

# Précis

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## The HIPC Initiative: Progress and Prospects

The Heavily Indebted Poor Countries (HIPC) Debt Initiative—designed to relieve the high external debt burdens of some of the poorest nations—was put in place by the World Bank and the IMF in 1996; an expanded, enhanced HIPC followed in 1999. With a more comprehensive approach to debt relief—including, for the first time, multilateral debt—the Initiative represents a major innovation in development finance. But is the Initiative likely to achieve all of its goals? A recent Operations Evaluation Department (OED) review assesses the progress and prospects of the Initiative, with a view to informing—and, where necessary, strengthening—its ongoing implementation.

### Background

In the mid-1990s, public concern with excessive debt burdens (see table) together with declining aid resources and a perception of development failure in many of the least-developed countries provided the impetus for debt relief. With the vocal support of advocacy nongovernmental organizations (NGOs), these concerns came to be shared by pragmatic policymakers in donor governments and international financial institutions. Within the World Bank, there was increasing recognition that the persistently rising debt burdens of some of its poorest borrowers reflected problems of insolvency rather than illiquidity, calling for a different response than attempted in the past. A working

group was formed to develop new ways to comprehensively deal with unsustainable debt. When the group's draft working paper was leaked to the press in 1995, it proved an unexpected catalyst. The development community quickly embraced the ideas outlined in the draft, and the HIPC Initiative was launched in 1996. The Initiative embodied the lessons of experience, linking aid effectiveness with the policy

**External Debt as Percentage of GDP  
(period average)**

Country category	1980–84	1985–89	1990–94	1995–00
HIPC	38	70	120	103
Other International Development Association (IDA) countries	21	33	38	33
Other lower-middle-income countries	22	30	27	26

Source: *Global Development Finance and World Development Indicators*.



environment and aid coordination, conditionality with ownership, and social impacts of macroeconomic policy with public expenditure prioritization.

### The HIPC Mandate Broadens

The goal of the original framework was to reduce the external debt of eligible countries as part of a strategy to achieve debt sustainability, thus eliminating the debt overhang as a constraint to economic growth and poverty reduction. But after 1996, the pressure continued to build for debt relief that was “broader, faster, deeper.” In response, the enhanced HIPC Initiative (E-HIPC) was crafted and approved in 1999. The strong influence of NGOs led to the creation of a direct link between debt relief and poverty reduction in E-HIPC, which took the form of targeting the anticipated debt service savings to spending on the social sectors. The debtors had limited influence on the design of the Initiative, even though they are central to its implementation. The outcome of this dynamic political process was that the original focus on removing the debt overhang—the key issue that the Initiative was created to address—was broadened. The E-HIPC thus came to acquire a more ambitious set of objectives: (1) to provide a *permanent* exit from debt rescheduling, (2) to promote growth, and (3) to release resources for increased social spending. The need to create the fiscal space for increased social expenditures was a critical prerequisite for broad-based support from the donor community, and it has had a major impact on the Initiative’s design and implementation.

### The Initiative is Likely to Achieve Its Original Goal

The HIPC Initiative has been a catalyst for far-reaching changes in the processes surrounding development assistance, reflecting the coming of age of a new authorizing environment with the active participation of civil society. It has made the processes of the sovereign debt regime more open and accountable and spurred development cooperation, including heightened coordination between the World Bank and the IMF. It has also been the catalyst for the Poverty Reduction Strategy process, which aims to help countries improve governance, transparency, and accountability, while promoting country ownership of poverty reduction strategies.

OED found that the HIPC Initiative, as one instrument in the development assistance architecture, is highly relevant in addressing a key obstacle to growth and poverty reduction facing many poor countries. And one of the principal findings of the review is that that the Initiative is likely to achieve its original fundamental goal—to provide some of the poorest countries with much-needed relief by reducing their debt stocks and debt service burdens. If the expected debt relief is delivered, the Initiative will succeed in reducing by half (on average) the HIPCs’ external debt stocks and their debt service, which will bring their debt burdens to levels comparable with, or lower than, those of

other poor countries. The countries that are past their decision point are already benefiting from significantly lower debt service.

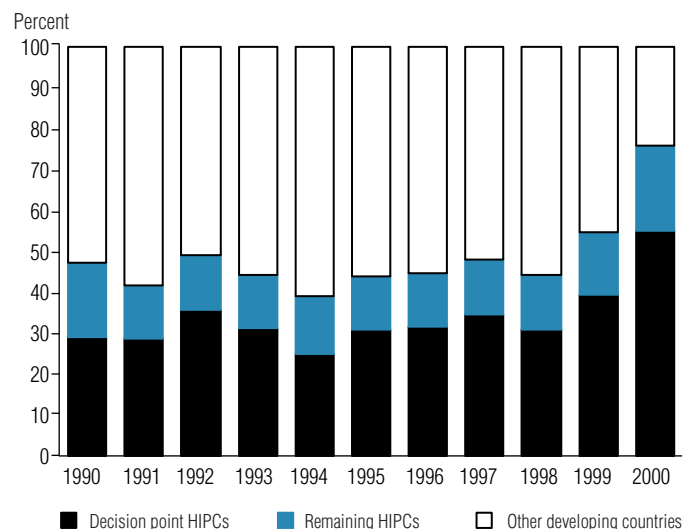
OED also found that beneficiary countries are allocating HIPC resources largely as anticipated in the decision point documents, and that budgetary resources for targeted sectors have indeed increased appreciably. In many HIPCs, the Initiative has increased national awareness of the external debt problem and is spurring efforts to improve debt management. A number of efforts are also underway to improve the management of public expenditures.

### But Expectations Exceed the Scope of the Program’s Design

While the Initiative’s objectives have expanded and become more ambitious, it remains a limited instrument. To fully achieve its current stated objectives, actions by development partners are needed that are beyond the Initiative’s purview. Thus the Initiative faces the risk of promising outcomes—in particular, on the freeing up of resources for increased social sector expenditures and “ensuring” debt sustainability—that it cannot deliver by itself. The Initiative’s design should have paid more attention to the participation of all creditors, to ensure that the anticipated relief is delivered in full, and building HIPCs’ capacity for debt management, a long-standing constraint.

**Additionality.** A key assumption underlying the objective of freeing up resources for higher social spending is that past aid levels would be maintained, so that HIPC debt relief would translate into additional real resources. To accomplish this, without diverting aid resources from poor but not highly indebted countries, an overall increase in aid resources is needed. But the Initiative’s design provides no mechanism to ensure this. Both global net resource transfers and those to the HIPCs in recent years show a sharp

### HIPCs’ Growing Share of Aggregate Net Resource Transfers



Source: OECD, DAC database.

decline, starting just about the time the Initiative was created. HIPC countries are indeed receiving an increasing share of declining global aid resources relative to other poor countries (see figure), but they are not receiving additional funds compared to what they were getting before the creation of the Initiative (that is, before 1996). To the extent that the Initiative has helped protect the share of the HIPCs, it may be judged a limited success, but it appears that the share of other poor countries has declined correspondingly. The resulting redistribution conflicts with the principle of performance-based allocation and could reduce the overall efficiency and effectiveness of aid. This outcome is a direct consequence of limited aid resources, and it cannot be overcome through design improvements in the Initiative itself as currently conceived.

**Debt Sustainability.** The objective related to debt sustainability has evolved to become more ambitious, fueling expectations of what the Initiative can deliver. The notion of debt sustainability has been contentious, with controversy about how to measure it and how to “ensure” it. The review concludes that the main indicator used in the Initiative, the net present value of debt-to-exports ratio, while not perfect, is operationally preferable to alternative indicators for practical reasons. The current threshold is also reasonable in comparison with the debt levels of non-highly indebted poor countries. But does the Initiative deliver debt sustainability? The main tool for assessing this is the debt sustainability analysis (DSA), the robustness of which has not yet been demonstrated convincingly. The DSA has two components. One assesses *current* levels of debt using a new methodology that provides a sound basis for calculating the amount of debt relief for each country. The other projects *future* debt indicators to assess each country’s likelihood of achieving debt sustainability. The review finds that the economic models and the methodological basis underlying these debt projections need to be made more transparent, and the growth assumptions more realistic.

To place the Initiative on a firmer footing, the DSA’s also need to better capture the potential effects of volatility in export earnings—a key risk factor. Improved risk analysis would provide a better assessment of each country’s likelihood of meeting the Initiative’s debt sustainability threshold. This by itself would not improve the prospects for debt sustainability, which is influenced by other factors discussed below, but it would permit a more informed debate about the policy changes needed in donor and recipient countries alike, as well as fostering greater realism in setting objectives and funding arrangements.

### Growth and Policy Performance are Central to Achieving the Initiative’s Objectives

A one-time debt reduction is not sufficient to guarantee that a country will avoid future debt problems. The prospects for debt sustainability depend on a number of factors that affect a country’s repayment capacity, including the amount and terms of new borrowings. The main

challenge is to ensure that all new funds are invested productively and efficiently to promote repayment capacity. The fiscal base in HIPCs is typically narrow, and exports are concentrated in a few commodities subject to highly volatile markets. The HIPC countries need to remove fiscal constraints and other policy obstacles to more rapid, broad-based growth. They also need to diversify and enhance their export base, which would require trade facilitation and better access to developed country markets.

A key ingredient for debt sustainability and poverty reduction is a credible strategy for growth. Here the link to the Poverty Reduction Strategy Paper (PRSP) process holds promise, but early evidence, including the World Bank’s own review of early PRSPs, indicates there is little emphasis on growth-related activities beyond the adoption of a sound macroeconomic framework and investment in human capital. Factors such as investment climate, trade access, and infrastructure development are critical to promote growth but have received little attention so far.

A necessary condition for accelerated growth is the adoption of sound policy frameworks that will foster economic stability, effective public expenditure management, and efficient and non-distorting revenue generation. A track record of strong policy performance has been a HIPC requirement from the outset. The specific requirements were progressively relaxed during the millennium rush—to reach the target of getting at least 20 countries to decision point by end-2000. Many of these countries have experienced subsequent policy slippages and have yet to convincingly demonstrate an ability to put sound policy frameworks in place.

### NGO and Donor Pressure has Increased Focus on the Social Sectors

The E-HIPC guidelines for increased public expenditures toward poverty reduction emphasize the social sectors—primarily education and health—over others with the potential to help reduce poverty through enhanced economic growth. The performance criteria highlight expenditures rather than outcomes or impacts, even though increased expenditures may encounter diminishing returns in the short and medium run. The capacity of many countries’ education and health ministries to manage increased budget resources efficiently is weak. Moreover, a substantial share of aid resources is already earmarked for social expenditures, and the World Bank’s public expenditure reviews indicate that financing is not always the primary constraint to achieving outcomes. The need for investment to promote growth may warrant a different balance between the social and other sectors, especially infrastructure and rural development.

Debtor country representatives have expressed concern about the inflexibility in the allocation of HIPC resources, noting that external strictures on their resource allocation can weaken budget discipline and domestic ownership. They criticized the over-emphasis on social sector expenditures as potentially undermining the achievement of HIPC objectives

without increased economic growth. Perhaps reflecting these pressures, over half of HIPC governments' revenues are expected to be earmarked for social expenditures in the coming years. Most countries consider this imbalanced and inconsistent with their focus on broader development goals. And since most countries' PRSPs are still being developed, these anticipated allocations are also inconsistent with the intended role of the PRSPs to set priorities.

## Conclusions and Recommendations

Excessive debt creates problems and must be effectively dealt with. But the HIPCs' unmanageable debt burdens are a symptom of deeper structural problems. While the HIPC Initiative appears likely to provide a much-needed respite from high debt service, debt relief is not a panacea for broader economic development problems, nor is a one-time debt reduction a guarantee that future debt will remain at sustainable levels. The HIPC Initiative is thus an important—but small—part of the overall development assistance framework. Perhaps the greatest challenge facing the Initiative is the expectations of what it can achieve within financing limitations and policy and institutional constraints in the HIPCs. Achieving its multiple objectives requires actions by HIPC governments to adopt sound policy frameworks and a balanced development strategy. It also requires actions by the international community to assist the countries to increase their exports and support necessary capacity building efforts. Donors face a further challenge to make adequate resources available to finance the development priorities of HIPCs and other poor countries, and ensure that HIPC debt relief is truly additional to other aid flows.

Four actions are recommended to address the strategic issues facing the Initiative:

- Clarify the purpose 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.
- Improve the transparency of the methodology and economic models underlying the debt projections and the realism of economic growth forecasts in the debt sustainability analyses. This would facilitate decisionmaking by providing a better assessment of the prospects and risks facing individual countries.
- Maintain the standards for policy performance. This would help minimize the risks to 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.
- Increase the focus on pro-poor growth in the performance criteria. There should be a better balance between growth-enhancing and social expenditures, relative to the current emphasis on the latter.

## Management Response

Management is in broad agreement with OED's recommendations. While agreeing that the objectives of the HIPC Initiative have grown in ambition over the years, the Management response noted that by reducing debt stocks, the Initiative was always meant to contribute toward a broader, more comprehensive development architecture, but not to supplant it. Management also expressed support for OED's emphasis that additionality is an important underlying principle of the Initiative, but contends that it should be assessed on a country-by-country basis and that transfers of additional resources to support development programs should not come at the expense of debt sustainability.

## Executive Directors' Perspective

The Committee on Development Effectiveness (CODE) commended OED for an excellent report, timed to inform management's annual update on HIPC planned for September 2003. The members supported the thrust of the recommendations. CODE's discussion emphasized several key points: (1) Debt relief is not a substitute for broader, growth-oriented development programs, and the HIPC should be seen as one of several instruments to support poverty reduction; (2) Additionality is an important part of the HIPC framework, but should not override performance-based allocation of resources; and (3) The realism of debt sustainability analysis and a clear external communication supporting wider public understanding of the report's findings were also important.



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▶ This *Précis* is based on "The Heavily Indebted Poor Countries (HIPC) Initiative: An OED Review," by Madhur Gautam.

▶ The complete study is available at:  
<http://www.worldbank.org/oed/HIPC>

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