



**The HIPC Initiative: The Goals,
Additionality, Eligibility, and
Debt Sustainability**

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EXECUTIVE SUMMARY

The HIPC initiative has identified the cycle of debt reschedulings and restructurings of many of the poorest countries as a serious development problem. It has mobilized the lender community to restructure loans with the aim of generating debt sustainability: the elimination of chronic debt repayment problems. The initiative encourages much more coordination among the community of lenders, in particular between the World Bank and IMF. It also calls for much greater transparency and involvement of the civil community than has occurred before. The initiative has introduced new and much improved measurements of the debt burdens of developing countries.

Nevertheless, aspects of the conceptualization and design of the initiative could stand improvement. How the multiple goals of the initiative are to be met with the limited set of instruments it is using needs clarification. How much the three goals of debt sustainability, growth promotion, and poverty alleviation are mutually consistent depends in large part on factors beyond debt reduction itself, in particular the availability of future grants, the terms of subsequent lending, growth prospects, and, most importantly, the policies of the HIPC governments themselves. The degree of additionality in aid resources (meaning the increase in the net present value of resource transfers from lender/donors) envisioned by the initiative has not always been clear. Without additionality the initiative does not by itself provide any additional resources for poverty alleviation and debt sustainability. Additionality requires either additional commitments by donors or else a diversion of aid resources away from less indebted (but potentially more needy) countries.

Historically, lower debt has not implied increased transfers. A simple econometric analysis of transfers and debt among selected HIPCs over the last decade suggests that more debt has, if anything, been associated with slightly *larger* net resource transfers. There is no reason to think that this positive association will apply to the debt reductions occurring under the initiative, but it is a mistake to think that lower debt automatically delivers additional resources.

Nevertheless, in the past, many such transfers were probably “defensive” (made to finance debt service obligations and avoid default) and consequently poorly targeted. A benefit of debt reduction is that what transfers do occur may be more precisely targeted. More generally, even in the absence of any additionality, debt reduction provides many advantages in terms of using the aid flows that do occur much more efficiently.

A point that deserves emphasis is that even the limited goal of debt sustainability alone cannot be met with the single tool of a one-time debt reduction, at least with any certainty. Future borrowing should be monitored to ensure that it is consistent with the initiative’s debt targets and broader indicators. Lenders and borrowers need to commit to future lending that maintains these targets, increasing the grant elements when limits are approached. The HIPC governments need to pursue sound fiscal and debt management policies. This point is recognized in the HIPC documents and among the staff with whom I had discussions. It is important that it be recognized by the public as well: Debt reduction is just a tiny step down the road to debt sustainability.

The eligibility criteria, while debatable, seem appropriate given the goal of debt sustainability. To the extent that poverty alleviation is a goal, requiring additionality, poverty rather than debt indicators would be more appropriate. The debt-inventory methodology for assessing the *current* debt levels of potential HIPCs is clear and reasonable. It would be desirable to implement it more widely.

Members of the Bank staff expressed alarm, however, over the treatment of the HIPC debt relief in the World Bank's Global Development Finance (GDF) data. The claim was that the GDF data simply failed to record relief provided under the initiative as assistance. This failure led outside observers making use of these data to infer that the initiative was not delivering relief as promised. This issue deserves further investigation. Such a failure would be most alarming. Moreover, this concern reflected a more general sense that the Bank has been falling down in its debt reporting responsibilities. The Bank's Debt Reporting System is central to the participation of poor countries in international capital markets. The system needs to provide accurate, accessible, and timely data.

In contrast to the debt-inventory methodology for assessing eligibility based on *current* debts, the methodological framework behind the projections of *future* debt in the DSAs (debt sustainability analyses) conducted by the Bank and Fund is somewhat murky. An acknowledged flaw is that the debt projections and the macro framework do not emerge from an explicit, consistent economic model. As a consequence it is not clear what assumptions the debt projections embody about the evolution of debt, the balance of payments, and the fiscal balance. Also unclear is the extent of additionality assumed in the DSAs. To what extent is the initiative promising additional resources to governments?

The assumptions about the future growth of GDP and exports incorporated in the debt projections seem optimistic. Some outside analysis suggests that these optimistic outcomes are required for the initiative to achieve debt sustainability. While there is some analysis of alternative scenarios more would be useful.

A general concern, then, is that the initiative, while highly laudable in many elements, faces the danger of appearing to promise more than it can deliver.

The report concludes with four recommendations related to the initiative.

I. Overview

The Operations Evaluation Department, (OED) approach paper describes the objectives of Highly Indebted Poor Country (HIPC) initiative as follows: “to reduce the external debt of countries to sustainable levels, the underlying premise being that debt is an impediment to achieving the long run *development goal* of sustainable economic growth.” It goes on to state that “the implementation of the initiative is expected to help governments focus on policies and reforms that are necessary for the simultaneous achievement of debt sustainability, sustained growth and poverty reduction.” (OED, undated).

The OED lists the key building blocks of the original initiative as: (i) the *eligibility criteria* to identify HIPCs eligible for debt relief under the program, (ii) *debt sustainability analysis*, (iii) *country performance criteria*, and (iv) *creditor participation*. It lists the six guiding principles of the program as: (i) targeting overall debt sustainability on a case-by-case basis, “thus providing a durable exit strategy from the rescheduling process” (ii) the requirement that to be eligible for relief a country must have “a track record” demonstrating “an ability to put to good use whatever debt relief would be provided” (iii) the use of “measures that build on ‘traditional mechanisms’” (iv) coordination among all creditors involved; (v) the preservation of the “financial integrity” and “preferred creditor status” of multilateral creditors; and (vi) the appropriate concessionality of new financing.

Pursuant to my terms of reference, this report deals primarily with the topics of eligibility criteria, the debt sustainability analyses, and likely outcomes.

The Official Financing Operations Division of the Policy Development and Review Department provides a comprehensive explanation of the initiative in its *Enhanced HIPC Initiative Guide Book* (December 2000). The provisions are complex and will not be repeated here. Instead I provide a brief summary of the procedures as I understand them, emphasizing the points that are relevant for my review. (I describe the enhanced 1999 rather than the original 1996 initiative.)

Eligible countries are drawn from 41 countries classified as HIPCs according to their low per capita GDP’s and high debt to export ratios. To be eligible a country must: “(i) be IDA-only and PRGF-eligible; (ii) pursue or adopt IMF- and IDA supported programs through end-2002; (iii) have received or be eligible to receive assistance under traditional debt restructuring mechanisms; and (iv) have an unsustainable debt burden.”

Eligibility is determined and the execution of the initiative occurs over four stages:

1. The First Phase

The candidate country must adhere to IMF and World Bank adjustment and reform programs for at least three years. During this phase it will continue to receive traditional assistance and Paris Club relief. Adherence to the program during this period establishes eligibility according to criterion (ii) above.

2. The Decision Point

A country's eligibility according to all four criteria above is formally established by the executive boards of the World Bank and International Monetary Fund (IMF) at a *decision point* at which time assistance is calculated. The fourth criterion, which will receive particular attention in this review, is based on a calculation of a country's net present value (NPV) of (public or publicly guaranteed) external debt relative to its exports or, in some cases, the NPV of debt relative to fiscal revenues. In order to arrive at a decision point a country must have, among other things, provided an interim Poverty Reduction Strategy Paper (PRSP) and the World Bank and Fund must have conducted a Debt Sustainability Analysis (DSA). The DSA includes assessment of the eligibility criteria as well as a forward-looking projection (over a period of 20 years) of debt. DSA's are expected to be performed at other points in the process as well. At the decision point the lending community commits to a level of irrevocable debt relief by the (floating) *completion point* conditional on good performance during the interim second phase.

3. The Second Phase

The country must continue to adhere to IMF and World Bank programs while receiving interim debt relief, with other creditors expected to reschedule or provide other assistance. The country must adopt and implement "a poverty reduction strategy developed through a broad-based participatory process."

4. Completion Point

Assuming that the country satisfied second-phase conditions creditors provide debt relief irrevocably. Another DSA is performed at this point "to assess the extent to which long-term debt sustainability was being achieved." (IMF and IDA, Enhanced HIPC Initiative-Completion Point Considerations, August 17, 2001). Additional relief at this point might be provided in order to meet the initiative's objectives.

As of October 2001, 3 countries (Uganda, Bolivia, and Mozambique) have reached completion points while 21 countries have reached decision but not completion points.

II. Scope and Summary of this Review

This review is limited to the methodology of the implementation of the initiative rather than how this methodology has been applied to particular countries. Such a review would require particular country-specific expertise that this reviewer lacks. As mentioned, particular attention will be placed on how the eligibility criteria and the debt sustainability analysis relate to the goals of the initiative.

A summary finding is that the HIPC initiative has been a bold and so far largely successful effort to reshape procedures under which the lender community provides assistance to the poorest, most-indebted countries. Particularly meritorious are the efforts: (i) to identify high levels of debt as a source of burden to these countries and to implement steps toward reducing this burden; (ii) to encourage much more collaboration among the World Bank, IMF, and Paris Club creditors; (iii) to provide much more transparency and civil community involvement in policy formation. At the same time aspects of the initiative raise doubts about its ability to deliver achievements in all of the directions that it promises. There are also flaws in the details of its implementation. The criticisms raised in this review should not be seen as yielding any judgment about the purpose and implementation of the initiative as a whole, but only to point out goals that seem unrealistic and procedures that seem incomplete or inconsistent. They are offered in hope of clarifying what the initiative can accomplish, and suggesting modifications that might allow the initiative to achieve what it can accomplish more successfully.

The review is based on an extensive reading of HIPC documents created by the Bank and IMF, as well as a number of external reports on the initiative. External critiques include Sachs et al. (1999), Gunter (2001, 2002), Development Finance International (2001), Martin (2001), and an extensive report by the United States General Accounting Office (June 2000). The report is also based on visits that I made to the Bank and IMF on January 24 and 25, 2002 and again on June 5 and 6, 2002. During those visits and in telephone interviews I discussed the initiative with various current and former members of the HIPC unit and with IMF staff.

III. Goals of the Initiative and Additionality

Any assessment of the initiative must be based on a clear understanding of its goals. The HIPC documents suggest at least three:

- (1) As quoted above, one purpose appears to be “to provide a durable exit strategy from the rescheduling process.” That is, the initiative is intended to reduce debt service obligations that the country can more easily meet with its export revenues and future transfers, eliminating the need for future reschedulings, defensive lending, and debt forgiveness.
- (2) As quoted in the first paragraph, the initiative is expected to raise long-term growth rates.
- (3) As stated in the sample press release provided in the *Guide Book* “the debt reduction operation will create room for additional public expenditures on poverty reduction.”

How the initiative will further all three goals is not always clear. In particular, how it “creates room for additional public expenditures” is not clearly spelled out. Moreover, these goals may conflict with one another, and how one evaluates the initiative depends very much on which goals one has in mind.

It is not clear the extent to which the initiative is intended to raise the net present value (NPV) of official resource transfers to the HIPCs, i.e., to provide additionality. Much of the discussion in the HIPC documents (e.g., “creating room”) suggests that additionality is intended. But there is no reason to think that debt forgiveness, by itself, will have this effect. The initiative will increase net resource transfers to the HIPC countries only if subsequent grants do not fall dollar-for-dollar with the reduction in debt-service obligations resulting from current debt. The DSAs and other documents were unclear about what assumptions were being made about the effect of the initiative on the amounts and terms of future transfers. According to the *Guide Book* projections are based on a survey of the donor/lender community to assess their anticipated transfers. But it is not clear how the donor/lenders’ own projections had taken the initiative into account. There are three possible pure scenarios:

- (1) The donor/lenders would provide the same gross future amounts irrespective of the initiative. In this case the reduction in debt-service obligations due to the initiative is fully additional.
- (2) Donor/lender projections of future gross transfers did not anticipate the initiative, and that donor/lenders will cut back future gross transfers to maintain net resource transfers. In this case there is no additionality and the debt projections overstate future gross and net transfers.
- (3) Donor/lender projections already anticipated the initiative by cutting back on future gross transfers by the amount of the reduction in debt service obligations delivered by the initiative. In this case the debt projections correctly reflect what will subsequently be transferred on a gross and net basis, but that gross transfers already have fallen

dollar-for-dollar with the reduction in debt-service obligations delivered by the initiative. The same net transfers would have occurred in the absence of the initiative.

Of course the true outcome could be anywhere between these three pure scenarios. What the debt projections in the DSAs assume is not clear. The discussion in HIPC documents often seems largely to imply the first scenario, in which there is full additionality.

The first objective, a “permanent exit from rescheduling,” can be achieved without any additionality. Indeed, to the extent that additionality occurs in the form of future loans rather than pure grants, the less additionality the better, to the extent that it would take the form of loans rather than grants. Less future borrowing reduces future debt-service obligations and hence the likelihood of future rescheduling. On the other hand, no additionality implies that the initiative will not create, at least directly, any “room for additional expenditures.” Hence the more the initiative achieves the first objective, the less it does toward the third. Achieving the second, growth, objective would also require additionality if the idea is that the initiative provides funds for investment. The more speculative “debt overhang” argument, that debt scares away private investment, might provide a reason for the initiative to raise growth even if it does not entail additionality. But for this argument to hold water private investors must anticipate that at some point the country will be making net resource transfers to creditor, which has not happened historically. At the same time, however, eliminating the expectation of future crises probably would have indirect positive economic effects.

Gunter (2001, 2002) reports preliminary evidence that there has been in fact no additionality, although the nature of this evidence remains in dispute. One claim is that his conclusion is the consequence of the faulty treatment of the initiative in the World Bank’s Global Development Finance (GDF) dataset. In any case, his analysis of completion point countries suggests that the initiative might have been associated with an increase in private foreign direct investment.

As discussed further below, if the initiative is meant to provide an exit from debt relief while not increasing overall aid or redirecting aid resources toward HIPCs away from other poor countries, then lack of additionality is actually a good thing. But what are the gains from reducing HIPC debt if there is no added transfer to the HIPCs? One is simply that the rescheduling process itself has been very costly for the HIPCs and creditors: debt negotiations are complex and require the extensive involvement of senior government officials, whose time and talents are scarce; furthermore, uncertainty about the outcome of the negotiations generates economic instability. A second gain is that aspects of the initiative involve more coordination and rationalization of the use of funds in eligible countries. For example, project lending will be replaced with general budget support. All of these effects are potentially growth and tax-revenue enhancing.

It should also be mentioned that if the initiative does not entail any additionality, it is misleading to talk about the “cost” of the program to creditors, as so many HIPC documents do. The creditors are not giving up anything. By forgiving debt, creditors are giving up debt-service payments while simultaneously divesting themselves of their obligation to provide transfers to finance those payments. Nevertheless, the initiative

might end up reshuffling obligations among individual donor/creditors, so that discussion of appropriate “burden sharing” might have some meaning.

IV. Net Resource Transfers and Debt: “Subtractionality”?

There is no simple way of knowing the extent to which debt relief achieved under the initiative will direct additional sources toward the HIPCs. As part of this review I examined the Global Development Finance (GDF) Data, provided by the OED, on the finances of 25 HIPCs over the periods for which data are available.¹ It should be noted that these data have been subject to a great deal of criticism and are different from the data used to determine eligibility. The second are based on an extensive debt inventory and were not available in this earlier period. An important difference is that the debt variables in the GDF Data are nominal values of outstanding debt rather than the NPV of future debt service payments used to determine eligibility. Nevertheless, the hope is that there is some association between the two sets of data.

I looked at three measures of net resource transfers to the HIPCs, the resources added by the rest of the world to what these countries produce themselves. The most narrow one is the official net resource transfer (ONT). The second is the aggregate net transfer (ANT), which includes private flows and remission of profits. The broadest is the trade deficit, imports less exports (M-X). For most countries the first two series tend to be very close together and stable over time. Exceptions are periods of extreme crisis when ONT tends to shoot up, as for Rwanda in 1996. Figure 1 reports the figures for ANT and M-X, each taken as a ratio to Gross National Income (GNI).

Does having more debt reduce these transfers? That would be the case if new transfers did not respond dollar-for-dollar with debt-service obligations. A panel regression of each of these transfer measures against the total debt stock (EDT), with all variables taken as a ratio to GNI, provides suggestive evidence about the connection between the stock of debt and net resource transfers. In fact, such regressions (including year and country dummies) on the unbalanced panel yield significantly *positive* coefficients between .033 and .050 (depending on the measure). The implication is that more debt was associated with a greater transfer. (The inclusion of country dummies controls for country size, so scale effects or any other permanent cross-country differences are not driving the result.) One explanation for a spurious positive association between net resource transfers and debt is that a higher transfer during the year raised the debt at the end of the year, biasing the coefficient upward. Lagging the debt variable by a year solves this problem, but doing so lowers the estimated coefficients only slightly, to about .03, and they remain very significantly positive. Hence a dollar more of nominal debt at the end of a year is associated with about three cents *more* worth of resources the following year. If the results apply to debt *reduction* under the HIPC initiative, then additionality is negative: *subtractionality*! Since the coefficient is small, and the reason for debt reduction under the initiative is different from the variation in debt levels during the estimation period, this result should not be interpreted as a forecast. Indeed, there is little reason to think that there would be subtractionality. But the results do not provide any reason to think that the initiative will direct additional resources to the HIPCs unless

¹ The periods covered are 1970-2000 except where indicated. The countries are Benin, Bolivia, Burkina Faso, Cameroon, Chad, Ethiopia (1981-2000), The Gambia, Ghana, Guinea (1986-2000), Guinea-Bissau, Guyana, Honduras, Madagascar, Malawi, Mali, Mauritania, Mozambique (1981-2000), Nicaragua, Niger, Rwanda, Sao Tome and Principe (1980-2000), Senegal, Tanzania (1988-2000), Uganda (1980-2000), Zambia.

doing so is an explicit commitment. Without this commitment there is no reason to think that the initiative will directly provide resources available for poverty reduction and growth. That is not to say, however, that making participation in the initiative *conditional* on a poverty-reduction and growth initiative is a bad idea. To the contrary.

I understand that the Bank cannot make commitments about future aid flows. It might nevertheless be useful for the Bank to focus the discussion so that both HIPC's and the lender/donor communities are clear about the issues at hand.

V. The Eligibility Criteria

As discussed above, eligible countries have to: (i) be poor (IDA-only), (ii) have appropriate policies (with IMF- and IDA supported programs) (iii) be eligible for traditional debt relief; and (iv) have “an unsustainable debt burden.” The initial HIPC initiative specified unsustainability as a ratio of the NPV of publicly or publicly-guaranteed debt to exports of 220 percent or above. The enhanced initiative lowered the ratio to 150 percent (although a debt-service ratio of 15 to 20 percent is also mentioned). An alternative fiscal/openness criterion targets countries that is (i) export at least 30 percent of GDP and (ii) collect at least 15 percent of GDP in tax revenue and have a NPV of debt to tax revenue ratio of 250 percent. By the completion point the initiative is intended to lower the debt ratios to these limits (*Guide Book*).

1. Debt Inventories

The NPV of debt is assessed on the basis of an inventory of the country’s public and publicly-guaranteed loans from external sources. Rather than summing the face value of these debts, the inventory calculates the debt-service payments scheduled discounted by the interest rate in the currency of denomination. This procedure thus adjusts for concessionality in the repayment terms.

The use of the debt inventory methodology is a very positive feature of the initiative. This method should be used more widely. A recommendation below is that such inventories be conducted for reporting countries and be updated at least annually if not quarterly. Aspects of the inventory method have been criticized, however.

a. Domestic Debt

One possible criticism is the exclusion of domestic debt. Paying off domestic debt adds to a government’s debt service burden just as much as paying off external debt. A problem with including domestic debt, however, is that domestic creditors are likely to be a very diverse group and integrating them into the process would prove unwieldy. Moreover, the level of domestic debt might be much more open to manipulation by the government. A government might quite easily increase its domestic debt (e.g., by taking over a failed bank) in order to become eligible for relief. Finally, reducing domestic debts might wreak havoc in fragile domestic financial markets.

The initiative was probably wise to stick with external debt. At the same time, to the extent possible the levels of internal debt should be monitored and reported at the decision and completion points. Moreover, to the extent that the PRGF initiatives add to fiscal burdens, care must be taken that these burdens not add to local debt.

b. Currency of Denomination Interest Rates

A second criticism is using the interest rate of the currency of denomination of the loan to calculate present values. Gunter (2002) worries that this practice will place more of the “burden” of relief on countries with lower interest rates (e.g., Japan). As discussed in the previous section, to the extent that there is no additionality from the initiative there is no

overall burden. But Gunter's criticism suggests how the initiative might shift obligations toward creditors with lower interest rates. Another possible problem is that countries with a larger share of debt denominated in low interest rate currencies would get more relief. Offsetting these objections, however, is the point that interest rate differentials among creditors should reflect expectations about currency movements with offsetting implications for the value of debt in different currencies. In this case none of these criticisms is valid. While no one can forecast what exchange rates are going to do, the initiative appears to have done the right thing in not presuming to know better than the market what will happen to currency values. Hence the current procedures appear justified.

2. Does the Initiative shift Aid Resources away from the Poor to the Indebted Not-Quite-so-Poor?

Sachs et al. (1999) criticizes the HIPC initiative for its focus on debt to export ratios while ignoring other indicators of poverty such as health and nutrition. Here the issue very much depends on the additionality of the initiative. If the purpose of the initiative is simply to "end the cycle of periodic reschedulings" without additionality then the criticism is invalid. Where aid resources are directed is independent of the initiative. To the extent that the program does provide additionality, however, it expands the commitment of aid resources to the more indebted poor countries, unless aid resources, overall increase is less available for the less indebted poor (e.g., Bangladesh). More clarity about the objective of the initiative would very much help sharpen this debate.

3. Do the Eligibility Ratios Deliver Debt Sustainability?

The next section discusses the forward-looking projections of the DSA procedures. It should be emphasized again, however, that the eligibility criteria and the amount of relief are not based on the forward projections. Instead, eligibility and the amount of relief are based on the ratios stated above.

Given the nature of the forward projections, it is a good thing that they were not used to determine eligibility or the amount of relief. Simple rules of thumb are better. The best justification for the figure in the enhanced initiative is econometric evidence that countries with debt-export ratios above the 150 percent level are much more likely to run into debt-servicing problems. It should always be recognized that such numbers are highly arbitrary, but in this sort of exercise there is a point to having a simple, clear rule.

It should be made more clear, however, that there is *no* current debt level that "ensures debt sustainability" with any certainty. It all depends on the future behavior of the country and its creditors. It would be a mistake to think that the completion of the initiative guarantees that a country will not face further debt-servicing problems down the road. It would be desirable to continue to monitor the debt inventory to ensure that the country continues to remain at or below the threshold. Domestic debt should be monitored. The country and its creditors should be expected to ensure that future loans are consistent with the HIPC targets.

VI. Debt Projections

The debt projections can be evaluated both in terms of (i) the methodology they employ to connect endogenous variables to exogenous variables and (ii) what assumptions they make about the exogenous variables themselves.

1. The Projection Methodology

A component of the terms of reference for this review was an assessment of the models on which the DSAs are based, the consistency with which they are applied, and their sensitivity to key assumptions. As discussed above, I had little quarrel with the eligibility criteria themselves. The criticisms that have been leveled at them seem unjustified. As for the projections, however, there does not appear to be any full statement of the model on which the projections are based. It would be useful for the Bank and IMF to provide an explicit statement of how the projections, including their balance of payments and fiscal components, are arrived at. A concern is that accounting identities are either not observed or are forced by using certain lines as arbitrary “buffers.” Inconsistency can and should be avoided. Arbitrariness is unavoidable in this sort of exercise but arbitrary assumptions should be made explicit and documented.

Key components of the debt projections are “balance-of-payments” projections provided to the HIPC unit by the IMF. The methodological basis of these projections was not provided. It was not clear that the methodologies behind the “balance-of-payments” projections provided by the IMF and the analysis performed by the HIPC unit were consistent. Particularly unclear was how the initiative itself was incorporated into the IMF’s projections about imports and future flows. It does not seem that the debt projections are integrated with the “macro framework.”

For all of these reasons what assumptions about additionality and fiscal impact are built into the debt projections remain murky. The debt projections do analyze various counterfactual scenarios with different projections about exports and the terms of future lending. They do not, however, provide a comparison between the situation with and without the HIPC initiative.

The Completion Point Document for Bolivia (May 21, 2001) illustrates aspects of my confusion about the DSA methodology. Table 2 explicitly indicates a (substantial) net cash flow to the fiscal budget from HIPC assistance (near or above 1 percent of GDP for each year between 1999 and 2004. In order for HIPC to add to the cash flow of the government, however, it must have a counterpart in the current account (that is, additional resources must be flowing into the country by at least this amount). I don’t know where to find it in the balance of payments.

Other external reviewers also had difficulty comprehending the basis on which DSAs are conducted. According to the U.S. GAO (2000, Appendix VI) “...inconsistencies and gaps in the types of information provided in the debt sustainability analyses presented challenges in our analyses of the documents.” The appendix concludes that:

Critical information that we derived from the debt sustainability analyses is not presented explicitly within HIPC documents. In some of the decision point documents, the actual amount of debt relief a country would receive is not explicitly presented and had to be deduced from other data provided. In addition, the amount of borrowing that each country would need after debt relief is not reported and required a complex methodology for us to derive. Finally, although the documents discuss the resources that debt relief would contribute to poverty reduction activities, they do not mention that these are financial resources that each country would have to borrow (page 110).

Development Finance International (2001) makes similar points: “It is important that there is consistency between the new borrowing assumptions of the DSA and the HIPCs PRGF limits and that there is an objective basis for the specified new borrowing limits of HIPCs. The debt sustainability analysis needs to be directly linked up to the Poverty Reduction Strategy Papers so one can see if debt relief (both amounts and timing) coupled with new inflows is sufficient to achieve HIPCs poverty reduction plans.”

I am told that these objections have now been addressed. Nevertheless, there remains a need for an explicit, consistent methodology for the debt projections that connects all the relevant components of the fiscal budget, national accounts, financial flows, and balance of payments.

2. Assumptions about Exogenous Variables

The projections are explicitly based on assumptions about how exports and GDP will grow over the next 20 years and about the terms on which new loans will be available. Critics (e.g., U.S. GAO, 2000, Gunter 2002) argue that assumptions about both are overly optimistic.

The terms of future lending depend almost totally on what the participants in the initiative choose to charge, so are hard to predict. One would hope that part of the initiative itself would be a commitment that these terms would assure future debt sustainability. My examination of the assumptions about credit terms suggested that the interest rates assumed were lower than they had been historically over the last decade but were not that much lower than what is currently being offered. It should be pointed out, however, that interest rates in G-7 countries are low relative to the recent past.

Martin (2001, Table 8) provides a comparison between the GDP and export growth assumptions in 28 DSAs over the period 2000-2005 with historical averages for 1989-1999. In only one case (Guyana) is projected GDP growth lower than the historical average. In one case (Rwanda) the projection is more than 7 percent higher than the historical average. In only 7 cases is projected export growth below the historical average. In three cases (Chad, Honduras, and Rwanda) projected export growth is more than 10 percent above the historical average.

Table 1 provides a comparison between projected export growth in the DSAs (taken from Martin, 2001) with my own calculations of the growth rate in export revenues from the GDF data for 24 HIPC countries for the period 1990-2000. Only for Guinea-Bissau, Madagascar, and Nicaragua (which all had very high export growth in the last decade) is the projection below the actual.

As pointed out by the U.S. GAO's own analysis (2000), the finding in the DSAs that HIPC debt relief achieved debt sustainability required these high growth and low interest rate assumptions.

Table 1: Historical and Projected Export Growth: Selected HIPCs

Country	1990-2000 growth (GDF data)	2000-2005 projection (Martin, 2001)
Benin	3.3	7.2
Bolivia	5.4	10.6
Burkina Faso	-2.3	8.6
Cameroon	1.7	6.4
Chad	0.3	43.6
Ethiopia	4.0	8.5
The Gambia	4.6	6.0
Ghana	9.4	16, 9
Guinea	0.3	7.7, 6
Guinea-Bissau	10.9	8.5
Honduras	10.5	12.7
Madagascar	9.5	8.6
Malawi	1.5	4.9
Mali	3.6	7.9
Mauritania	-2.3	3.9
Mozambique	9.9	20.1
Nicaragua	12.4	9.7
Niger	-6.0	2.2
Rwanda	-0.5	7.6
Sao Tome and Principe	5.4	12.3
Senegal	0.0	7.6
Tanzania	9.4	11.9
Uganda	10.6	11.5
Zambia	-3.0	11.5

3. The Burnside-Finizza Analysis

Burnside and Finizza provide an analysis of the HIPC initiative that makes explicit a number of assumptions about the program. They assume that (i) the

initiative is fully additional and (ii) that all the resources it transfers are added expenditures by the government. They show that under these assumptions, without any increase in growth or tax revenue, there is no permanent effect on indebtedness. What the government had been spending on debt service it is now spending on poverty reduction and growth enhancement. They then show that the program can have positive effects on debt if the expenditures lead to higher growth and increased tax revenue. The results emphasize the importance of growth and fiscal improvements to debt sustainability.

Burnside and Finizza go on to hypothesize that the increased fiscal expenditure is financed through seigniorage rather than directly with transfers that occur as a consequence of the program. Under this assumption the program does reduce debt and enhance debt sustainability. But the seigniorage creation has domestic inflationary effects. It should be pointed out that seigniorage provides an alternative to aid flows (as through HIPC) as a form of finance, but this point stands quite independently from the HIPC initiative itself. A general lesson of their analysis is that what follows from the HIPC initiative depends very much on macroeconomic policy across the board. Different assumptions have very different implications. Debt reduction is just a tiny piece of a large puzzle.

VII. Likely Outcomes

A full analysis of various counterfactual scenarios was not possible given the lack of a complete methodological framework. I did, however, develop a simple EXCEL program to project debt for a hypothetical country over time that (a) respects accounting identities across the balance of payments and fiscal accounts and (b) can incorporate various assumptions about (i) additionality and (ii) the expenditure impacts of the program. A copy of the program will be made available to the HIPC unit. The main implication of the program is that one-time debt reductions are likely to do little for debt sustainability unless there are very good growth prospects or improvements in fiscal balance.

One concern about the HIPC initiative is that the resource transfers involved will tend to increase the real exchange rates of recipient countries. This concern seems second-order at most. This outcome requires, first of all, that there be significant additionality. Moreover, any increase in net inflows necessarily raise the excess of imports over exports, which may be accompanied by an increase in the price of nontraded relative to traded goods: To the extent that the inflows are spent on nontraded goods rather than imports, they raise the relative price of nontradables, drawing resources out of the traded goods sector. With a fixed exchange rate tying down the absolute price of traded goods the overall price level rises. It is not clear why this effect is in itself a “problem,” however. Moreover, it is the necessary consequence of any net transfer into the country, not just those associated with HIPC. Since transfers under HIPC are likely to be small relative to overall transfers, their additional effect is likely to be negligible. If the real exchange rate effects of aid transfers are perceived as a problem, then the only solution is not to make the transfers.

VIII. Recommendations

I conclude with four specific recommendations for modifying the HIPC initiative:

- (1) The purpose of the initiative needs to be clarified. Issues concerning the size and allocation of aid resources should be distinguished from the goal of ensuring debt sustainability. Debt sustainability should be interpreted narrowly to mean delivering a given stream of net resource transfers to poor countries without creating the need for periodic debt rescheduling and restructuring. The allocation of aid resources should be seen as determining the size of the streams of net resource transfers. Hence the goal of debt sustainability can be clearly separated from the goal of poverty alleviation. Both goals are worthy ones but require different responses. Poverty alleviation requires increasing the resources we deliver to poor countries (or, even better, improving policies there). Debt sustainability requires redesigning the way we deliver those resources. Historical methods have generated too much in the way of debt service obligations that have either been forgiven, rescheduled, or been paid for by grants after complex negotiations. Given the net resource transfer involved, it makes administrative sense to reduce the two-way flow of funds. I would recommend that the senior administration of the World Bank and Fund appoint a small team of distinguished development experts to narrow and focus the initiative. Given the publicity surrounding the initiative any diminution in what it promises to deliver needs to be explained clearly to the outside community.
- (2) Even if the initiative is seen as having only the more modest goal of ensuring debt sustainability, a one-time debt reduction is insufficient to avoid future debt problems with any certainty. Future lending needs to be monitored to ensure that HIPC targets are respected. The initiative should require commitments from both sides to maintain HIPC targets. Other indicators (e.g., internal debt) should also be monitored for warning signs of debt problems with subsequent lending designed accordingly.
- (3) The debt projections component of the debt sustainability analysis (DSAs) should be based on a simple, transparent methodological framework. Outside observers cannot penetrate the assumptions behind the numbers that appear in the debt projections. The requirement for projections should either be dropped, or else the World Bank and IMF should develop an explicit methodological framework. I recommend that the senior economists at the Bank and Fund appoint a team of economic and financial experts to provide an explicit unified framework for providing projections that will be applied uniformly across the HIPCs. The product should provide a means of analyzing the impact of the initiative making explicit assumptions about additionality, fiscal balance, and various components of the current account. The framework should simultaneously obey fiscal, national income, and balance-of-payments identities. Behavioral assumptions should be kept minimal but made explicit. The growth projections embodied in the DSAs should also follow from an explicit methodology.
- (4) The Bank needs to review its data keeping. There are allegations that the debt reporting system is in shambles, particular that it is grossly misreporting the effects of the HIPC debt relief. To a large extent debt difficulties can be avoided by the timely

availability of accessible, high-quality data. Bad data were at the root of several major financial crises. Lenders need to know what each other are doing. In the past the Bank has performed a major service in providing data. One suggestion is that the debt inventory methodology developed by the HIPC initiative be used more widely and more frequently, and applied to both official and private debts.

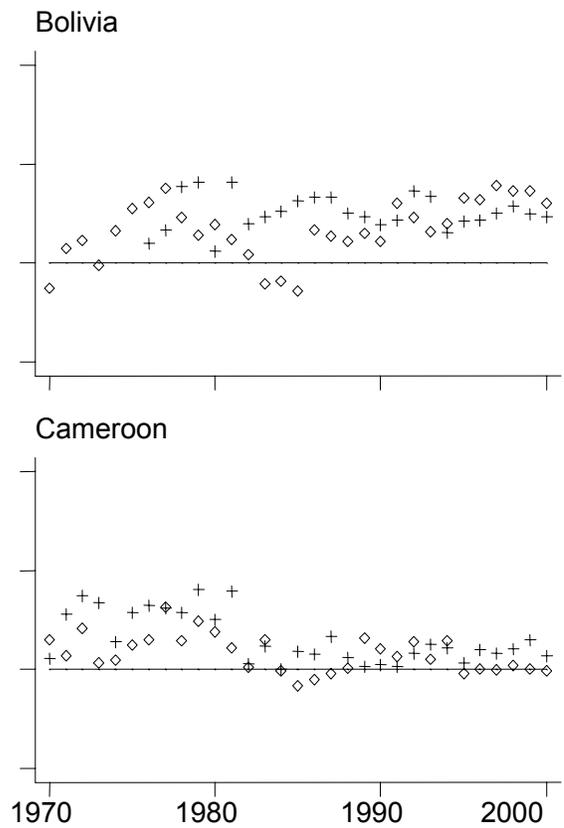
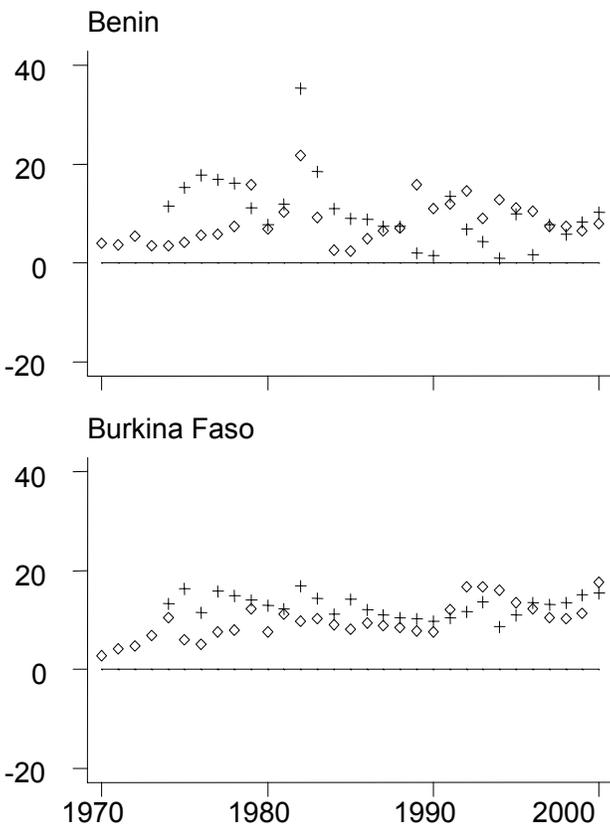
These recommendations are not meant to imply any criticism of the overall motivation for the initiative or of the individuals responsible for its design and implementation. The initiative is a bold one that has successfully transformed thinking about assisting debt-burdened countries. Because it is so revolutionary, it is not surprising that problems have been encountered in its first five years. But it is important that the Bank and Fund remain flexible about the design and implementation of the initiative.

Figure 1 Transfers to Selected HIPCs: Various Measures

1. Graphs by country

◇ NT/GNI

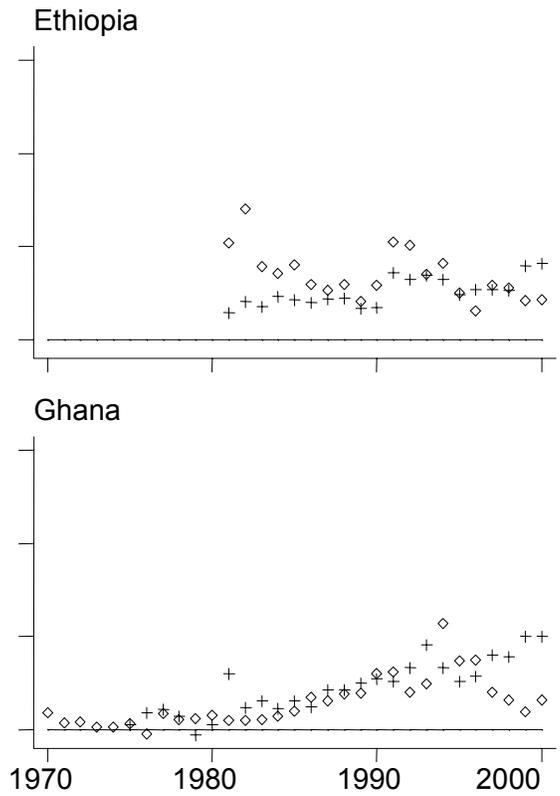
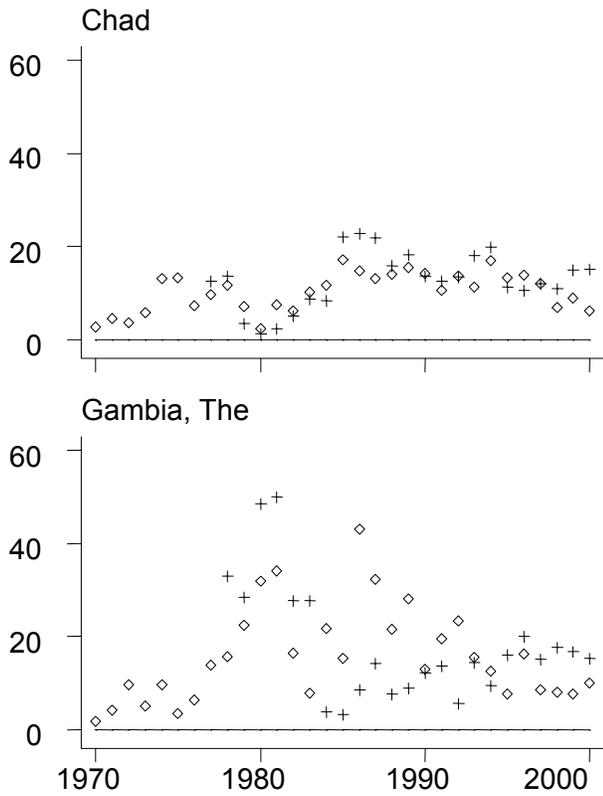
+ (M-X)/GNI



year

◇ NT/GNI

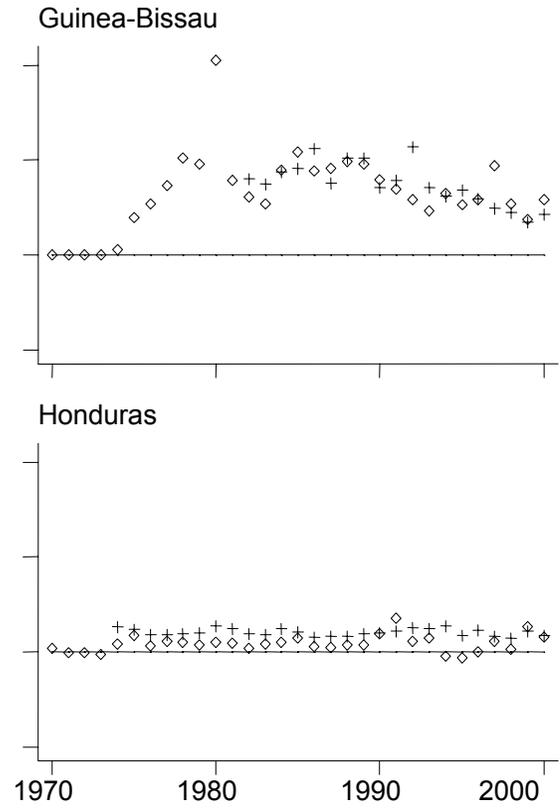
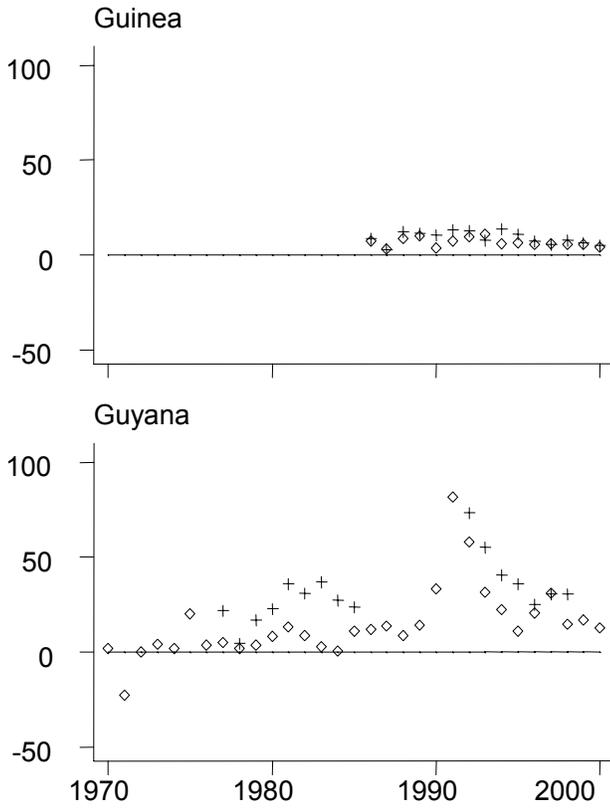
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year

◇ NT/GNI

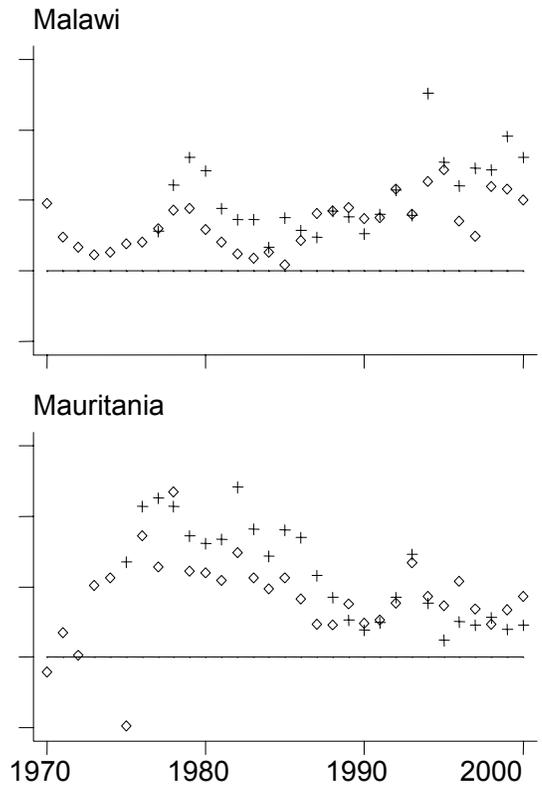
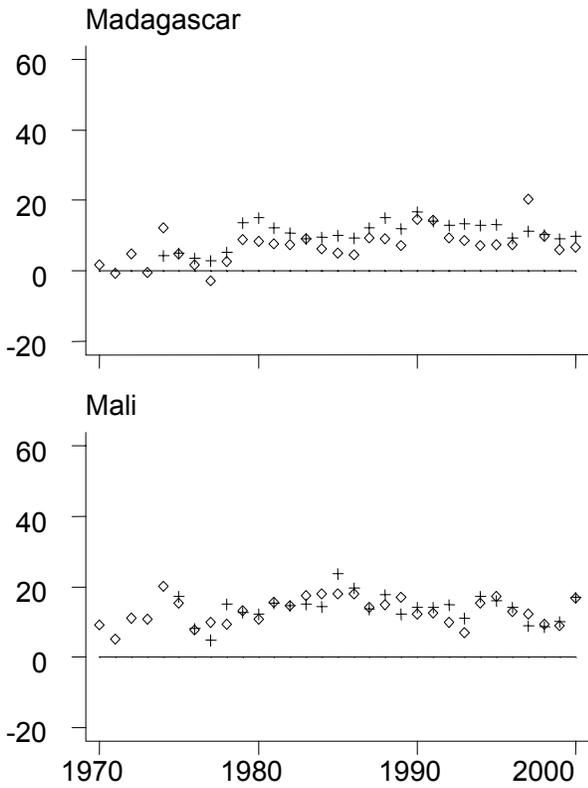
+ (M-X)/GNI



year

◇ NT/GNI

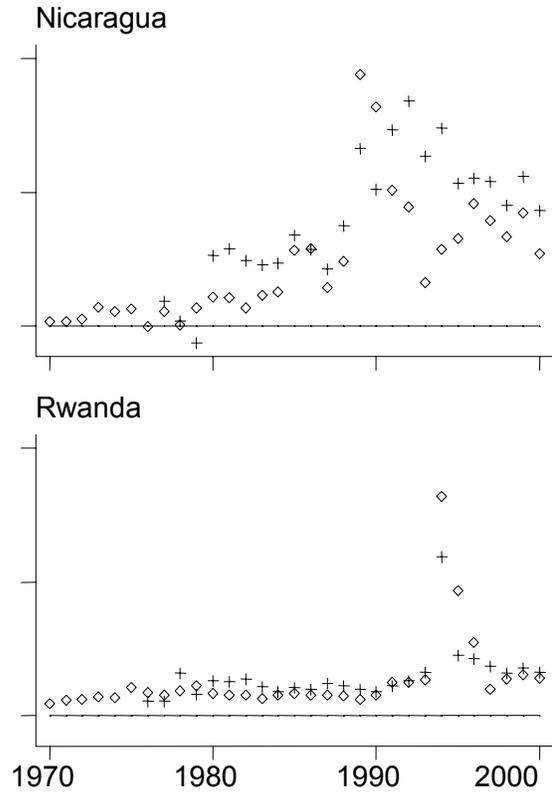
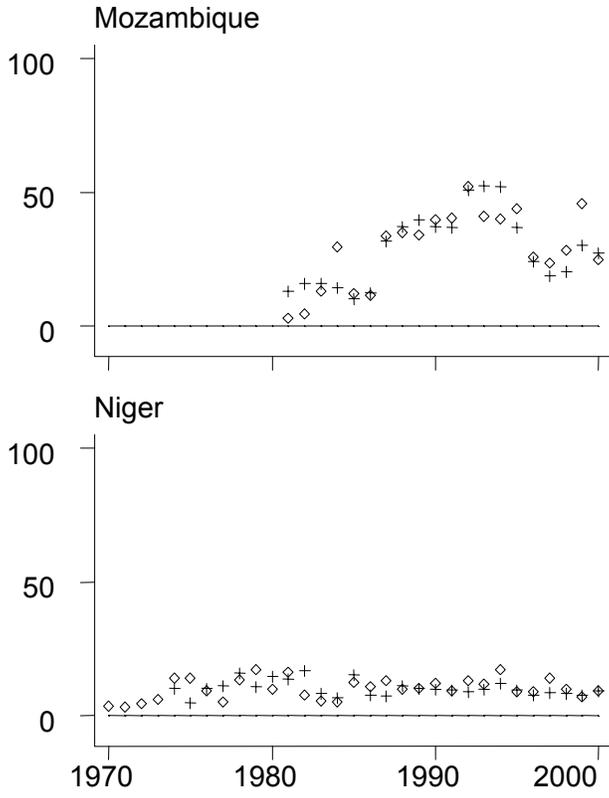
+ (M-X)/GNI



year

◇ NT/GNI

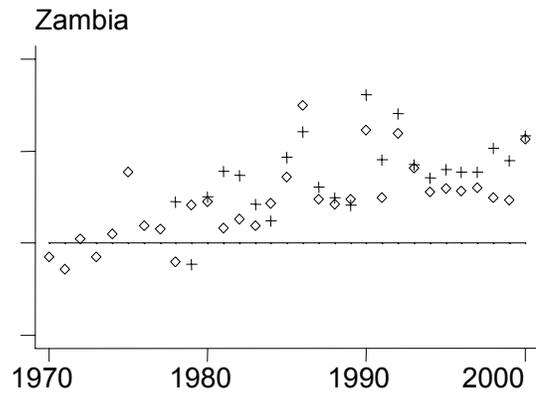
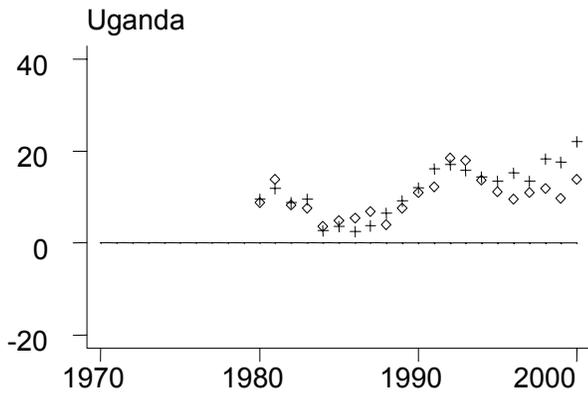
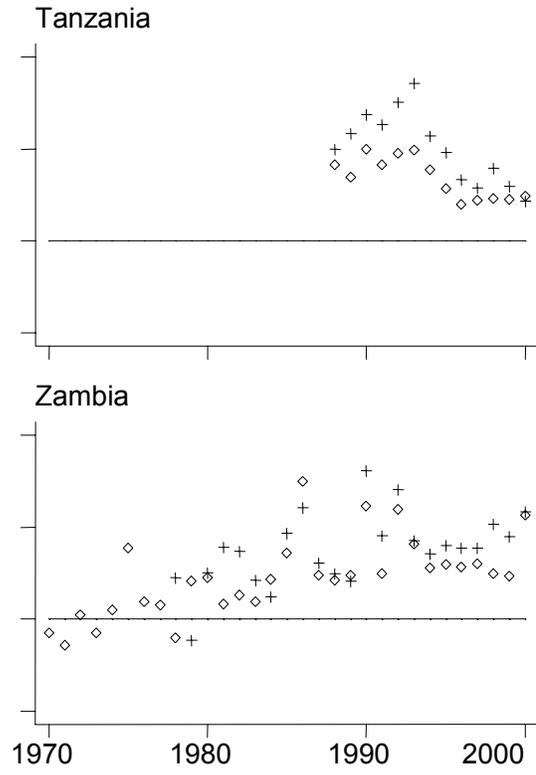
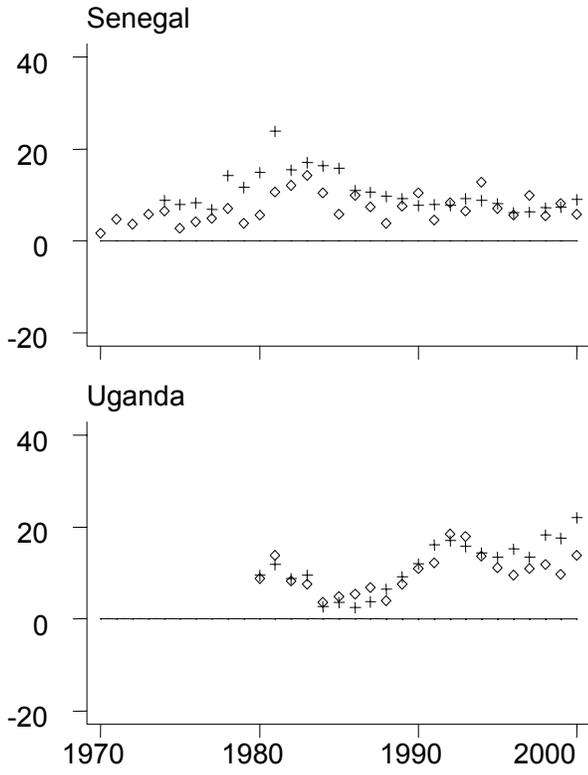
+ (M-X)/GNI



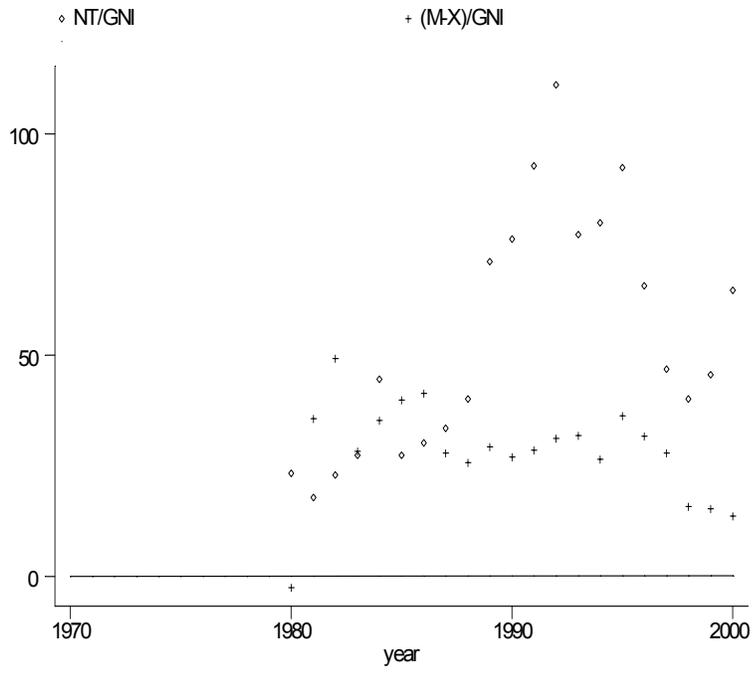
year

◇ NT/GNI

²³ + (M-X)/GNI



year



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