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New Ways of Achieving Debt Sustainability beyond the Enhanced HIPC Initiative

In 1996 the Heavily Indebted Poor Countries (HIPC) Initiative was launched by the Bretton Woods institutions to reduce the external debt burden of low-income countries (LICs) to sustainable levels in a reasonably short period of time because debt constitutes an obstacle to sustainable economic growth and poverty reduction. In some HIPCs, however, debt sustainability has been in danger despite debt relief under the HIPC Initiative. Debt relief is a necessary but not a sufficient condition for development. It can do no more than play a catalytic role. The question, then, is how to achieve debt sustainability beyond the HIPC Initiative.

Debt sustainability is an important indicator of the achievement of the Millennium Development Goals (MDGs) by 2015.[1] Unless financing resources for low-income countries (LICs) are extended significantly and used more efficiently, achieving both – debt sustainability and the MDGs – may prove to be something akin to squaring the circle.

The main reason why there is a need to reduce debt in LICs is that external debt is a major cause of poverty. External debt affects growth, and growth affects poverty.[2] The link between external debt and growth is established through the investment channel. Debt service diverts budgetary resources from investments needed to support economic growth.[3] In addition, the private sector may be discouraged from investing if governments need to service debt rather than provide a satisfactory environment for investments in such things as good infrastructure. Investors often regard high indebtedness as due to economic problems and bad governance. This is one reason why a highly indebted country does not attract investment. High debt may, moreover, trigger capital flight.[4]

Key Features of the Enhanced HIPC Initiative

It was because traditional debt mechanisms designed to addressing the debt burden of LICs proved incapable of attaining sustainable debt levels that the IMF and the World Bank set up the HIPC Initiative in 1996. While the goal of the original Initiative was to reduce high external debt as a constraint on economic growth, the Enhanced Initiative, established in 1999, sought to provide a viable exit from debt rescheduling, to promote growth, and to free financial resources for more social spending to reduce poverty.

This mechanism establishes the first comprehensive framework for poverty reduction that includes all creditors – multilateral, Paris Club, and other official bilateral and commercial creditors – with the aim of reducing the external debt of the world's poorest and heavily indebted poor countries. Accordingly, the Initiative has established a new paradigm for international action.

First Stage of the HIPC Process

The Initiative breaks down into two stages. The first stage of the Initiative includes a three-year period in which candidate countries are expected to establish the track record needed to qualify for the HIPC Initiative. During this stage the Paris Club provides flow rescheduling on Naples terms[5] and other bilateral and commercial creditors should offer at least a similar treatment. The eligibility criteria for the HIPC Initiative are as follows.[6]

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[1] United Nations: United Nations Millennium Declaration, Resolution Adopted by the General Assembly, New York, 18 September 2000.

[2] See Boileau Loko, Montfort Mlachila, Raj Nallari, Kadima Kalonji: The Impact of External Indebtedness on Poverty in Low-Income Countries, IMF Working Paper, WP/03/61, Washington DC 2004; David Dollar, Aart C. Kraay: Growth is Good for the Poor, World Bank Policy Research Working Paper, No. 2587, Washington DC, April 2001.

[3] See Paul Krugman: Financing vs. Forgiving A Debt Overhang, in: Journal of Development Economics, Vol. 29, North-Holland 1988, Elsevier Science Publishers B.V., pp. 253-268, 1988.

[4] See S. Ibi Ajayi, Mohsin S. Khan: Introduction, in: Ibi Ajayi, Mohsin S. Khan (eds.): External Debt and Capital Flight in Sub-Saharan Africa, Washington DC 2000, IMF-Institute, pp. 1-8, 2000.

[5] On Naples Terms means a reduction of debt service of up to 67 per cent on a net present value basis.

- HIPCs' per capita income needs to be below US$ 895.
- Eligible countries need to be in receipt of International Development Association (IDA) credits and they are expected to have a strong track record of performance under IMF / World Bank supported programmes.
- HIPCs need to prove a track record in employing strategies focused on poverty reduction and sustainable economic growth rates. A candidate country is expected to develop, in cooperation with civil society, a Poverty Reduction Strategy Paper (PRSP).
- The country has to be heavily indebted, i.e. even after full use of traditional debt-relief mechanisms candidate countries would still not be in a position to reach a sustainable external debt level.

Having concluded the first stage, a candidate reaches the so-called decision point, at which the boards of the World Bank and IMF decide, on the basis of a comprehensive debt sustainability analysis (DSA), whether the country has qualified for the Initiative.[7] This analysis would reveal whether the adoption of a Paris Club stock-of-debt operation under Naples terms and comparable treatment by other bilateral and commercial creditors would be sufficient to attain a sustainable level of external debt. If the country's debt is seen as sustainable, the country would not qualify for the HIPC Initiative. Otherwise, a country would be deemed eligible for assistance under the Initiative.

Second Stage of the HIPC Process

During the second stage of the Initiative, the country concerned establishes a second track record by adopting the policies agreed upon at the decision point. Paris Club creditors would provide flow reschedulings on Cologne terms,[8] and other bilateral and commercial creditors would offer debt relief on comparable terms. IMF and World Bank would supply interim assistance. Other multilateral creditors would supply interim debt relief on a discretionary basis. The duration of the second stage to reach the so-called completion point has not yet been fixed, but it is contingent on the successful implementation of the PRSPs, Poverty Reduction and Growth Facilities (PRGFs), as well as on reaching the structural trigger points. These triggers are meant to promote pro-poor growth and to ensure that HIPC countries increase their spending on poverty-reduction measures. They include policy measures in the fields of governance, budget management, health, education and agricultural reform.[9]

At the completion point, all creditors provide debt relief without any further policy conditionality. The floating completion point gives good performers the opportunity to reach this point earlier than bad ones. The stock-of-debt operation on Cologne terms committed to by Paris Club creditors would then take effect. Under the Initiative the international community can provide additional debt relief at the completion point beyond that committed at the decision point for the case that there have been any exogenous shocks; this is referred to as topping up.[10] Until September 2004 three countries received additional debt relief: Burkina Faso, Ethiopia and Niger.

Their high levels of debt and their promising economic policies and poverty-reduction programmes have qualified 27 countries for participation in the HIPC Initiative. By September 2004 a total of 14 countries had completed the Initiative and have thus been accorded comprehensive debt relief. A further 13 countries reached the decision points and have therefore been accepted for participation in the Initiative. However, because of their political instability and some inconsistencies in their PRSPs, 11 countries failed to qualify.

The sunset clause was intended as a means of identifying the end of the Initiative, since moral hazard problems in particular indicate the need to prevent it from becoming a permanent facility. Under this clause, all countries reaching the decision point would be allowed to complete the Initiative. Countries not reaching the decision point would no longer be allowed to take part in the Initiative. Since 1996 the clause has been extended three times. In September 2004, at the annual meetings of the Bretton Woods institutions, the development committee agreed to re-extend the sunset clause by two years until the end of 2006 to give more countries an opportunity to take part in the HIPC Initiative.

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[6] See Anthony R. Boote, Kamau K. Thugge: Debt Relief for Low-Income Countries and the HIPC Initiative. IMF Working Paper, WP/97/24, Washington DC 1997; David Andrews, Anthony R. Boote, Syed S. Rizavi, Sukhwinder Singh: Debt Relief for Low-Income Countries. The Enhanced HIPC Initiative, International Monetary Fund, Pamphlet Series No. 51, Washington DC 1999.

[7] See Anthony Boote, Kamau K. Thugge, op. cit.

[8] Cologne terms means 90 per cent debt reduction on NPV basis or higher, if necessary.

[9] See IMF: Annual Report 2001, Washington DC 2002.

[10] For a detailed description of the procedure of the topping-up approach, see IMF, IDA: Enhanced HIPC-Initiative – Completion Point Consideration, Washington DC, August 17, 2001.

Definition of Debt Sustainability

A country's external debt may be seen as sustainable if the country is able to meet all of its current and future debt-service payments without having to restructure its debt, and without impairing its economic growth prospects. Since this definition does not include domestic debt, it does not extend to fiscal debt sustainability.[11]

Even though the main objective of the HIPC Initiative is to help countries to reach sustainable levels of external debt, their ability to repay their debt is greatly influenced by their fiscal situation. Domestic debt should therefore be taken into account. The HIPC Initiative should reduce debt-service obligations to a level at which the country concerned is able to meet its debt service without any need for future rescheduling or debt forgiveness.[12]

Indicators of Debt Sustainability

It is generally difficult to identify the "correct" indicators for a given country's debt sustainability. Even assuming that the "correct" indicators are chosen, there are still problems involved in defining the "correct" threshold values for a country's debt sustainability.

In general, debt stocks or, alternatively, debt-service payments (numerator) are related to variables that reflect a country's potential repayment capacity (denominator); the latter may include, for example, gross domestic product (GDP), development of exports or, instead, government revenues.[13]

In the framework of the enhanced HIPC Initiative, one of two alternative indicators is used to assess debt sustainability.

- A country's debt stock (net present value) is not in excess of 150% of its export earnings.
- Its debt stock (net present value) does not exceed 250% of government revenues. The underlying assumption here is that a country's exports-to-GDP ratio is at least 30% and its ratio of government revenues to GDP is at least 15%.[14]

Included in the numerator of an indicator, the debt stock is a variable well suited to measuring the burden represented by debt-service payments. Either the present value or the net present value (NPV) of debt stocks can be used for this purpose. But in view of the fact that a certain share of external credit is provided on concessional terms, the present value is not a suitable variable for measuring a country's debt burden. The net present value is used because it takes account of the degree of loan concessionality involved. The market interest rate is used to discount the sum of all future debt-service obligations (interest and redemption) down to their present value. If the interest rate on a loan is below the commercial level, the net present value of a debt will be lower than its present value. The differential between these two variables is, finally, the grant component.[15]

Debt sustainability cannot be measured adequately on the basis of only one indicator for all countries. To cite an example, a very open economy may have a low level of debt measured in terms of export earnings but a very high level of debt in relation to government revenues. For this reason several indicators should be used to assess debt sustainability.

While using a small set of simple, practice-oriented indicators is a good way to ensure transparency and fairness, a uniform set of indicators may be unable to reflect conditions in given countries adequately. Another factor in need of critical review is that the threshold values for participation in the enhanced HIPC Initiative and the possible levels of debt relief are not based on theoretical analyses. Indeed, the threshold values used consist of empirical data derived from the most important IMF and World Bank indicators, which have in the past caused financial difficulties for many debtors.

Debt-service payments are taken into account in the debt sustainability analysis, but this indicator is not part of the decisive indicator for qualification for the HIPC Initiative. This is the best indicator for measur-

[11] See IMF, IDA: The Challenge of Maintaining Long-Term External Debt Sustainability, Washington DC, April 17, 2001, p. 4.

[12] See World Bank: Debt Relief for the Poorest. An OED Review of the HIPC Initiative. Washington DC 2003.

[13] See Kathrin Berensmann: Die Zukunft der HIPC-Länder: Ist Schuldentragfähigkeit langfristig erreichbar? in: Dirk Messner, Imme Scholz (eds.): Zukunftsfragen der Entwicklungspolitik, Baden Baden 2004, Nomos Verlagsgesellschaft, pp. 315-328.

[14] See IMF: Annual Report 2001, op. cit.

[15] The main problem in calculating net present value is the choice of an appropriate discount rate, since net present value fluctuates substantially in the wake of changes in discount rates. A discount rate of this kind should be both risk-free and stable and geared to world-market interest rates. It is because of these criteria that interest rates with a five-year term – known as currency-specific commercial interest reference rates (CIRRs) – are used for government bonds issued by industrialised countries in secondary markets. Another problem is that, while calculations of net present value indicate future debt-service payments, they do not include factors such as growth rates that influence repayment capacity. And while net present value can be used to identify problems associated with debt-service payments, it does not indicate when those problems are likely to occur. See IMF, IDA: Debt Sustainability in Low-Income Countries – Proposal for an Operational Framework and Policy Implications, Washington DC, February 3, 2004.

[16] Ibid.

ing the present debt burden. Since many concessional loans specify a multi-year redemption-free period, debt-service payments reflect only present, not future, debt burdens.[16] Another criticism voiced is that debt-service payments represent only immediate cash flows and are therefore influenced mainly by the maturity structure of debt.

Domestic and private-sector debt is omitted from the analysis – even though the financial resources mobilised to pay for domestic debt are no longer available to service foreign debt. The fiscal situation of debtor countries should therefore be included in debt sustainability analyses, even though data on government revenues and expenditures tend to be very poor in LICs. A further obstacle is the difficulty involved in comparing the fiscal data of centralised and decentralised countries.

Similarly, private-sector external debt should be considered if it plays a major role. Private-sector external debt is often important in countries with large mineral or natural resource sectors. Some countries, e.g. Bolivia, Chad, Guyana, Mozambique, Tanzania and Uganda, rely heavily on inflows of private-sector capital; the external debt they owe to private-sector creditors should therefore be included in the analysis of their debt sustainability.[17]

In addition to these quantitative indicators, qualitative indicators could be taken into account as well. First, the debt sustainability analysis should consider the Millennium Development Goals (MDGs), because achieving these goals is crucial to reducing poverty. Debt sustainability under the HIPC Initiative should therefore be analysed with a view to identifying the financial resources needed by each country to achieve the MDGs. However, it will be difficult both to gauge whether MDGs have been achieved and to finance the costs of achieving them.[18]

Second, the quality of institutions and economic policy should be considered, because countries with better institutions can service higher debts than those with institutions that do not perform well. The World Bank uses the Country Policy and Institutional Assessment (CPIA)-index for this purpose which includes four areas:

- economic management, e.g. fiscal policy, management of external debt etc.
- structural policies, e.g. financial stability, competitive environment for the private sector etc.
- policies for social inclusion and equity, e.g. social protection and labour, building human resources etc.
- public sector management and institutions, e.g. property rights and rule-based governance, quality of budgetary and financial management etc.

However, it is difficult to measure the quality of institutions. Therefore, to include qualitative indicators in the assessment of debt sustainability carries some risks.

Debt Situation after the Enhanced HIPC Initiative

Although debt has been substantially reduced after enhanced HIPC relief, debt sustainability has not been achieved for the long term. According to IMF estimates, the NPV of the debt-to-exports ratio before enhanced HIPC relief was 274% in the 27 countries that had reached their decision points. According to IMF and World Bank estimates, this ratio will be 128% at the completion point in 2005 after enhanced HIPC relief. After full delivery of traditional debt relief and assistance under the HIPC Initiative, the debt stocks of the 27 HIPCs that have reached the decision point will probably decline by about two thirds in 2003 NPV terms.[19]

Similarly, debt service-to-exports ratios have been considerably reduced: based on an average of 1998/1999 to 2003, the weighted average of this ratio in the 27 countries fell from 16% to about 10%. During this period debt-service payments in relation to fiscal revenues declined from 24 to 15%.[20] The German government has contributed nearly €6 billion toward meeting the Initiative's overall costs of roughly US $53 billion.

Even though these aggregate data cast the HIPC Initiative in a highly positive light, some individual countries are still faced with ratios of debt to export earnings of over 150%, which exceeds the limit for debt sustainability set by the IMF and World Bank under the HIPC Initiative.

[17] See Matthew Martin: Assessing the HIPC-Initiative: The Key HIPC-debates, in: Jan J. Teunissen, Age Akkerman (eds.): HIPC Debt Relief, Myths and Reality, FONDAD (Forum on Debt and Development), The Hague 2004, pp. 11–47.

[18] Current estimates show that the cost of achieving MDGs is between US$ 30 and 100 billion. See Peter Wolff: Finanzierungsmechanismen zur Erreichung der MDGs, in: Dirk Messner, Imme Scholz (eds.), op. cit., pp. 301-313.

[19] See IMF, IDA: Heavily Indebted Poor Countries (HIPC) Initiative – Status of Implementation, Washington DC, September 12, 2003.

[20] See IMF, IDA: Heavily Indebted Poor Countries (HIPC) Initiative – Status of Implementation, Washington, DC, August 20, 2004.

Table 1
NPV of Debt to Export Ratio for HIPC Graduates
(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

[1] These data refer to 12-month periods which begin in the middle of the year, e.g. 10 July 2000 to 9 July 2001.

[2] Based on a backward-looking three-year average of exports of goods and services on the previous year, e.g. export average over 2000-02 for NPV of debt-to-exports ratio in 2002.

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

Sources: IMF: various country reports.

This is true of the following HIPC graduates: Burkina Faso, Ethiopia, Benin, Nicaragua, Mauritania and Uganda (Table 1). Since 2001, when it was provided with debt relief, this ratio has risen constantly in Bolivia and is expected by the IMF and World Bank to reach a level of roughly 160% in 2006. The World Bank and the IMF estimated that in the interim period 7 of the 13 HIPCs that have not yet graduated will once again be faced with a situation of unsustainable debt, i.e. in excess of the debt sustainability thresholds defined within the HIPC Initiative.[21] In other countries, e.g. Tanzania, Senegal, Guyana and Mali, debt relief substantially reduced this ratio, and it has not risen sharply since they graduated. By contrast, debt-service payments in terms of exports and fiscal revenues declined substantially in most HIPCs.

Factors Endangering Debt Sustainability

The main threats to debt sustainability in HIPCs were, first, exogenous shocks and, second, structural problems. High debt levels following completion of the Initiative are for the most part the result of exogenous shocks[22] which have caused a decline in export earnings and therefore often adversely affected the external repayment capacity of HIPCs. The term exogenous shock refers to the occurrence of a sudden event that is beyond the control of the competent authorities and has severe impacts on the economy. In LICs the most frequent events of this kind are commodity price shocks, natural disasters and exchange-rate shocks.

Due to structural weaknesses, which include in particular an underdiversified economic structure and a lack of export diversification, HIPCs are vulnerable to exogenous shocks. In 1999 nearly two thirds of the HIPC countries qualifying for the Initiative achieved over 50% of their export earnings with three products or fewer.[23] Moreover, LDCs principally export primary goods: in the late 1990s primary goods accounted for over 60% of the total exports of LDCs.[24] Most of these goods are agricultural products, which are dependent on climatic conditions and therefore highly vulnerable to natural disasters.

A classic example of high debt stemming from exogenous shocks is Burkina Faso, where falling cotton prices and the white fly pest led to a decline in cotton exports. This had a marked impact on the country's total exports because cotton accounted for an average of some 40% of the country's total exports between 1999 and 2001. Political instabilities in Côte d'Ivoire, one of Burkina Faso's neighbours, likewise contributed to a decline in that country's exports.[25] Furthermore, fluctuations in exchange and interests rates led to a higher level of foreign debt than was anticipated.

Uganda experienced a similar trend when it was confronted with a higher than expected debt due to declining commodity prices in world markets. In Ethiopia the unexpected increase in the NPV of the debt-to-export ratio after full debt relief under the HIPC Initiative was caused mainly by adverse interest- and exchange-rate changes. In late 2002 and early 2003 this ratio was projected at 174%, and it rose to 218% in 2004.[26]

Contribution of the HIPC-Initiative to the Solution of Structural Problems

Due to structural problems HIPCs are unable to generate sufficient internal resources to reduce poverty; the chief reason for this is that internal conditions – such as unstable macroeconomic frameworks, underdeveloped enterprise and financial sectors, and lack of good governance and appropriate jurisdiction – are not in place.

[21] Ibid.

[22] See Kathrin Berensmann, op. cit.

[23] See IMF, IDA: The Enhanced HIPC Initiative and the Achievement of Long-Term External Debt Sustainability, Washington, DC, April 15, 2002.

[24] See IMF: Fund Assistance for Countries Facing Exogenous Shocks, Washington, DC, August 8, 2003.

[25] See IMF: Burkina Faso. Enhanced Heavily Indebted Poor Countries (HIPC) Initiative Completion Point Document, Washington, DC, March 28, 2002.

[26] See IMF: Ethiopia Completion Point Document, Washington, DC, April 2, 2004.

While debt relief itself only addresses the symptoms, not the causes, of development blockades, economic reforms play a particularly important role in achieving long-term repayment capacity. It is for this reason that the HIPC initiative makes debt relief contingent on economic and political reforms designed to ensure an HIPC country's ability to repay its loans.

To reach the so-called completion point – i.e. to receive debt relief – HIPC countries are required, first, to set up, and run for at least a year, a poverty reduction programme based on a Poverty Reduction Strategy Paper (PRSP) and, second, to achieve macroeconomic stability. Credits in the framework of the Poverty Reduction and Growth Facility (PRGF) are only granted if HIPCs can demonstrate that they are implementing reforms designed to guarantee macroeconomic stability. Third, HIPCs are required to implement some additional structural reforms in the framework of what is known as the social and structural completion point triggers, which are designed to promote pro-poor growth and ensure that HIPCs increase their spending for poverty reduction measures. The triggers include e.g. policy measures in the fields of governance, budget management, health, education, and agricultural reform.[27]

This long-term conditioning of debt relief on national poverty reduction strategies (PRSPs) is intended to pave the way for sustainable successes in poverty reduction. The initiative in this way forges a close link between poverty reduction and debt relief. And it is precisely in this respect that the Initiative has made some progress: the World Bank and the IMF estimate that GDP-linked expenditures for poverty reduction measures have risen by roughly one third in the past five years.[28] It should, however, be noted here that these are only aggregate data on expenditures for poverty reduction measures.

In general, it is too early to come up with any final evaluation, although it can be said that structural problems have been addressed only in part. Although spending increases in social sectors such as education or health promote growth in the long term, *pro-poor growth* measures have been given too little consideration. Due to the uniform requirements of PRSPs and PRGFs, too little attention has been paid to the specific situations of the countries concerned. In addition, the coordination of PRSPs und PRGFs needs to be improved as a means of better coordinating micro- and macroeconomic policy reforms.[29]

However, structural problems have existed for decades, and PRSPs and PRGFs are unable to overcome these problems in the short or medium term. HIPCs will for this reason not be able to generate sufficient financial resources to reduce poverty and to achieve the MDGs by 2015. After all, even low debt service has to be refinanced through Official Development Assistance (ODA).

Proposals for Ensuring Debt Sustainability

Four proposals for ensuring debt sustainability in low-income countries dominate the current debate:

- the "Debt Sustainability Framework in Low-Income Countries" proposed by the IMF and World Bank
- two proposals for 100% debt relief by multilateral institutions made by the American and British finance ministers
- the International Finance Facility (IFF) to finance grants instead of credits endangering debt sustainability
- new IMF financial instruments designed to mitigate exogenous shocks.

Since the creation of another HIPC Initiative – HIPC III – might discourage creditors from lending to low-income countries in general – because it could generate debtor moral hazard – most stakeholders reject a future HIPC III.

New Debt Sustainability Framework

At their annual meetings this year, the IMF and the World Bank put forward a proposal for ensuring debt sustainability in low-income countries – the Debt Sustainability Framework in Low-Income Countries – which had already been proposed in a different form at the spring meetings this year. This framework is intended to offer low-income countries and their creditors guidance on the design of financing strategies with a view to ensuring debt sustainability.[30] The framework incorporates the following characteristics.

[27] See Amar Bhattacharya: From Debt Relief to Achieving MDGs, in: Jan J. Teunissen, Age Akkerman (eds.), op. cit., pp. 97–108; IMF, IDA: 2003, op. cit.

[28] See IMF, IDA: Heavily Indebted Poor Countries (HIPC) Initiative – Status of Implementation, Washington DC, September 12, 2003.

[29] See IMF: Independent Evaluation, World Bank Operations Evaluation Department: the Poverty Reduction Strategy Initiative, An Independent Evaluation of the World Bank's Support Through 2003, Washington, DC, 2004.

[30] See ibid.; IMF: IMF Discusses Operational Debt Sustainability Framework for Low-Income Countries, Washington, DC, 2004.

- First, the framework includes an analysis of debt sustainability based on the adoption of indicative country-specific debt thresholds. One important factor affecting debt problems is a country's economic policy performance. An assessment of the quality of a country's economic policy and institutions is therefore included in the framework. This analysis is based on the World Bank's CPIA index. Good performers, for example, could carry a higher debt burden than bad performers.
- Second, a uniform forward-looking analysis of debt burden (debt and debt service) by the IMF and the World Bank – in a baseline scenario and in a situation of potential shocks – is included in the framework. It is, however, crucial for them to base their decisions on realistic assumptions on macroeconomic data – especially growth rates. While the HIPC Initiative deals with existing overindebtedness, this framework offers forward-looking guidance.
- Third, the aim of the framework is to provide guidance on an appropriate borrowing (lending) strategy for bilateral and multilateral donors which includes the risk of debt distress. The indicative thresholds for debt indicators are intended to warn creditors and borrowers when there is a danger that a country's debt may become unsustainable.

The framework will be included in the operations of the World Bank and the IMF. The grant element in IDA 14 should, for example, be based on the analysis included in the debt-sustainability framework, and the Fund plans to include the framework in its conditionality.

In general, the framework is superior to the Debt Sustainability Analysis under the HIPC Initiative. While the same thresholds for debt indicators were used for all HIPCs under the HIPC Initiative, the new framework uses indicative country-specific debt thresholds. This makes possible a country-specific analysis. In addition, a wider range of debt indicators is used, including an assessment of the quality of economic policy and institutions (CPIA index). In contrast to the HIPC Initiative, which has addressed existing debt problems, the operational framework is forward-looking.

There are, however, two main critical points. Domestic debt should also be taken into account as a threshold, and not only in the general debt sustainability analysis, because the financial resources mobilised to pay off domestic debt are in this case no longer available for servicing foreign debt.

US Treasury Secretary John Snow and others criticised the framework for being unable to ensure long-term debt sustainability in HIPCs; in particular, they noted, debt thresholds are too high. The threshold for the debt to export ratio for good performers is 300%, i.e. twice as high as the threshold under the HIPC-Initiative, and the threshold for debt service in terms of revenues is 40%. At the annual meetings of the Bretton Woods institutions, the American Treasury Secretary and the British Chancellor of the Exchequer put forward two different proposals for reducing HIPC debt owed to multilateral institutions.[31] While bilateral donors grant HIPCs 100% debt relief, multilateral donors cancel only about 50% or less of their debts.[32]

The US Proposal for 100% Debt Relief

The US Treasury Secretary called on the following multilateral financial institutions to grant HIPCs a 100% debt write-off: IMF, IDA, African Development Fund (AfDF) at the African Development Bank Group. Debt relief is necessary to ensure the sustainability needed to ensure economic growth and poverty reduction. He also proposed that graduated HIPCs should receive 100% grants from the IDA facility and the AfDF until 2015. Net resources to HIPCs should at least remain constant and it should be left open whether net resources should increase.

While this proposal would help to ensure debt sustainability in HIPCs, it has, basically, the following drawbacks. It is not appropriate to provide non-graduated HIPCs a 100% debt write-off without their having implemented any structural reforms. Debt relief alone does not solve structural problems and therefore cannot ensure debt sustainability. For this reason the HIPC Initiative makes debt relief contingent on economic and political reforms.

Similarly, it is not specified according to which performance system resources would be allocated to graduated HIPCs. The Debt Sustainability Framework proposed by the Bretton Woods Institutions is not considered, but this framework is appropriate for deciding on the relative composition of loans and grants because it takes into account structural reforms, governance and the development of institutions.

[31] See Gordon Brown: Statement by Gordon Brown, International Monetary and Financial Committee, Tenth Meeting, Washington, DC, October 2, 2004; John Snow: Statement by John Snow, Development Committee, Seventieth Meeting, Washington, DC, October 2, 2004.

[32] The idea of 100% debt relief by multilateral institutions gained importance since the publication of the Meltzer Report in 2000. See International Financial Institution Advisory Committee (IFIAC): IFIAC Report 2000, www.house.gov/jec/imf/meltzer.htm as of November 7, 2004.

In addition, debt relief to HIPCs would entail moral-hazard problems because good performers with sustainable debt levels which had not qualified for the HIPC Initiative would not be eligible for a 100% debt write-off. Moreover, repayment of loans provides an incentive for using financial resources efficiently.

Unless net financial resources for low-income countries were increased substantially, HIPCs would receive more money than other low-income countries. This would mean a reallocation of net financial resources in favour of the HIPCs.

Moreover, it will prove to be difficult to finance debt relief. Unless additional financial resources are mobilised, the financial solidity of the IDA and PRGF facilities could be endangered, i.e. these facilities would be decapitalised over time. In contrast to loans, grants weaken these facilities' ability to offer future development assistance. The position of IMF and World Bank relative to other bilateral and multilateral donors would be weakened.

The British Proposal for 100% Debt Relief

The British proposal calls for 100% debt relief by multilateral donors, to be financed with additional resources. IMF gold could also be revalued, since it is currently valued by the IMF at about one eighth of its market value, from about US$ 50 billion to US$ 400 billion. 100% debt relief within the PRGF would in this case be financed through a revaluation of IMF gold as well as through off-market transactions. 100% debt relief on the loans granted by the World Bank and the African Development Bank would have to be financed by commitments from all donors.

The UK is prepared to meet 10% of the graduated HIPCs' debt to the World Bank and the African Development Bank. In addition, the UK would extend debt relief to all LICs able to guarantee that the money saved would be used to reduce poverty.

There are two main arguments against this proposal. First, many bilateral donors are faced with fiscal constraints and will not, therefore, be able to provide additional funds for the HIPCs or other low-income countries. Second, financing the PRGF with IMF gold would be possible only if that gold was undervalued compared with the market price. The financing of the PRGF would in this case be dependent on the world market price of gold.

On the whole, conditions should be attached to 100% debt relief, and the debt sustainability framework mentioned above should be used to assess the optimal amount of loans relative to grants. Nevertheless, grants to LICs have to be increased relative to loans for ensuring debt sustainability.

The IDA-13 agreements reached in 2002 may be seen as a step in this direction. The agreements provide for loans to the HIPC countries which may in certain cases contain a grant element of up to 40%. Debt sustainability is an important criterion for access to IDA loans; in other words, the lower a country's debt sustainability, the higher must be the grant element of the loans with which it is provided. Moreover, debt sustainability is set to play a central role in the IDA-14 agreements. The debt sustainability analysis proposed in 2004 by the IMF and World Bank[33] will influence the decisions made on IDA-14 loans.[34]

Proposals for Mobilising Financial Resources

Various proposals have been put forward for multilateral donors to finance 100% debt relief and to finance grants for LICs to achieve their MDGs by 2015: imposition of world-wide taxes on capital movements, pollution, or arms exports, issuing SDRs for development purposes, global lottery, establishment of an International Finance Facility (IFF), and an increase in net Official Development Aid (ODA) amounting to 0.7% of donors' GDP, which was one of the commitments made at the Monterrey conference in 2002.[35] Although some of them are very old, no international agreement on these proposals exists. Basically, free-rider problems would make it very difficult to enforce any world-wide tax. The most promising proposal is for an IFF, which was again put forward by the British Chancellor of the Exchequer, Gordon Brown, at the annual meeting of the Bretton Woods institutions this year.[36]

The general principle is that donors would be indebted in international capital markets for generating grants to LICs. Donors commit themselves in the long term to providing the IFF with capital. On this basis

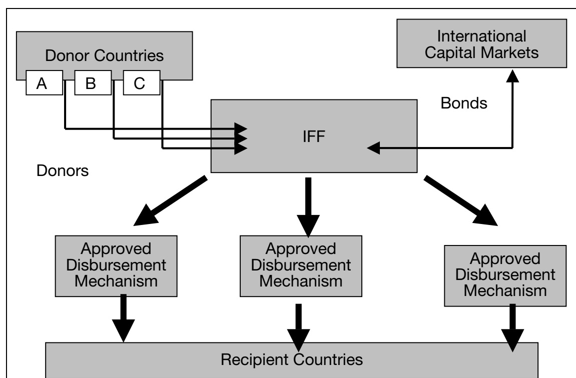
[33] See IMF, IDA: Debt Sustainability in Low-Income Countries – Proposal for an Operational Framework and Policy Implications, Washington, DC, February 3, 2004.

[34] See IDA: Additions to IDA Resources: Thirteenth Replenishment, Washington, DC, 2002; IDA: Debt Sustainability and Financing Terms in IDA 14, Washington, DC, 2004.

[35] For an overview of these approaches see Helmut Reisen: Innovative Approaches to Funding the Millennium Development Goals, OECD Policy Brief No. 24, Paris 2004; or Anthony B. Atkinson: New Sources of Development Finance: Funding the Millennium Development Goals, United Nations University, World Institute for Development Economic Research (WIDER), Policy Brief No. 10, 2004, Oxford University Press; or Peter Wolff, op. cit.

[36] See Gordon Brown, op. cit.; HM Treasury and Department for International Development (DFID): International Finance Facility, a Technical Note, Norwich, February 2003.

Figure 1
Overview of the International Finance Facility



Source: HM Treasury, International Finance Facility-proposal, April 2004, p. 4.

the IFF would issue bonds in international capital markets.

The IFF would operate as follows: donors would commit themselves to providing finance in the future. Since their commitments would serve as backing for bonds, they could have an AAA rating. The bonds would be issued in the international financial markets by an existing institution. Grants would be given to developing countries through existing bilateral and multilateral donor channels. Each donor allocates his committed funds according to overarching principles agreed upon by donors at the establishment of an IFF.

The IFF would front-load aid commitments of bilateral donors by raising sufficient financial resources to meet MDGs by 2015. The IFF would annually issue bonds, for example, with repayment periods of 15 years for a period of 10 to 15 years. Financial resources would immediately be transferred to LICs, but donors would have to pay for the bonds only within the next 15 to 30 years. Accordingly, donors could provide immediately financial resources for LICs, but have to pay for them when bonds become due.

According to Gordon Brown, there are several sound arguments for the IFF. This facility would leverage additional funds from international financial markets increasing the amount of ODA for the years to 2015. In addition, the IFF would improve aid effectiveness because its funding levels would be predictable, stable, long-term and coordinated, and the funds could therefore be used continuously for poverty reduction and sustainable growth. Since it would be financed by a small number of countries this core group would have few coordination problems.

Although this is the best of the current proposals, it has three major drawbacks. First, although donors would have only future financing obligations, these would currently be future liabilities which would have to be considered in the donors' state budgets. Many industrialised countries are, however, faced with serious fiscal problems and will not therefore agree to the IFF. Second, the front-loading of aid commitments is justified only if the financial resources which low-income countries receive from the IFF generate economic growth and resolve structural difficulties in those countries. Third, it is questionable whether these bonds will be accepted in international capital markets.

New IMF Financial Instruments for LICs

Since exogenous shocks constitute a substantial risk to the debt sustainability of LICs, the multilateral donors should help to mitigate the impacts of such shocks. The financial instruments of the international financial institutions, and especially of the IMF, need to be modified, because the instruments designed to mitigate exogenous shocks have had only limited success.

Currently, the IMF has two facilities for addressing the effects of exogenous shocks: the Compensatory Financing Facility (CFF) and emergency-assistance loans. For shocks due to natural disasters, the IMF provides emergency-assistance loans, which are disbursed quickly and granted in the medium term to countries with balance-of-payments problems.[37]

The aim of the IMF's CFF is to provide medium-term compensation for temporary shortfalls in export earnings or for surplus grain imports needed to respond to exogenous shocks. It has not, however, been used since the year 2000[38] because it is available only in the medium term, a considerable number of conditions are attached, and the loans provided are not concessional in nature.

To absorb external shocks, the IMF generally provides either additional stand-by arrangements or PRGF loans, which are not designed explicitly to mitigate exogenous shocks in the short term. Stand-by

[37] See IMF: Role of the Fund in Low-Income Member Countries over the Medium Term – Issues Paper for Discussion, Washington, DC, 2003; IMF: Fund Assistance for Countries Facing Exogenous Shocks, Washington, DC, August 8, 2003; IMF: Ethiopia Completion Point Document, Washington, DC, April 2, 2004; and IMF: The Fund's Support of Low-Income Member Countries: Considerations on Instruments and Financing, Prepared by the Finance and Policy Development and Review Departments, Washington, DC, 2004.

[38] See IMF: Review of the Compensatory Financing Facility, Washington DC, February 18, 2004.

arrangements are designed to provide medium term support for countries facing short-term balance-of-payments problems. However, while stand-by arrangements meet the first two criteria for an instrument suited to mitigating exogenous shocks, the loans are not provided on concessional terms: the interest rates on them are one to two percentage points above the base rate. The PRGF is designed to provide long-term support for countries faced with persistent structural balance-of-payments problems and to promote sustainable, pro-poor growth.[39]

Since the IMF lacks an instrument for providing short-term loans to help mitigate exogenous shocks – especially commodity-price or currency shocks – new facilities need to be developed. They should meet the following criteria:[40]

- highly concessional credits: since LICs are likely to have problems repaying loans on market terms, the loans should have a high degree of concessionality;
- short-term availability: the instruments should be made available quickly and without any complicated procedures;
- medium-term repayment period: to give the countries affected a chance to recover from a shock, the subsidised loans should be repayable over the medium term.

The IMF could, for example, develop a facility containing a flexible element for payment terms when a borrower country is adversely affected by an external shock. To this end, it would be possible to convert part of such loans into a grant, to lower interest rates, or to prolong repayment periods. The IMF would have to define criteria for determining the conditions under which countries were eligible to borrow from such facilities and how much they might borrow.[41] If commodity prices fell by more than 15%, it would be conceivable, for example, for payments on part of the loans to be deferred or for part of the loans to be converted into grants.

An automatic mechanism of this kind that triggered a flexible element would enable repayment terms to be altered quickly and on the basis of transparent rules. This would, however, entail the risk of the debtor seeking to influence to his own advantage criteria that would trigger a change in his repayment terms. In addition, it carries the risk that producers would not be encouraged to diversify their production, as under Stabex.

Nevertheless, there is a need for a new facility that contains a flexible element relating to payment terms when external shocks occur, since the countries affected are best able to mitigate the effects of shocks when they have swift access to financial support.

Conclusion

Owing to their difficult economic structures, most low-income countries will be, in the medium term at least, dependent on subsidies from donors. What is needed to ensure long-term debt sustainability is more grants and more concessional credits which could be financed by the IFF. Otherwise, these countries will not achieve their Millenium Development Goals and will again find themselves faced with unsustainable debt levels.

Due to financial difficulties it will be not possible, however, for multilateral institutions to offer 100% debt relief. If additional grants are provided, conditions should be attached to them, and the debt sustainability framework mentioned above should be adopted to analyse the optimal amount of loans relative to grants.

The operational framework is appropriate to evaluate debt sustainability and to address structural problems in low-income countries as well as to decide on the relative composition of loans and grants. This framework should, however, obtain only for graduated HIPCs and other LICs, and not for HIPCs in the interim phase of the HIPC process, because these countries should first complete the Initiative under current conditions. In case debt relief committed at the decision is not sufficient to reach debt sustainability according to the criteria valid under the HIPC Initiative, topping off should be granted. Any 100% debt relief for HIPCs in the interim phase would undermine the HIPC process.

[39] Similarly, between 1975 and 2000 the European Union (EU) had an instrument to compensate for exogenous shocks: the Stabex scheme. The Commission offered Stabex funds in case an African, Pacific and Carribean (ACP) country suffered an income loss as a consequence of a decline in export revenues for specific agricultural products. However, Stabex was bound up with a number of problems. First, there had been long delays in disbursements generating procyclical instead of anticyclical effects. Second, farmers had not been encouraged to diversify their production. Third, it was not ensured that producers received funds. In 2002, the EU had established a new mechanism (FLEX) to absorb commodity price shocks. See Paul Collier, Patrick Guillaumont, Sylviane Guillaumont Jeanneney, Jan Willem Gunning: Reforming Stabex, in: the World Economy, Vol. 22, No. 5, 1999, Blackwell Publishers, pp. 669-682; IMF: Fund Assistance for Countries Facing Exogenous Shocks, Washington, DC, August 8, 2003.

[40] See Kathrin Berensmann, op. cit.

[41] See Christopher L. Gilbert, Alexandra Tabova: Realignment of Debt Service Obligations and Ability to Pay in Concessional Lending: Feasibility and Modalities, in: Andreas Antoniou, Abbas Berya: Long-Term Debt Sustainability in Low-Income Countries: the HIPC Initiative Revisited, Commonwealth Economic Paper Series No. 61, Commonwealth Secretariat, London 2004, pp. 79–125.