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New approaches to debt relief and debt sustainability in LDCs

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Background

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New approaches to debt relief and debt sustainability in LDCs

Olav Bjerkholt

Introduction

The aim of this paper is to summarize for discussion purposes arguments related to the debt crisis of poor developing countries and the attempts to cope with it through the HIPC Initiative.

The debt crisis affecting most LDCs and several other low-income countries can be traced on the debtors' side to various structural causes of indebtedness often exacerbated by weak macroeconomic policies and conflicts, but also to the official creditors' willingness to take risks unacceptable to private lenders. Liquidity problems that arose were initially met with postponement of payments through reschedulings and new lending which quickly led to an unsustainable build-up of debt stocks. Debt relief efforts since 1988 have brought debt ratios down, but not to sustainable levels.

The debt problem is an integral part of the poverty trap that many of the poorest countries are caught in, a vicious circle of low levels of private investment, low degrees of export diversification, high vulnerability, low growth, and high debt ratios. For many of these countries the trap was exacerbated by further marginalization in the wake of the globalization.

The HIPC Initiative was proposed by the World Bank and the International Monetary Fund in 1996 to provide comprehensive debt relief to some of the world's poorest and most heavily indebted countries.¹ It was viewed as a response to growing international public concern with the excessive debt burden of poor countries. An evaluation of the HIPC Initiative by the World Bank Operations Evaluations Department (OED) notes as striking that "the debtor states were not a major force behind the innovation", despite the fact that many of the ideas inherent in the HIPC Initiative were proposed by developing countries during the New International Order (NIEO) events of late 1970s and early 1980s (OED, 2003). (Perhaps it should be viewed as regrettable that the intense and polarized international dialogue of that time came to nothing.)

Instead of being brought forth by the poor countries themselves, the emergence of the HIPC Initiative was influenced to a quite considerable degree by NGOs and world civil

community working through domestic and international political arenas. The same forces were equally active in promoting the Millennium Development Goals.

The global concern was not only the debt problem, but that burden of debt it was exacerbated by the declining trend in financial development assistance and the poor performance in poverty reduction in many poor countries. The HIPC Initiative established qualifying criteria for HIPCs and promised to reduce within a reasonable time the debt burden of qualifying countries to “sustainable” levels.

External Debt as Percentage of GDP (period average)				
Category	1980-84	1985-89	1990-94	1995-2000
HIPC	38	70	120	103
Other IDA countries	21	33	38	33
Other lower-middle-income countries	22	30	27	26

Source: Global Development Finance and World Development Indicators, quoted from OED (2003).

As seen from the table the HIPC Initiative was a late response to the debt problem of poor countries, the debt had cumulated steadily since the 1970s. Particularly aggravating was the prolonged deteriorating terms of trade and economic decline in the 1980s with per capita growth rates averaging -2.2 percent for Sub-Saharan Africa during 1980-89. Not surprisingly this led to increasing debt service problems and mounting arrears. Efforts at reducing the burden of debt in this period through reschedulings, concessional loans and grants instead of non-concessional loans succeeded in providing substantial net transfers, and postponing the debt crisis. Needless to emphasize this was a disastrous development with regard to attracting private capital for participation in the globalization of the 1990s.

The HIPC Initiative represented an innovation relative to the traditional debt relief mechanisms. It recognized that the problem of the HIPCs was insolvency rather than illiquidity and thus required a more radical and comprehensive approach. It offered debt relief, also of multilateral debt, to the extent that remaining debt would be “sustainable”, a concept which quickly became controversial. It broadened the scope of conditionality in connection with debt relief to include social criteria in addition to the macroeconomic and structural policy reform criteria.

According to the critical review by OED the HIPC Initiative has “marked a turning point in the evolution of development finance”, it has become “a catalyst for far-reaching changes in the processes surrounding development assistance, reflecting the coming age of a new authorizing environment with the active participation of civil society (OED, 2003, p.ix). On the other hand the HIPC Initiative has become highly controversial for its design, its assumptions and the way it has been conducted. As noted in the OED assessment: “... it is striking how critical many commentators are with respect to the actual or anticipated achievements of the initiative. ...the HIPC Initiative has become a lightning rod for broader policy disagreements regarding equitable and sustainable development and the role of aid” (OED, 2003, p.2). The debt issue can thus not be considered as having been resolved and even less the Millennium Development Targets which are floating for the greater part on verbal commitments.

Section 2 provides some background on the structural causes of indebtedness, on the benefits of debt relief as development aid and a brief history of the debt crisis, while section 3 gives a brief overview of the implementation of the HIPC Initiative. Section 4 reviews the major criticisms that have been raised against the HIPC Initiative, while section 5 discusses where to go from here and how the MDGs can be linked to the debt relief. Section 6 concludes.

The burden of debt and the benefits of debt relief

Structural causes of indebtedness in LDCs

The build-up of the unsustainable debt in most of the LDCs has taken place over decades. The African countries, most of which gained independence in the early 1960s, had good growth in the first decade and until the economic shocks of the 1970s. The oil price hike of OPEC I and OPEC II hit very hard on many developing countries. The main structural problem is the high concentration of export earnings in one or a few natural resource or agricultural commodities. With exports concentrated in highly volatile commodity markets and generally declining terms of trade the prospects for broad-based growth were limited.

The Sub-Saharan economies were quite sensitive to export commodity price fluctuations and indeed also to adverse weather conditions. The export instability index in the LDCs is at least 50 percent higher than in other developing countries (UNCTAD, 2000, table 6). The terms of trade shocks in the 1980s and 1990s reduced government revenues generated from exports. External borrowing was sought to finance high public sector spending, rather

than adjusting the fiscal budget down. The growing debt service that resulted led to further borrowing.

The average per capita GNP for LDCs is only a quarter of the developing country average. Most of the LDCs population in sub-Saharan Africa and Asia live close to subsistence level. More than two thirds of the population and labour force live in the countryside and work in the agricultural sector. Capital stocks are meagre, the per capita consumption of combined coal, oil and electricity is on average one tenth of the prevailing levels in the developing countries as a whole. Population growth is on average one percent higher than in other developing countries, and the export concentration much higher (UNCTAD, 2000).

This dismal situation implies that the LDCs to a great extent also lack the socio-economic infrastructure needed to promote growth, both with regard to physical infrastructure such as telecommunications and transport facilities and with regard to human capital. These factors have important financing implications in terms of the magnitude of resource requirements for development, the availability of domestic finance, and the required degree and characteristics of external financing.

For many of the countries these difficulties, often combined with various domestic social, economic and structural constraints, failures in some countries to pursue sound economic policies that could stimulate economic growth, and wars and conflicts in others resulted in a long and persistent economic decline. Declining revenues and resistance to painful fiscal adjustments led to extensive borrowing to meet the deficit (Daseking and Powell, 1999).

The development in HIPC countries during the 1990 indicates that there is little or no structural transformation going on. The share of manufacturing has fallen from slightly above 10 percent in 1990 to slightly below 10 percent in 2001 (Gunter, 2003, p.22). For the same countries in the same period there is an increase in the nominal amount of FDI but as share of global FDI it is approaching zero, and what there is of FDI may be mostly concentrated in natural resource extraction, often as exclaves to the economy. It has furthermore been a declining trend in the HIPC's terms of trade throughout the 1990s. The agricultural products which make up a significant share of the export potential have faced significant barriers of trade. Exports have however increased quite well during the 1990s, also increased as a share of world exports, but this may be due to a large extent to natural resource exports with very limited effect on long-term growth.

Debt relief as development aid

Borrowing abroad, and thus creating external debt, is not an impediment to development. On the contrary, the possibility of external borrowing enhances a poor country's possibilities for growth and development. More external borrowing may enhance even more the growth potential, up to the point of the optimal debt burden, say as a debt-to-GDP ratio, determined by how much growth to be gained from external borrowing relative to the rate of interest. A debt higher than that easily becomes a constraint on growth and development. The negative effects of too high debt burden works along different channels.

The debt overhang effect, as discussed by Sachs (1989), Krugman (1988) and others et al., is the negative effect of debt through its impact on investment and thereby on growth. A highly indebted country will attract less foreign investment and it will discourage domestic investors through various and well known mechanisms. Whether the debt overhang in the 1990s really had any effect in poor countries such as Sub-Saharan Africa is not obvious. OED (2003) argues that it had negligible effect as these countries had already lost ability to attract foreign investment.

Another effect of severe indebtedness is that high debt service payments crowd out high-priority public expenditures. The fiscal limitations in covering debt service as well as enough public expenditures may also reflect insufficient efforts to increase public revenues and inefficient management of public expenditures. Aid flows are not as helpful in filling such gaps as the pure size of overall aid suggests because of the inefficiency of aid processes, when aid is given as project finance or tied procurement. When high debt is present positive net transfers from donor countries often require a complex and inefficient restructuring and negotiation process. The uncertainty surrounding such processes can again have negative influence on investments and the effective use of capacity. Thus part of the negative effects of the debt overhang can be part of the process that traditionally has been used to deal with it (OED, 2003, Annex F).

On the other hand one might consider the effects of debt relief given as development aid. There are several reasons why debt relief can be said to be an efficient and effective form of resource transfer, particularly if the debt relief is given as an across-the-board reduction in debt stocks with corresponding reductions in debt service payments. The benefits of debt relief are argued persuasively in CAFOD et al (2002).

Debt relief minimizes the unpredictability of aid flows, in contrast to many bilateral aid programmes with low stability, low predictability and high pro-cyclicality. Moreover the granting or withholding of aid tends to aggravate economic cycles. Empirical analyses show that aid flows tend to be more volatile than fiscal revenue or output, and highly unpredictable. This is by itself a reason for the divergence between budgeted and actual spending often observed in African countries. Debt relief on the other hand is highly predictable, stable and, therefore, can act as a counter-cyclical source of finance. As a result, debt relief helps low-income governments to strike a balance between poverty reduction expenditure commitments, while striving to maintain fiscal stability.

Debt relief thus acts as *de facto* budget support. By enhancing central government spending capacity, debt relief supports the development of locally owned government expenditure priorities and monitoring systems. In line with donors' emphasis on Medium Term Expenditure Frameworks, debt relief acts as an important boost for (some) donors' efforts to increase the predictability of flows and enhance coordination and common pool approaches. Aid can distort the relationship between recurrent and capital spending, when donors prefer to spend on tangible capital projects as opposed to meeting recurrent budgetary costs. Aid, unlike debt relief, thus can leave recipient governments cash poor and project rich. Debt relief on the other hand not only enhances the national budgets, it also facilitates a closer integration of budget management systems and an improved coordination between capital and recurrent expenditures.

Debt relief can be expected to spur economic growth by reversing the mechanism that make the debt overhang hamper growth. High levels of indebtedness lead to HIPC governments increasing their borrowing from domestic credit sources resulting in higher interest rates and the crowding out of local investors access to affordable credit. Given good governance one may expect to find a positive effect of debt relief upon domestic private savings and investment, as well as upon the attraction of foreign investment. Debt write-offs can relieve the pressure on domestic borrowing, increasing the availability, and reducing the cost, of domestic credit thereby acting as a spur to economic growth. On the other hand, there is little if any evidence of a positive interaction between aid flows and domestic savings. Debt relief is also anti-inflationary, as higher levels of indebtedness tend to go along with increased inflationary pressures.

Debt relief cuts down on transaction costs. This is a more important factor than generally recognized. Aid can tie up recipient governments' meagre administrative staff in

endless negotiations, report writing and separate auditing procedures with an array of official donors. Informal estimates suggest that officials can spend half their time on donor-related activities rather than on improving the delivery of public sector services and administration. Given the shortage of skilled administrators this is nothing but a costly diversion.

Debt relief improves local accountability and good governance, again in contrast to the side effects that aid flows often generate. Debt relief in the current context of locally owned Poverty Reduction Strategies has the added benefit of increasing, and sometimes even kick-starting, political participation in decision-making over the management and distribution of public resources.

A brief history of the debt crisis

The debt crisis of poor countries dealt with through the HIPC Initiative today has a history of about 25 years, as repayment problems first emerged as a general problem in the late 1970s and early 1980s. During the 1970s many developing countries had considerable increase in their external borrowing. Most low-income countries had restricted access to private finance to private finance and contracted loans primarily from other governments or from or guaranteed by their export credit agencies.

The role of the export credit agencies is particularly important. Their function has to a large extent been to support domestic exports by providing or guaranteeing loans to developing countries with risks, especially political risks, the private sector was unwilling to take. The creditor governments used the commercial lending or guaranteeing to promote their own exports for protecting domestic employment. Such “export pushing” was not least prevalent towards countries that also were aid recipients. The risks were substantial but the creditor governments were willing to accept them as contingent liabilities, complementing the direct grants and the concessional ODA loans provided as part of the overall development cooperation policy.

The build-up of the debt burden was due not only to the official creditors’ willingness to lend, but also to a number of exogenous and endogenous factors, such as adverse terms of trade shocks, failures in governance, insufficient macroeconomic structural adjustment and reform, weak debt management, as well as political factors such as internal and external conflicts.

Some aid agencies started to forgive aid-related debts at an early stage, but that has counted for just a small part of the debt. The strategy pursued by official creditors and the

international financial institutions was to offer comprehensive non-concessional rescheduling of payments falling due, while IMF provided new loans linked to structural adjustment programs. From the mid-1980s the debt crisis came to figure prominently on the agenda of G-7 meetings.

During the 1980s the recoverability of much of the debt was increasingly questioned by creditors. Private creditors chose to a great extent to sell their stock of claims in low-income countries at a discount. Official creditors instead of cutting their losses by writing off debt started comprehensive non-concessional “flow reschedulings” within the Paris Club, combined with new lending from IMF and multilateral development banks. New credits from exports credit agencies were exempt from rescheduling to encourage additional flows of official financing. The Paris Club reschedulings delayed payments by new grace periods. Payments falling due could be reduced by as much as 90 percent immediately. A majority of the HIPCs had Paris Club reschedulings, but the debt service paid by HIPCs still increased from 17 percent of exports on average in 1980 to a peak of 30 percent of exports on average in 1986 (Daseking and Powell, 1999, p.5). The Paris Club reschedulings thus provided substantial cash relief, allowing adjustment programs to be fully financed, but at the same time also led to steadily increased debt stocks outstanding.

In retrospect one may wonder why the reschedulings which amounted to little more than a postponement of the day of reckoning, seemed to ignore that many of these countries were in fact insolvent. As Daseking and Powell (1999) elaborates, the reschedulings were – for different reasons - a convenient short-term solutions both for creditors and debtors.

From 1988 the debt crisis was handled on terms decided by the G-7 meetings and the reschedulings on Toronto terms from 1988 were followed by London terms from 1991, Naples terms for 1995 and Lyon terms from 1996. The initiative for these rounds was taken in 1987 and doubtlessly from recognition that the debt was unsustainable and needed action beyond the non-concessional Paris Club reschedulings. The Toronto terms and the successor reschedulings became increasingly complex deals that required a high degree of coordination among creditors. The outcome was very substantial reductions in the net present value (NPV) of debt stocks through reschedulings and interest rate reductions. Toronto terms reduced NPV by 33 percent, London terms by 50 percent, Naples terms by 67 percent, and Lyon terms by 80 percent. These concessional reschedulings came to be known in the context of the HIPC Initiative as “traditional debt-relief mechanisms”.

Powell and Daseking (1999) estimates the cost to creditors of the debt relief since 1988 to at least \$30 billion. The aggregate outcome for HIPCs of these rounds can be indicated by the debt service in percent of exports which from a peak of around 32 percent in 1986 was reduced to about 18 percent in 1997. The debt burden in percent of exports changed over the same period from about 470 percent in 1986 to a peak of more than 500 percent in 1992 to about 270 percent in 1997. This history together with the realization that the debt burden for HIPCs was still unsustainable was the background for the HIPC Initiative.

Implementation of the HIPC Initiative

The HIPC Initiative was launched in 1996. It was designed as a comprehensive and concerted action to deal with the external debt of poor countries in its entirety with the explicit objective of resolving it in a sustainable way. For the first time the multilateral creditors were part of the debt relief effort.

After two decades of debt relief measures the HIPC Initiative reflected a recognition that the problem of poor countries was one of insolvency rather than merely illiquidity. The debt relief thus had to be more comprehensive than the traditional debt relief measures had allowed.

The original objective was “to bring the country’s debt burden to sustainable levels, subject to satisfactory policy performance” (World Bank and IMF, 1996) by removing the “debt overhang”. After a relative short time the HIPC Initiative was under fire for being a too limited effort and it was publicly doubted that it would deliver debt sustainability as promised and the Initiative was criticized for not addressing the poverty issue directly. Under some pressure the World Bank and the IMF introduced major changes in the framework in 1999 (World Bank and IMF, 1999), renaming it as the Enhanced HIPC Initiative (E-HIPC) in distinction from the original one (O-HIPC), and extending the objective to provide a “permanent exit” from debt rescheduling.

While the O-HIPC focused more narrowly on the debt overhang, the ambition in E-HIPC was raised to provide “a permanent exit from rescheduling” and the focus broadened to “twin objectives”: removing the debt overhang and “to free up resources for higher social spending aimed at poverty reduction to the extent that cash debt-service payments are reduced” (OED, 2003, p.63). While the debtor countries had no explicit role in O-HIPC, also in E-HIPC the role was very limited. OED (2003) finds this noteworthy “since the HIPC

process envisages the debtor government and the civil society in poor countries firmly taking the driver's seat and owning the process (p.15).

Below we describe quite briefly the HIPC Initiative procedure and the current status. The best sources of the implementation of the HIPC Initiative and the current status are the IMF and World Bank (2003) and OED (2003).

The HIPC Initiative procedure

Under the O-HIPC for action to be taken an eligible debtor country, i.e. a HIPC, had to establish a three-year track record of macroeconomic stability and policy reform to qualify for the *decision point*, at which the country's situation would be scrutinized in a debt sustainability analysis. Then after an additional three-year track record of macroeconomic stability and policy reform the *completion point* would be reached, at which the debt would be brought down to "sustainable" levels by agreements of all creditors. Debt sustainability was for operational target purposes defined as NPV debt-to-exports within the range of 200-250 percent. There was an alternative target, the so-called "fiscal window", of NPV debt-to-revenue of 280 percent, which could be applied only economies which passed the thresholds of export/GDP at least 40 percent and revenue/GDP at least 20 percent.²

The enhancements comprised (1) a lowering of the indicators used to represent debt sustainability, (2) a more flexible time schedule, (3) a linking of the HIPC debt relief to the country-owned poverty reduction strategies represented by the PRSPs, and (4) the provision of interim debt for countries having passed the decision point.

The HIPC Initiative's objectives are based on the assumption that past aid levels to HIPCs will be maintained, such that the HIPC Initiative resources would be additional. There is, however, nothing in the design that can ensure that this will happen. The outcome might well be lower aid levels, both for HIPCs and non-HIPCs.

The new single target value for debt sustainability was set to a NPV debt-to-exports ratio of 150 percent. Also now there was a fiscal window of NPV debt-to-revenue ratio of 250 percent for countries which passed thresholds now adjusted to export/GDP 30 percent and revenue/GDP 15 percent.

The qualification for reaching the decision point was a three-year track record of good performance as before, but also required a Poverty Reduction Strategy Paper (PRSP) developed together with civil society. As the preparation of PRSPs can be a drawn-out process this requirement was modified to an *interim* PRSP, in an effort to get more countries

quickly to the decision point. For countries fulfilling these requirements traditional debt relief by the Paris Club stock-of debt operation under Naples term would either bring the debt ratio down to the target level, in which case it would exit from E-HIPC or else, it came to the decision point, at which the amount of assistance was calculated and distributed among all creditors (multilateral, bilateral, commercial).

The fixed three-year interval between the decision point and the completion point was abandoned in favour of a “floating completion point”, allowing both shorter, and when needed, longer intervals between decision and completion points. Arrival at completion points required as before a macroeconomic track record, the completion of PRSP if interim and one year PRSP implementation, and the implementation of policies, the so-called “triggers” or performance benchmarks, for structural and social reforms.

The timing of the completion point was thus timed to the implementation of the policies determined at the decision point. All creditors would then provide the assistance at the completion point, i.e. commit themselves unequivocally to the debt reductions over the future horizon, following a different procedure for different creditors (Paris Club, multilaterals, and others).

There are thus a number of differences between the HIPC Initiative and many earlier actions aimed at reducing the debt burden of individual countries. The HIPC Initiative represents a more coordinated and systematic effort, more coordination on the creditor side and a systematic approach of including the countries with the most severe debt problems. It furthermore aims at providing a permanent exit of the process of debt rescheduling. And, finally, it includes an element of poverty reduction.

A key element and an innovation in the HIPC Initiative is the Debt Sustainability Analysis (DSA). The DSA uses an inventory methodology to calculate current debt levels as a basis for calculating the amount of debt relief for individual countries. The DSA also comprises projections of future debt levels to assess the likelihood of achieving debt sustainability. The macroeconomic foundation in these projections, i.e. the modelling basis as well as growth assumptions, have not been made transparent. This has drawn much criticisms not least from the World Bank OED which has criticized the projection in quite harsh terms in OED (2003). The U.S. General Accounting Office has likewise found that inconsistencies and gaps in the projections made them difficult to evaluate (GAO,2000).

Status of HIPC

There are altogether by 2003 42 countries classified as HIPC. They are:

Angola*	The Gambia*	Nicaragua
Benin*	Ghana	Niger*
Bolivia	Guinea*	Rwanda*
Burkina Faso*	Guinea-Bissau*	São Tomé and Príncipe*
Burundi*	Guyana	Senegal*
Cameroon	Honduras	Sierra Leone*
The Central African Republic*	Kenya	Somalia*
Chad*	Lao PDR*	Sudan*
Comoros*	Liberia*	Tanzania*
Democratic Republic of Congo*	Madagascar*	Togo*
Congo*	Malawi*	Uganda*
Republic of Congo	Mali*	Vietnam
Côte d'Ivoire	Mauritania*	Yemen*
Ethiopia*	Mozambique*	Zambia*
	Myanmar*	

* = LDCs

32 out of the 49 LDCs are among the 42 HIPCS. There is also a high concentration in Africa, 32 out of 42 HIPCs are Sub-Saharan countries.

The HIPCs comprise about 14 percent of the total of developing countries population in 2000, but only 5 percent of the total gross national income. The share of total external debt of all developing countries is according to OED (2003) approximately 8 percent, thus small relative to the share of population, but large in relation to the share of income.

The status of the 42 eligible HIPCs as of August 2002 are as follows: Six countries have reached the completion point: Bolivia, Burkina Faso, Mauritania, Mozambique, Tanzania, and Uganda. Four of these had decision point under O-HIPC, but was re-entered into E-HIPC. Tanzania and Mauritania had decision points in 2000 and reached completion point already in 2001 and 2002. The target value for NPV debt-to-export was 150 percent for all countries except for Mauritania for which it was set to 137 percent. The percentage reduction in NPV of debt at the completion point varies from 27 (Mozambique) to 54 (Tanzania).

Twenty countries have reached the decision point and receive interim relief: Benin, Cameroon, Chad, Ethiopia, The Gambia, Ghana, Guinea, Guinea-Bissau, Guyana, Honduras, Madagascar, Malawi, Mali, Nicaragua, Niger, Rwanda, Saõ Tomé and Príncipe, Senegal, Sierra Leone, and Zambia.

Sixteen countries are not yet at decision point. Four of these are considered to have potentially sustainable debt without HIPC assistance: Angola, Vietnam, Kenya, and Yemen. Of the remaining twelve countries eight are conflict-affected which for that reason have difficulties reaching decision point: Burundi, Central African Republic, Democratic Republic of Congo, Republic of Congo, Myanmar, Somalia, and Sudan. For the last four countries there are various other reasons for no reaching decision points: Comoros, Côte d'Ivoire, Lao People's Democratic republic, and Togo.

Full details of the implementation so far are given in IMF and World Bank (2003) and OED (2003), including cost estimates for all 26 countries which have reached decision point or beyond.

Review of the HIPC Initiative

IMF and the World Bank have recognized that there is no guarantee or even likelihood that the HIPC Initiative will provide debt sustainability in any meaningful sense for all the HIPCs involved. In fact, it has been explicitly recognized that some of the countries will not achieve the Initiative's own target values for at least ten years (IMF and World Bank, 2001, p.19). The World Bank Operations Evaluation Department has recently reviewed the HIPC Initiative in a very insightful, comprehensive and updated review, although the recommendations concluding the review are somewhat veiled formulated, OED (2003).³

Since the HIPC Initiative was launched and put into effect it has been exposed to severe criticism on a number of counts, foremost that it will not deliver the debt sustainability it has been designed to provide. It has been asserted that the debt sustainability analysis (DSA) which is a core element in the HIPC, is flawed both conceptually and applied in an inappropriate way. In particular that the growth assumptions made in the projections for the HIPC countries are too optimistic to the extent that it undermines the entire process.

Other criticisms are that a) developing countries' suggestions have not been taken seriously enough, b) E-HIPC's burden sharing is unrelated to economic power, c) HIPC has financing problems postponed to the future, d) anticipation of HIPC is likely to defer

traditional development assistance, e) discounts rates are used inappropriately or inconsistently.

A more fundamental criticism is that the debt relief offered through HIPC is not based on a country's need for sustainable development.⁴ Furthermore, it has been asserted that the debt relief may lead to corresponding changes in the traditional development assistance, that the debt relief is unduly delayed by the inclusion of the poverty aspect as it has to wait for the PRSPs to be finished and may divert resources away from growth-enhancing activities, and that part of the debt relief is nothing more than ole-fashioned debt rescheduling.

The concept of debt sustainability

The definition of debt sustainability targets in the HIPC Initiative is no more than a rule of thumb, changed from O-HIPC's target of NPV debt/exports within 200-250 percent to E-HIPC's target of NPV debt/exports equal to 150 percent.

Underlying this rule of thumb is the idea that the debt sustainability or the solvency of the country must somehow be related to the ratio of the debt to an appropriate measure of the country's resources. Why exports in the denominator rather than GNI/GNP/GDP? The problem was addressed in Cohen (1988), who argued that exports are too narrow as such a measure of resources, while GDP is too broad. In an elegant analysis Cohen finds that the appropriate measure is a linear combination of GDP and exports with Sraffian invariability property.⁵

Cohen's study as other literature on debt sustainability from the 1980s or earlier was addressing Latin American debt problems, more than the type of vulnerable economies that the Sub-Saharan HIPCs represent. Debt-to-GDP is completely missing as an indebtedness indicator in the HIPC Initiative documents, although it has a clear advantage over the debt-to-exports as a much less volatile indicator. Debt-to-government revenue may also have more merit than the debt-to-exports as an indicator of ability to service debt for HIPCs, although there are problems such as off-budget accounts and moral hazard/incentives with this indicator.

Hjertholm (2001) traces the history of debt sustainability targets used in the HIPC Initiative and concludes that they lack a strong analytical basis. He finds that they originated as "switching values" for sustainability/unsustainability of debt, based on average calculations. But as HIPCs encounter debt problems for a wide variety of reasons at different levels of foreign debt, the target values are inadequate as applied to any country. Country-

specific targets need to be adopted. The target values serve as anchors of debt relief without any empirical foundation for the countries to which they are applied. The “true” target values may be either lower or higher than the HIPC Initiative values, and as a result, the debt relief funding will be allocated inconsistently with individual country needs.

The LDCs with exports based on a limited range of primary commodities with prices set in international markets, the export earnings are very volatile and the E-HIPC’s use of a three-year backward looking average is not a satisfactory basis for assessing the future debt sustainability and not empirically well corroborated. The linking of debt sustainability to export earnings is based on the assumption that the availability of foreign exchange is the main constraint facing the LDCs. The constraint is more typically felt at the budget level. Export earnings are not necessarily linked very closely to higher government revenue, particularly not when export earnings are held in off-shore accounts or are the result of tax holidays and slashed export tariffs to attract foreign investors. The debt-carrying capacity of the government is related 1) the debt-service requirements for a given value of NPV debt stock, 2) the domestic debt service, and 3) the projected flows of official grants and concessional loans. The debt service-to-government revenue or the debt service-to-GDP may be better indicators of poor countries debt-servicing capacity than the export indicator.

A more fundamental criticism of the E-HIPC’s concept of debt sustainability is that it reflects a very narrow definition of sustainability, ignoring development objectives. The World Bank’s formal definition of a country with external debt sustainability as one which “can meet its current and future obligations in full, without recourse to debt reschedulings or the accumulation of arrears and without compromising growth” (World Bank, 2001) can be counterposed to a frequently quoted passage by Jeffrey Sachs: “it is perfectly possible... for a country to have a ‘sustainable debt’ while millions of people are dying of hunger” (Sachs, 2002).

One of few econometric studies of relevance for assessing debt sustainability of HIPCs is Kraay and Nehru (2003), which uses probit regressions for the study of debt distress, defined as resort to exceptional finance.⁶ The study uses data for a large number of low-income countries and finds that debt distress can largely be explained by three factors: the debt burden, the quality of policies and institutions, and shocks. As measures of the debt burden Kraay and Nehru (2003) finds that flow measures are more significant indicators than indicators. Based on debt stock as in E-HIPC.

The implications of the study is that the “sustainable” level of debt varies with the quality of policies and institutions, as measured by the World Bank Country Policy and Institutional assessment (CPIA) ratings, in a quite substantial way. This finding has an intuitive appeal, but it has never been well corroborated before, and speaks strongly in favour of a more individual debt sustainability assessment than used in E-HIPC. This supports Hjertholm (2001)’s observation and Kraay and Nehru (2003) gives a very convincing demonstration of this point, which undermines the logic pursued in E-HIPC.

What is wrong with the HIPC Initiative?

Most criticisms raised against the HIPC Initiative are included in the comprehensive statement of Gunter (2001, 2002, 2003), whose argument we summarize below.

Inappropriate eligibility criteria

Gunter (2003) key criticisms are that the current eligibility criteria are neither based on a comprehensive measure of poverty nor on a comprehensive measure of indebtedness. Gunter (2003) argues, as many others, for the relevance of a fiscal indicator of indebtedness, but the fiscal window in HIPC has unwarranted thresholds. Several of the countries for which DSAs have been undertaken under the HIPC Initiative will pay more than 20 percent of fiscal revenues as external debt service after debt relief.

Gunter argues that the use of “IDA-only” in the definition of HIPC, which again is based on nominal GDP per capita, ignores not only the distortion of not using purchasing power data, but more fundamentally that poverty is a multi-dimensional concept. This is of course also the basis for the classification of LDCs. Gunter’s key example of an unfairly excluded country is Nigeria which is poor and highly indebted. Gunter (2003) suggests that the Human Poverty Index for developing countries (HPI-1) of the Human Development Report should be instead for the poverty classification. Of relevance here should be CDP’s work on indexes for LDCs.

Using the HPI-1 for poverty and debt-to-GDP for indebtedness, Gunter asserts that there are more than 20 non-HIPCs which are poorer and more indebted than the two highest ranked HIPCs.

Unrealistic growth assumptions

The growth assumptions used in the DSAs of the E-HIPC have received vast criticism as being overly optimistic, if not outright biased. The lack of transparency in these calculations is also a problem. Too optimistic growth projections inflate the denominator and

underestimate the numerator of the debt-to-exports indicator and thus may lead to highly misleading results.

Insufficient provision of interim debt relief

Several of the HIPC's have in fact not been able to pay debt service in full in recent years. For countries accepted into the E-HIPC it is not allowed to accrue arrears, As a result the actual debt service payments will be higher. As a result these countries get into difficulties in reaching completion points unless interim debt relief is forthcoming in sufficient quantities. Hence, countries are queuing up between decision points and completion points.

Delivering HIPC debt relief through debt rescheduling

Gunter (2003) points out that the debt reduction offered by E-HIPC is to a certain extent based on reschedulings rather than cancelling of debt stock. This reduces the debt service in the short-term, but increases the total debt service a country has to pay in the long-term. A debt rescheduling maybe appropriate for borrowers with temporary payment problems, but as the historical experience has shown, it is not a solution for HIPC's.

Lacks in creditor participation and financing problems

Gunter (2003) points out, as indeed stated in the latest HIPC Status Report (IMF and World Bank, 2003), that full creditor participation, as the E-HIPC is based upon, has not been achieved. Furthermore, parts of the financing needed for the multilateral debt is still lacking, and if not forthcoming, will result in lower IDA assistance to other countries in the future.

Currency-specific short-term discount rates

A somewhat more technical point but still of quite substantial importance is the use of discount rates in the calculation of the net present value of debt, as pointed out by Gunter (2003). The rates used are commercial interest reference rates provided by OECD for its member countries based on commercial lending rates. These are short-term rates as they are the average rates for the last six-month period before the reference date of the DSAs. The use of these short-term rates rather than uniform discount rates have implications both for creditor and debtor countries as well as for the overall cost estimates of the HIPC Initiative.

First, it affects burden sharing between the creditor countries as countries with high lending rates at the time of calculation get a smaller burden than countries with lower rates. In short, booming economies gain, countries in recession lose. Second, for debtor countries it means that the amount of assistance depends upon the current (6 months) world interest rates at the decision point. Third, the estimates of NPV of debt and thus of costs of assistance as

well as the development of the sustainability indicator vary over time and thus adds interest rate volatility to the volatility of exports. Additional arbitrariness is caused by inconsistent use of discount rates for non-OECD currencies, as pointed out by Gunter (2003).

An improved HIPC Initiative or a more radical approach?

A number of participants in the global discussion of HIPC and the debt issue have suggested a more or less radical shift of focus of the debt relief effort. Gunter (2003) argues in favour of a second enhancement of the framework of the HIPC Initiative, with changes in six areas in line with the criticism raised above: (1) revisions of HIPC eligibility and debt sustainability indicators, (2) the appropriate use of growth projections, (3) the provision of interim debt relief, (4) the delivery of debt relief, (5) adjustments in the burden-sharing concept, and (6) the appropriate use of discount rates for the NPV calculations (Gunter, 2003, p.15).

Others regard the HIPC Initiative as basically flawed and propose a more radical shift of focus, primarily by arguing that poverty not debt is the core of the problem. These proposals will more often than not refer to the Millennium Development Goals (MDGs), the internationally agreed development targets to halve poverty by 2025, as the obvious reference and benchmark for any effort to assist the poorest countries and view the debt problem as a subordinate or even residual part of a grand poverty relief effort. The UN Financing for Development Conference at Monterrey in 2002 provides a strong moral foundation for such proposals, considering the broad consensus that emerged from that conference as an international commitment to achieve the MDGs. The G-8 African Action Plan for Africa likewise stated: “No country genuinely committed to poverty reduction, good governance and economic reform will be denied the chance to achieve the Millennium Development Goal through lack of finance”. Despite the stated commitments donors have not pledged the additional aid resources that are needed to meet these goals.

The same winds in the global community that led to the enhancement of the HIPC Initiative in 1999 also promoted the MDGs, but the inclusion of social expenditures in the E-HIPC fall short by far of fulfilling the MDGs. An optimistic view of the outcome of the HIPC Initiative, as embedded in the growth projections is that the HIPCs after debt relief and the assumed additionality will be able to generate the additional funds needed to fulfil the MDGs by attracting private sector investments and benefit from the global marketplace. A less

optimistic view sees the HIPC (or most of them) as highly vulnerable even after receiving the debt relief of the E-HIPC, with quite limited possibilities for attracting foreign investments, particularly as global trade rules limit their ability to develop their markets and thus likely soon to be left with unsustainable debts again.

A doubly enhanced HIPC Initiative?

Gunter (2002, 2003) argues in favour of changes in the framework of the HIPC Initiative, in line with the criticisms rendered above.

Revisions of HIPC eligibility and debt sustainability indicators

Eligibility is proposed changed to be based on poverty index (HPI-1) rather than income and on fiscal debt sustainability, rather than debt-to-exports. The thresholds on the fiscal window should be abandoned and the NPV debt-to-revenue ratio reduced. Possibly could the fiscal debt sustainability be combined with debt-to-GDP be used together. To avoid moral hazard problems with countries trying to qualify for HIPC treatment a longer backward average of revenue than the current three-year average could be used. Vulnerability factors, particularly related to export concentration and export price volatility, also ought to be taken into consideration, such that country-specific vulnerability factors are taken into account when determining the amount of debt relief.

The appropriate use of growth projections

Here the suggestion in Gunter (2003) is to use the 90 percent lower bound for the growth rate, rather than the point estimates. This makes a considerable difference for most countries. Even so, for most of the HIPCs more attention should be given to the export price volatility and the export price attention than seem to be the case in the E-HIPC DSAs.

The provision of interim debt relief and the delivery of debt relief

The proposal is more interim debt relief to make sure the process gets off the ground and cancellations of debt service and debt rather than new reschedulings.

Adjustments in the burden-sharing concept

The burden-sharing is at the outset supposed to be proportionally among creditors. This raises some problems as some creditors developing countries, some even non-members of IMF and World Bank. The proposal is to base the burden-sharing to larger extent on economic power.

The appropriate use of discount rates for the NPV calculations

The proposal is to replace the currency-specific discount rate with one fixed low discount rate for all NPV calculations.

Starting from Millennium Development Goals

A more radical refocusing is argued by EURODAD (2001), proposing with reference to the Monterrey International Conference on Financing for Development a bottom-up approach to the debt sustainability issues by starting from what is required for a sustainable development for each country and deriving from that what is the affordable level of debt. The Monterrey commitment by heads of states to provide countries committed to poverty reduction with the necessary financial resources to reach the Millennium Development Goals (MDGs) by 2015. Indeed, the Monterrey consensus paper states that “future reviews of debt sustainability should also bear in mind the impact of debt relief on progress towards the achievement of the development goals contained in the Millennium Declaration”.

A number of NGOs and also development agencies have argued vehemently for a link to be established between the MDGs and the sustainability of debt relief, also referred to as “human development sustainability analyses” (Northover, Joyner and Woodward, 1998). This is indeed in line with the closer integration of debt relief with broader human development objectives that low-income countries in NEPAD have argued for within the UN Financing for development process.

Rather than calibrating the debt relief to be sufficient to allow a substantial increase in social expenditures as in the E-HIPC, the objective of debt relief is seen as part of a global effort to mobilize the finances needed to achieve the MDGs, considered as “costed poverty reduction programmes”. The “payability” or sustainability of poor country debts is thus integrated with a broader set of economic and human development objectives.

In this approach the foreign exchange earning capacity is toned down in the overall assessment of debt sustainability, as only one of several financing and development considerations. Debt-serving obligations must be constrained to the extent that agreed poverty reduction expenditures are fully funded.

More emphasis is in these proposals put on the fiscal sustainability of debt servicing, by putting a ceiling on the debt service as a share of government revenue, e.g. 5 percent, or in more elaborate terms as a share of government revenue net of expenditures for poverty reduction, servicing domestic debt etc.

For the poorest countries this line of reasoning comes very close to imply a full cancellation of all debt repayment. It has been estimated that full cancellation of the post-decision point debts of all African countries over the next five years will come to about 0.15 percent of the annual fiscal revenue of the G-7 countries, or a correspondingly smaller if distributed over all OECD countries.

An example of this “bottom-up approach” relative to that of E-HIPC, is outlined in EURODAD (2001)⁷ as a four-step procedure as applied to a single country:

Step 1: The starting point consist in assessing the overall resources available to the government’s central budget. This is defined here by fiscal revenue and donor grants. Other sources of donor support such as technical assistance are not taken into account because these funds do not constitute resources available to country authorities for spending on sustainable development. We also argue that loan disbursements should not be included in this definition, as they would be used to finance activities that are not directly profitable.

Step 2: From this starting point of the resources available to the government, we then subtract the amount of resources that the country will need to spend to achieve the MDGs as the internationally agreed benchmark. This figure can be assessed by computing, for each ‘goal’, the annual level of investment required to meet the 2015 target. Valuing the resources needed is notoriously difficult for some of the MDGs, thus the scope could be limited to ‘goals’ related to health (combat HIV/AIDS, malaria and other diseases, improve maternal health and reduce child mortality), education (achieve universal primary education), and environmental sustainability (halve the proportion of people without sustainable access to safe drinking water and improve the lives of at least 100 million slum dwellers).

Step 3: Repayment of domestic creditors should also be prioritised over external debt, particularly with respect to the stability of national financial systems.

Step 4: No more than a third of the remaining resources should be used to service the foreign debt in order to take into account other ‘non-essential’ but nonetheless key public expenditures that need to be made. These would include the costs of running the civil service, police force and judiciary, as well as basic investments on infrastructure (EURODAD, 2001).

Conclusion: debt sustainability vs. sustainable development

Which conclusions to be drawn from the controversies surrounding the HIPC Initiative?

- The concept of *sustainable debt* with a corresponding operational indicator may turn out to be much less value and general applicability than the prominence it has got in the HIPC Initiative. This does not rule out a role for indicators to assess the situation in poor countries. Flow indicators, say for fiscal sustainability (cf. Cuddington, 1997) or external balance sustainability, may turn out to be more valuable diagnostic tools. Of major interest would also be poverty indexes or poverty reduction indexes, that are comparable between countries, and linked to the achievement of the MDGs.
- It is furthermore easy to agree with a number of critics that although the underlying motivation for the HIPC Initiative was relieve poor countries from the debt burden, most of them would never be able to cope with by their own devices, and provide fiscal room for poverty reduction, the poverty dimension has lost out compared to the debt issue. This was embedded in the design of the HIPC framework, but it is quite imaginable on the basis of constructive proposals to imagine a revised HIPC framework. The problem will hardly be in the design of a framework addressing sustainable development more than debt sustainability, but in the political and financial support that may not be forthcoming for a vastly enhanced HIPC effort.
- The country coordination required in the HIPC Initiative is primarily a creditor coordination. A further role for the HIPC Initiative towards in the direction of fulfilling MDGs may require a long overdue coordination of donor countries, pooling of resources rather than letting 40 aid agencies work side by side in Africa, cancelling ODA debt, agreements on replacing loans by grants (cf Meltzer commission), etc., towards creating what has been called a *new aid architecture* (cf. Birdsall and Williamson, 2002). The lack of participation of the poor countries themselves in the HIPC decision-making is also a unsatisfactory aspect.
- In line with the findings of Kraay and Nehru (2003) there is a need to assess the implications in development aid of the considerable differences in the quality of policies and institutions. Kraay and Nehru, indeed, proposes as policy conclusions from their findings that the amount of new lending should be calibrated to the probability of debt distress. Badly run countries will have a higher share of grants, the same would hold for countries more exposed to shocks. The amount of finance would, however, reward countries with good policies and support their efforts for growth and attraction of private capital.

- It is necessary to make the most out of LDCs' own ability to mobilize domestic resources for finance. UNCTAD (2000)'s analysis indicates a relatively high marginal propensity to save in the LDCs as compared to other developing countries. This has not resulted in much saving as growth in income per capita by and large has been negative. To generate a positive development that would result in domestic savings it seems necessary to provide international support to counteract the vulnerability of the commodity exports and the declining terms of trade. The close association between falling and volatile commodity prices and unsustainable external debt does not seem to have got the attention deserved within the HIPC framework (UNCTAD, 2002). The debt relief offered to the poorest countries amount to a very small part of the finance required. In a further enhancement of the HIPC Initiative an argument could be made for having two categories of countries as the LDCs caught in the international poverty trap may need much more comprehensive measures to achieve sustainability.
- The most ominous aspect of the overall picture is the lack of overall resources to support the MDGs. If all industrial countries contributed the recommended 0.7 percent of GNP in official aid for developing countries and multilateral institutions (DAC members of OECD currently spend only 0.25 percent of GNP), it would go along way towards satisfying MDG commitments. The difficulty of achieving this, again raises the question of whether new global taxes according to one of the many proposed schemes would be an easier way.

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Notes:

¹ The original group of HIPC's was established in 1994 for analytical purposes and comprised 32 countries with a 1993 per capita GNP of US\$695 or less, and either a 1993 NPV of debt-to-exports ratio of at least 220 percent or an NPV of debt-to-GNP ratio of at least 80 percent. Also included were nine countries that had received, or were eligible for, concessional reschedulings from the Paris Club, to make up a total of 41 HIPC's (Daseking and Powell, 1999, p.14, n.15). Later Nigeria and Equatorial Guinea were dropped from the list and Comoros, Gambia and Malawi added to make up 42 HIPC's from 2002.

² The fiscal window seems to have been included purely to accommodate France's insistence that Cote d'Ivoire should be included among the HIPC's, see Martin (2002).

³ The four summary conclusions of World Bank Operations Evaluation Department run as follows:

1. Clarify the purposes and objectives of the Initiative, ensure that its design is consistent with these objectives, and that both the objectives and how they are to be achieved are clearly communicated to the global community.
2. Improve the transparency of the economic models and methodology underlying the debt projections and the realism of economic growth forecasts in the debt sustainability analyses. This would facilitate decision making by providing a better assessment of the prospects and risks facing individual countries.
3. Maintain standards for policy performance. This would reduce the risks for achieving and maintaining the initiative's objectives. When the established policy performance criteria need to be relaxed, there should be a clear and transparent rationale.
4. The performance criteria need to increase the focus on pro-poor growth. There should be a better balance between growth-enhancing and social expenditures, relative to the current emphasis on the latter.

⁴ A recent UN General assembly draft resolution stresses in this regard that "debt sustainability depends upon a confluence of many factors, at the international and national levels, and underscores that no single indicator should be used to make definitive judgements about debt sustainability and emphasizes that country circumstances should be taken into account" (UN, 2003).

⁵ Cohen added another insightful paper on the sustainability issue in Cohen (1996).

⁶ The paper seems inspired by an almost classic contribution by McFadden et al. (1985).

⁷ EURODAD stands for European network on Debt and Development.