e.g. measures in the fields of governance, budget management, health, education, or agriculture.

While it is generally too early to attempt an assessment of the long-term impacts of the PRSPs and macroeconomic reforms involved, it can be said that thus far the PRSPs have only in part tackled the structural problems concerned. Evaluation reports published by the IMF and the World Bank have come to the following findings on the issue of structural reforms: Even though increased expenditures in social sectors – e.g. for improvements in the education and health sectors – do promote long-term growth, too little attention has been paid to pro-poor growth approaches. The unified requirements for PRSPs often mean that insufficient consideration is given to country-specific conditions. Furthermore, the linkages between micro- and macroeconomic reforms are inadequate.

On the other hand, though, these structural problems have existed for decades now, and PRSPs and PRGFs will be unable to resolve them in the short/medium-term. Most HIPC countries will for this reason not be able to generate the funds needed for poverty reduction from their own budgets. It would therefore be important to increase net transfers and step up the grant share of credits provided to low-income countries. In other words, even relatively low debt-service payments will have to be refinanced through official development assistance (ODA).

New Proposals on Achieving Debt Sustainability

The ongoing debate on ensuring that low-income countries retain their debt sustainability even after they have completed the HIPC Initiative centers on five proposals.

1. Debt Sustainability Framework

At their 2004 annual meeting, the Bretton Woods Institutions presented a revised proposal on ensuring long-term debt sustainability: the Debt Sustainability Framework in Low-Income Countries. The framework will be used to identify critical debt situations in the future. It would thus have a preventive function. Furthermore, the framework is to serve as a guideline for the relative composition of credit and grants.

Unlike the Enhanced HIPC Initiative, the framework involves a country-specific approach for assessing debt sustainability based on threshold values for debt indicators, including e.g. debt or debt-service payments in relation to exports, GDP, or government revenues. Instead of automatically applying the same values for all countries concerned – as was done under the HIPC Initiative – the new framework will factor in the quality of national institutions and economic policies, which will be measured with the aid of the internal rating procedure (Country Policy and Institutional Assessment

Index, CPIA) used by the International Development Association (IDA) for granting credit.

If countries do well on the CPIA index, higher debt is seen as sustainable because better institutions and economic policies are seen as a positive measure of a country's repayment capacity. Three country types are distinguished in this connection: countries with poor, moderate, and good performance on the CPIA Index. This also creates an incentive for debtor countries to improve the quality of their institutions and economic policies.

Furthermore, debt-sustainability analyses will also factor in external shocks by using stress tests based on econometric simulations to expose countries to various economic shocks, including e.g. currency or interest-rate shocks. These analyses indicate what debt levels may be reached when external shocks occur, and these risk factors can then be included in a debt-sustainability analysis.

Debt sustainability analyses will play a key role in coming to decisions on loans and grants provided in the framework of the IMF and World Bank facilities, as they will e.g. in the provision of financial resources in the framework of the IDA and the PRGF Facility.

In view of these features, the framework may be seen as a real step forward as compared with the HIPC procedure, and the framework represents a guideline well suited for coming to decisions on providing financial resources to low-income countries. It can be used both for county-specific analyses and forward-looking analyses. By comparison, the HIPC Initiative was designed only to reduce existing debt burdens.

Still, the framework does have several weaknesses: Domestic debt should be included in the analysis as a threshold value, and not merely be considered in the accompanying debt sustainability analysis, even though it may be difficult to compile data on domestic debt. The reason why it should be included is that domestic debt has an immediate influence on repayment capacity for external debt. Financial resources needed to service domestic debt are of course not available to repay external debt.

Moreover, at the 2004 annual IMF/World Bank meeting the high threshold values came in for criticism for working counter to the aim of ensuring long-term debt sustainability in low-income countries. Low-income countries with good institutions may have debt-to-exports ratio of up to 300%. This figure is twice as high as the threshold value used for debt-sustainability assessments under the HIPC Initiative. For this reason the US and the UK presented new proposals at the annual IMF/World Bank meeting aimed at providing further debt relief for the HIPC countries as a means of ensuring their long-term debt sustainability; the proposals provide for conversion into grants of most of the funds made available to these countries.

2. The Official US Proposal on 100% Debt Relief

US Treasury Secretary John Snow recommended that the most important multilateral financial institutions grant an immediate 100% cancellation of the debts of all HIPC countries. Accordingly, by the target date set for the achievement of the MDGs, the year 2015, all graduate HIPC countries would be given grants instead of credits from the IDA and the African Development Fund (AfDF), a member of the African Development Bank Group. Under the proposal the net flows of funds provided to the HIPC countries would at least not decline in volume. Whether these net flows should not instead be increased is a matter that is still under discussion.

Although these higher grants would certainly contribute to ensuring the long-term debt sustainability of the HIPC countries, this positive aspect is at the same time overshadowed by some serious negative aspects: The proposal does not provide for a country-specific assessment based on indicators for debt sustainability; under it all HIPC countries that have not yet reached the completion point would be granted 100% debt relief, and all graduate countries would generally receive only grants up to the year 2015.

Assuming constant aggregate net flows to low-income countries, an increase in the flows for the HIPC countries would amount de facto to a reallocation of grants in their favor. Countries that are not participating in the HIPC Initiative and, thanks to their better debt management or the preventive measures they have adopted to mitigate external shocks, have made less use of external funding would in this case be not given 100% grants. In other words, the proposal would tend more to punish countries with a good economic performance record and to create inappropriate incentive structures (moral hazard). This would furthermore serve to distort ODA allocations in favor of the HIPC countries.

For these reasons 100% grants should not be provided across the board, and such grants should be graduated and keyed to the need to achieve debt sustainability and linked to the implementation of PRSPs as well as to PRGF conditions and country ratings on the CPIA Index.

Assuming constant aggregate net flows to developing countries and higher grants to the HIPC countries, the revolving funds available for further lending – e.g. in the framework of the PRGF or the IDA facility – would necessarily decline, and this, in the long-term, would deplete the revolving funds available for further lending. If the facilities are not topped up with fresh funds, IMF and World Bank would, in the long-term, be unable to use the facilities to support as many countries as at present, and this would also weaken the financial position of the two financial institutions vis-à-vis other donors.

3. The Official UK Proposal on 100% Debt Relief

UK Chancellor of the Exchequer Gordon Brown likewise proposed that the multilateral donors grant 100% debt relief. Unlike the US proposal, though, the British proposal would extend to all low-income countries, provided they are able to guarantee that the funds thus made available were used for purposes of poverty reduction.

To ensure that, in view of increasing volumes of grants in relation to credits, the move does not drain the facilities of the financial institutions, the proposal calls on bilateral donors to top up the facilities. The proposal also calls for an upward revaluation of the IMF's gold reserves in order to finance the PRGF facility. Since at present the market value of the IMF's gold reserves is roughly eight times higher than their book value, there would be sufficient financial leeway here.

4. A New Proposal on Financing the MDGs: the International Finance Facility (IFF)

It is as yet unclear how 100% debt relief, together with the future grants set to be provided by the multilateral financial institutions, would be financed. One drawback of the UK finance minister's proposal to use the proceeds from a revaluation of the IMF's gold reserves to bolster the PRGF is that the funding of this IMF facility would be dependent on the development of the gold price, and thus uncertain.

At present the most promising and realistic approach to financing development programs must be seen in the International Finance Facility (IFF) proposed by the UK. Under this proposal the donors would borrow in the international capital markets to the benefit of the developing countries. The IFF would issue donor-backed medium-term bonds in the international capital markets. The proceeds would then be made available to low-income countries in the form of grants, using the existing donor channels.

The intention would be to use this approach to prefinance a share of ODA over the coming 30 years via the international capital markets. This would allow the donors to provide grants on short notice which would have to be repaid by donors only when the bonds reach maturity; in other words, the donors could initially provide the low-income countries with more capital than they pay into the IFF (an approach known as front loading). Since the IFF bonds would be secured through implicit official donor government guarantees, they could be issued at the best terms possible (AAA rating). The IFF could be headquartered with one of the multilateral financial institutions.

Donors should be expected to bear the additional burden posed by front loading and such government guarantees only if full debt relief and the provision of grants prove to be the right approach to strengthening the long-term repayment capacity of these low-income countries and/or resolving their structural problems, reducing their need for financial resources over the long-term. Another problem that must be anticipated in connection with implementation is that many industrialized countries, including e.g. Germany, are faced with major long-term budgetary risks and for this reason will be reluctant to assume additional debt in favor of the developing countries.

5. IMF Financial Instruments Designed to Mitigate Exogenous Shocks

Measures by both developing countries and donors are required to mitigate external shocks. The only mitigation strategy that focuses on the causes of exogenous shocks must be seen in efforts to diversify the exports of the HIPC countries. This in turn presupposes reform of economic structures, itself a very protracted process. Developing countries largely lack any other instruments to mitigate exogenous shocks because their institutions and markets – e.g. their financial or insurance markets – are insufficiently developed. Moreover, the experiences made with stabilization funds (e.g. EU Stabex, 1975-2000) have not been encouraging.

In view of the fact that on their own the HIPC countries will not be able to mitigate exogenous shocks over the medium-term, the donors should provide them with support. On the one hand, donors could give these countries technical support in developing functioning insurance systems and financial markets. On the other hand, donor countries should offer financial facilities designed to mitigate shocks. These should have the following features:

- Short-term availability: HIPC countries should be able to obtain the financial resources they need quickly and without any complicated procedures.
- Medium-term repayment periods: Concessional credits should have medium-term repayment periods to ensure that the countries concerned are not forced to repay their credits on the heels of an exogenous shock.
- A high degree of concessionality: These credits should have a high degree of concessionality since the HIPC countries will not be in a position to repay loans at market terms.

The IMF does have a facility designed to mitigate exogenous shocks – the **Compensatory Financing Facility**. Its purpose is to provide support in cases involving temporary export losses or excessively high expenditures for grain imports. However, this facility has not been drawn on since 2000, the reasons being that it is linked to a good number of conditionalities, the loans provided under it are not concessional in nature, and the funds are not made available on short notice.

When external shocks occur, the approach frequently used is to provide either PRGF credits or Stand-By Arrangements that are not explicitly designed to mitigate exogenous shocks in the short term. In cases of natural disaster the IMF can provide emergency assistance, which is disbursed quickly and is intended to be available to address medium-term balance-of-payments problems. Furthermore, in cases of exogenous shocks HIPC countries can apply for debt relief in addition to that agreed on at the decision point (topping up). Three graduated HIPC countries have already received such additional aid: Burkina Faso, Niger, and Ethiopia.

The IMF could introduce new instruments suited to mitigating exogenous shocks; one possibility would be an instrument with a flexible element as regards repayment modalities (terms, interest rates, grant elements) for the case that shocks should occur (fluctuations in primary commodity prices or exchange rates). To implement such an instrument, it would be necessary to define what countries are to have access to such financing facilities as well as to decide on the criteria and the amounts that would be made available. An automatic mechanism of this kind would make it possible to alter repayment modalities rapidly and on the basis of transparent rules.

Conclusion

On their own, low-income countries are unable to generate sufficient financial resources to reach the MDGs by 2015 and will therefore continue to be dependent on concessional donor credits and grants. The countries currently participating in the HIPC process should first be required to complete the initiative in keeping with the present criteria. If the debt relief they are granted in the framework of the initiative fails to lead to debt sustainability, they should be provided topping up. Any immediate debt relief for these countries would undercut the HIPC Initiative and encourage moral hazard. The new Debt Sustainability Framework is well suited for coming to country-specific assessments of debt sustainability in graduate HIPC countries and in other low income countries as well as to formulating decisions on the relative composition of credits and grants. Granting 100% debt relief would not be compatible with this framework.

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