A Joint Submission to the World Bank and IMF Review of HIPC and Debt Sustainability

August 2002

Executive Summary

At the World Bank and IMF annual meetings in September 2002, it is understood the two institutions will be discussing the progress of the Heavily Indebted Poor Countries (HIPC) Initiative and a number of proposals that have been put forward for its reform. CAFOD, Christian Aid, Oxfam GB and EURODAD believe that this review must, as agreed at the UN Financing for development Conference in Monterrey in March, include an assessment of the HIPC Initiative's role in helping finance the achievement of the Millennium Development Goals.

The Millennium Development Goals (MDGs) are internationally agreed development targets including the aim to halve poverty by 2015. The HIPC Initiative has already freed up resources from debt servicing for 26 low-income countries, enabling pro poor expenditure and some progress towards the MDGs. However, these socio-economic gains under HIPC are by no means universal and, where they exist, they are limited and precarious. The HIPC countries, as with all low-income countries, continue to face development challenges such as the spread of HIV/AIDS, low levels of literacy and poor nutrition, equipped with only scarce and highly vulnerable domestic resources.

The Monterrey consensus re-affirmed that developing countries would need to supplement these domestic resources. Yet, despite the international commitment to achieving the MDGs, donors have not pledged the sufficient additional aid resources that are required to meet these goals. Most low-income countries have limited sources of capital available to them. They are not able to attract substantial private sector investment, and global trade rules limit their ability to develop their markets. Debt relief is therefore an important additional source of finance, and for the reasons that this paper outlines, it could be one of the most efficient and effective forms of resource transfer for the poorest countries.

However, the current system of debt relief, the enhanced HIPC Initiative, is not working effectively. Some countries will soon be left with unsustainable debts once again. The way in which debt relief is calculated for each country needs to be reviewed and alternatives adopted. The reliance on a debt-to-export ratio to calculate debt relief packages, based on World Bank and IMF projections, is flawed. Not only are some countries spending more on debt payments after they receive debt relief, but they are overshooting the World Bank and IMF's own definitions of debt sustainability.

In this paper, we propose that the World Bank and IMF and their shareholders radically overhaul the way in which debt relief is calculated and provided. The over-arching objective of debt relief must be to help mobilise the finances needed to achieve the MDGs. If HIPC countries are to meet these targets the principle of a 100% debt cancellation option needs to be agreed. Similarly, a broad set of economic and human development objectives must be applied when deciding what level of debt repayments a country can afford to make.

The G8 Africa Action Plan for Africa states, "No country genuinely committed to poverty reduction, good governance and economic reform will be denied the chance to achieve the Millennium Development Goals through lack of finance." Our aim is to see debt relief as a mechanism centred on human development that provides support to low-income countries to achieve the MDGs. We are asking the World Bank and IMF, and their shareholders, to make this aim a reality.

Introduction.

> *"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."*
> **Monterrey Consensus of the International Conference on Financing for Development - March 2002**

At their 2002 Spring Meetings, the World Bank and the IMF agreed to "discuss the issue of debt sustainability and, consequently, financing and policy implications, at the next [Annual] meeting."[1] With other members of the official donor community, they signed up to the explicit commitment made in the Monterrey Consensus paper that future reviews of debt sustainability should also include an analysis of the part that debt relief plays in making progress towards achieving the 2015 Millennium Development Goals (MDGs).

As international development agencies, we have become increasingly alarmed at the weaknesses becoming evident in the HIPC Initiative and the widespread doubts regarding its ability to achieve the promised objective of a "robust exit from the burden of unsustainable debts." In particular, we are concerned that levels of debt repayment after HIPC initiative debt relief are far too high, undermining the necessary investment needed to accelerate poverty reduction. In the absence of radical reform, HIPC will join a long list of failed poverty reduction initiatives. This paper by CAFOD, Christian Aid, Oxfam GB and Eurodad, is our joint submission assessing the HIPC Initiative's role in helping achieve the MDGs, and of the World Bank and IMF's review of the HIPC Initiative's debt sustainability analysis.

What HIPC is delivering.

Preliminary analysis of the HIPC Initiative's achievements shows that in some eligible countries debt relief has resulted in demonstrable social and economic gains. For 2001-2003, the HIPC Initiative reduces the average debt service paid by HIPC graduates by about one third. Among these countries, social expenditures are expected to increase in 2000-2003 from the levels in 1998-1999[2]. Where countries have had resources freed up from debt servicing, the proceeds have resulted in some new development programmes and economic progress:

- Mozambique has introduced a free immunisation programme for children;
- User fees for primary education have been abolished in Uganda, Malawi and Tanzania, as have user fees in rural areas of Benin;
- Mali, Mozambique and Senegal are due to increase spending on HIV/AIDS prevention;
- Uganda and Mozambique, among the early beneficiaries of debt relief and enhanced aid flows, have consistently sustained annual growth rates over 5%.
- The requirement to engage in a consultation process in designing Poverty Reduction Strategies has helped to increase the potential for poor people to influence national resource allocation processes.

These examples demonstrate that debt relief can generate additional resources that contribute to furthering human development. They also highlight the human cost of transferring limited public resources from governments in poor countries to creditors. Today, over half of the countries

[1] Development Committee communiqué April 2002
[2] *"Sustainable Debt: What has HIPC Delivered?" Lucia Hanmer and Ruth Shelton August 2001*

receiving debt relief still spend more than 15% of their government revenues on debt servicing, diverting precious resources away from poverty reduction.

HIPC is on a precipice.

The socio-economic gains made as a result of enhanced debt relief are by no means universal and, where they exist, they are limited and precarious. Low-income countries face development challenges equipped with only scarce and highly vulnerable resources. The fragile economic and human conditions prevalent in most HIPCs suggest that the benefits derived from limited amounts of debt relief are likely to be small or easily reversed.

- In Africa, the scourge of HIV/AIDS will leave over a million children without teachers. In Mozambique alone, the Government estimate that 17% of their children will die of AIDS by the end of this decade.[3] The World Bank estimates that combating HIV/AIDS will cost low-income countries at least 1 to 2 per cent of GDP[4]. Yet thirteen of the 26 countries receiving debt relief are still spending more on debt than on public health. For example, Zambia has almost one million people affected by HIV/AIDS, but is spending 30 per cent more on debt servicing than on health.[5]
- For almost all HIPCs, private sector flows will not make up for chronic resource deficits. The marginalisation of the African continent from global trade is equivalent to a loss of 21 per cent of regional GDP or $68 billion per annum[6].
- For Africa in 2001, adjusting for inflation, non-fuel commodities are at one half the annual average value for the period 1979-81. The World Bank and IMF estimate 8-10 of the HIPC countries most affected by the slump in commodity prices will have higher debt to export ratios by completion point than the 150% target set by HIPC itself.
- The HIPCs continue to rely on external official assistance, particularly in the form of grants, to fund their domestic spending and balance of payments gaps. Despite optimistic projections in decision point documents, new HIPCs are not receiving the levels of external financing anticipated that will in turn help them achieve the MDGs. [7]

In sum, the development gains made with the small additional resources provided by the enhanced HIPC Initiative will be swept away without additional financing. We believe that this year's World Bank and IMF stocktaking of the HIPC framework needs a clear analysis and strengthening of the relationship between debt relief and the overall official development assistance envelope.

Achieving the Millennium Development Goals in the poorest countries.

> "*No country genuinely committed to poverty reduction, good governance and economic reform will be denied the chance to achieve the Millennium Goals through lack of finance.*"
> **G8 Action Plan for Africa - 2002**

OECD donors and the World Bank and IMF have signed up to the objective of meeting the 2015 Millennium Development Goals (MDGs). While the global target of reducing the number of people living in absolute poverty may well be met because of progress being made in South Asia

[3] Stephen Lewis UNAIDS June 2002
[4] *Can Africa Reclaim the 21st Century* – World Bank 2000 p. 236
[5] Debt Relief and the HIV/AIDS Crisis in Africa – Oxfam July 2002
[6] *Can Africa Claim the 21st Century p20* – World Bank 2000
[7] The Enhanced HIPC Initiative and the Achievement of Long-Term External Debt Sustainability – April 15 2002

and China, most low-income countries are currently on trajectories that clearly show they will not achieve the MDGs.

For Africa, it is estimated that halving the proportion of people living in extreme poverty by 2015 will require growth rates of around 7-8 per cent[8] and investment levels of more than 30% of GDP[9]. However, the continuing stagnation of Africa's terms of trade coupled with low saving rates will require the continent to access other sources of external finance if African countries are to achieve this level of economic growth.

Even when the commitments made at Monterrey and in the G8 Africa Action Plan are taken into account, the pledged ODA increases fall far short of the levels of additional resources needed to achieve the MDGs[10]. Indeed, the US$ 6 billion that was pledged in Kananaskis for Africa, with a smattering of caveats, only restores aid flows back to 1990 levels. In the medium term at least, it is difficult to foresee another round of aid pledges that will bridge the finance gap needed to achieve the 2015 targets or to finance recipient countries' costed poverty reduction programmes.

Nor is it likely that private sources of credit will fill this gap. Low-income countries face continuing difficulties in reversing their marginalisation from global flows of private sector finance - difficulties that are exacerbated by the current investment climate and slowing of global growth.

There is now a growing credibility gap between the rhetoric of the G8 leaders, the World Bank and IMF, and the reality of development financing. They repeatedly stress their commitment to the MDGs and "support" for countries striving to achieve them, but their own pledges on financing fall short of the levels of development assistance, including debt relief, that they themselves say are needed to achieve the MDGs. Clear country specific analysis of the financing implications for reaching the 2015 targets, or the nationally prioritised targets set out in Poverty Reduction Strategy Papers (or domestic equivalents), must be at the centre of the donor/creditor-recipient country/debtor relationship. The commitment to achieve the MDGs must include a full discussion of all options for closing the outstanding funding gaps and include realistic projections for each of the sources of finance.

Debt relief acts as a *de facto* source of development assistance. But before turning to the relationship between debt sustainability analyses and the international community's poverty reduction goals, it is important to assess separately the effectiveness of debt relief and the enhanced HIPC Initiative as vehicles for delivering development finance and debt sustainability.

Debt relief as pro-development finance.

A growing body of literature suggests that debt relief is the most efficient and effective form of resource transfer with many indirect benefits for the macro economy, growth prospects, the prudential management of public resources, and development policy as a whole.

- Debt relief minimises the **unpredictability of aid flows**. Many bilateral aid programmes are still bedeviled by problems of **low stability and low predictability** and **high pro-cyclicality.** Moreover the granting or withholding of aid tends to aggravate economic cycles. Empirical analyses by the IMF[11] show that aid flows tend to be more volatile than

[8] UNECA, World Bank, African Development Indicators, 2001
[9] *Can Africa Claim the 21st Century* – World Bank
[10] NEPAD summary
[11] *Aid, Public Sector Fiscal Behaviour, and Developing Country Debt*, S. Feeny and M. McGillivray;

fiscal revenue or output, and highly unpredictable. In one in five African countries there is a divergence of at least 30% between budgeted and actual spending – and this is exacerbated by fickle aid flows. 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 meeting poverty reduction expenditure commitments, while striving to maintain fiscal stability.

- Debt relief is **anti-inflationary**. A recent IMF paper[12] points to a strong correlation between higher levels of indebtedness and increased inflationary pressures.

- Debt relief spurs **economic growth**. There is a positive correlation between debt relief and domestic private savings and investment, as well as FDI[13]. Some African finance ministries and regional analysts suggest that 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 to affordable credit. 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 investment and savings.[14]

- Debt relief 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. Where debt relief results in increases in national budgets, it facilitates a closer integration of budget management systems and an improved coordination between capital and recurrent expenditures. Aid, however, can distort the relationship between recurrent and capital spending. Some donors prefer to spend on tangible capital projects as opposed to meeting recurrent budgetary costs. Aid, unlike debt relief, can leave recipient governments cash poor and project rich.

- Debt relief cuts down on **transaction costs**. Aid can tie up recipient governments' meagre administrative staff in endless negotiations, report writing and separate auditing procedures with an array of official donors. Some 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[15].

- Debt relief improves **local accountability** and good **governance**. Debt relief within the context of locally developed and owned Poverty Reduction Strategies has the added benefit of increasing, and sometimes even kick-starting, political participation in

---

The instability of Debt Service Payments and Economic Growth: Is there a Case for Debt Relief, G. Dijkstra and N. Hermes; *How Volatile and Unpredictable are aid flows And What Are The Policy Implications* Ales Bullit and Javier Hamann IMF 2001

[12] Africa: The Role of Price Stability and Currency Instability - Carmen M. Reinhart International Monetary Fund Kenneth S. Rogoff *International Monetary Fund*

[13] *Private Capital Flows to Tanzania in 1999-2000*, Govt of Tanzania 2002 and *Private Capital Flows to Uganda in 1999-2000*, Govt of Uganda 2002

[14] Elbadawi, Ibrahim and Gelb, Alan (2002), *Financing Africa's Development: Towards a Business Plan?* paper for AERC Policy Seminar

[15] *Can Africa Claim the 21st Century?* – World Bank 2000, p45

decision-making over the management and distribution of public resources. As development agencies, we have heard many of our partners in recipient countries express their frustration with national governments, and particularly with the official donor community, regarding their unwillingness to take seriously the inputs of a wider group of stakeholders in the design and implementation of national Poverty Reduction Strategies. Nevertheless, some have reported improved access to key decision-making processes and a rise in public accountability regarding the management of public finances.

To sum up, the continued reliance on ear-marking and the detailed conditionality and institutional controls by donors undermines the accountability of recipient governments to their own public and civil society agents, and weakens incentives and their capacity to improve public resource allocation for the intended beneficiaries – poor people.

The Enhanced HIPC Initiative and perverse results.

i) The numbers game.

The World Bank and IMF's literature on the results of the enhanced HIPC Initiative produce, and reproduce, some spectacular headline figures on debt reduction. Some of the more recent papers talk of debt reduction of up to "$41 billion over time"[16]. But any judgement regarding the financial benefit of the enhanced HIPC Initiative must start by analysing the impact for the HIPCs themselves. And here, the results can best be described as modest.

- Out of 20 HIPCs which have already reached HIPC decision point, 4 countries (Mali, Niger, Sierra Leone and Zambia) will have annual debt service payments due in 2003-2005 which will actually be higher than their annual debt services paid in 1998-2000.
- 5 countries will be paying almost as much in debt service payments as before HIPC (Ethiopia, Guinea-Bissau, Honduras, Nicaragua, Uganda).
- In 6 countries, annual debts serviced will be reduced by a modest $15 million in 2003-2005.
- The medium to longer term projections on debt servicing are also alarming - Senegal's debt service jumps by 61 per cent in 2004; Nicaragua's rises by 60 per cent in 2002; Mauritania's rises by 46 per cent in 2007; and Honduras faces an increase of 93 per cent in 2002.
- Over half of the HIPCs are spending more than 15% of their government revenue on debt servicing.

ii) The mirage of debt sustainability.

While the World Bank and IMF's use of headline figures can give a misleading picture of the overall benefit of the HIPC Initiative, there is also a misconception over the time at which countries achieve debt sustainability, defined by the World Bank and the IMF as a 150% debt-to-exports ratio. Board papers assert that debt sustainability will be reached on reaching Completion Point, and explicitly act on the assumption that debt relief will be "delivered unconditionally". But the debt relief, rather than occurring immediately, is implemented over as long as 30-40 year periods depending on the relief method chosen.

iii) "Topping up"

The slide in commodity prices is already leaving some countries overshooting the World Bank and IMF defined threshold of debt sustainability. The IFIs' response of supplementing the HIPC Initiative with a "one-off" post-Completion Point "topping up" facility is little guarantee that the

[16]*Financial Impact of the HIPC Initiative – First 26 Countries* – IMF July 2002

Initiative's graduates will be in a position to sustain their debt-servicing liabilities in the short term, let alone meet the promise of a "robust exit from unsustainable debts".

- Uganda, the first and bellwether HIPC graduate, currently has debts of over 200% of the debt-to-exports ratio. This will be the third time Uganda has exceeded its debt sustainability <u>after</u> reaching Completion Points.
- The March 2002 Completion Point Board paper for Burkina Faso concludes with the expectation that after receiving its "topping up" the country may achieve debt sustainability by the year 2016! However, contrary to most preceding definitions (NPV-to-exports) of debt sustainability produced by the World Bank and IMF, it asserts, "debt sustainability is not endangered" because of sufficient liquidity to cover debt servicing. This is the first time, and against the agreed rules, that the World Bank and IMF have changed definitions of debt sustainability to include liquidity as the operative criterion.

iv) The predictability of overshoots on debt sustainability.
World Bank and IMF projections and estimates for future growth, investment rates and financial inflows have been systematically overoptimistic and bear no relation to rates achieved in the past. The use of wholly unrealistic assumptions about the future financial and economic performance of HIPCs is bound to lead to unrealistic debt sustainability analysis and countries overshooting their sustainability thresholds.

v) The use of debt-to-exports ratio.
Amongst the multiple difficulties faced by HIPCs is their extreme vulnerability to external shocks. In particular, their high concentration of exports on a limited range of commodities leaves them acutely sensitive to external shocks in commodity prices and climatic conditions. The current export criterion of the Net Present Value of debt to exports for debt sustainability analysis therefore has a limited use. Because of its reliance on the narrow and highly volatile variable of export earnings as a means to calculate future debt sustainability, it is the key failing of HIPC.

Also, exports alone do not reflect the resources available to HIPC governments for poverty reduction expenditures. It would be quite possible, under the current criteria, for a country's debts to be considered sustainable from the point of view of external viability, while having insufficient resources to meet even the most basic poverty reduction expenditures. For most HIPCs, exports are therefore an unreliable predictor of medium, and, for some, even short-term debt sustainability.

Linking HIPC to MDGs and debt sustainability.

In this submission CAFOD, Christian Aid, Oxfam GB and Eurodad urge that a clear link be established between MDGs, the HIPC review, and the sustainability of debt relief, and that full consideration be given to the following steps as ways to mobilise the necessary financial flows:

- **The over-arching objective of debt relief must be support for the global effort to mobilise the finances needed to achieve the MDGs or costed poverty reduction programmes. A number of development agencies and official bodies have put forward credible "human development" debt sustainability analyses[17]. The World Bank and IMF need to give these serious consideration and open dialogue with**

[17] *A Human Development Approach to Debt Sustainability Analyses for the World's Poor* – CAFOD Northover, Joyner, Woodward 1998 and 2001*; Forever in your debt? Eight poor nations and the G-8* - Lockwood, Donlan, Joyner, Simms Christian Aid 1998*; Putting Poverty Reduction First* – Eurodad 2001*; The unbreakable link – debt relief and the MDGs* – Greenhill Jubilee Research. 2002.

relevant institutions. If the imperative of meeting the MDGs in HIPCs is to be achieved, the principle of a 100% debt cancellation option needs to be agreed. Total cancellation of all debt repayment of the post-Decision Point African HIPCs due over the next five years would cost some $6.8 billion. This represents approximately 0.17 per cent of the combined fiscal revenue of the G7 in any one year during the 1990s.[18] The costs would be significantly lower for individual G7 countries if the resources for this cancellation were found from the World Bank and IMF's own resources[19] and spread across all OECD countries.

- **Any analysis of the "payability" or sustainability of developing country debts must be integrated with a broader set of economic and human development objectives. While assessments of foreign exchange earning capacity should form part of an overall judgement of sustainability, this should be only one of a number of financing and development considerations. Future criteria must include an explicit analysis of the trade-off between meeting debt-servicing obligations and ensuring that agreed poverty reduction expenditures are fully funded.**

- Debt relief must be acknowledged as a proven and efficient delivery mechanism capable of supplementing other financial flows necessary to achieve the MDGs or costed poverty reduction programmes.

- Board papers, including all Joint Staff Assessments and all HIPC Completion Point Documents, must contain explicit analysis of country-specific actions, their costs and the financial resources needed (and therefore outstanding deficits that have to be filled) in order to achieve the development goals or national poverty reduction programmes.

- The fiscal sustainability of debt servicing must be prioritised. It is a crucial element in integrating debt service with the overall management of resources targeted towards poverty reduction objectives. One approach proposed is the reduction of debt-servicing outflows to below the ceiling of 5% of government revenues.[20]

- This proposal has raised the important question of the form of future development financing for low-income countries. Whilst *ad hoc* discussions on this issue have already taken place during the debate over shifting IDA from loans to grants, the grace periods and repayments terms will mean that such a move will not have a significant effect on debt-servicing levels before 2015. The international donor and creditor communities have a fiduciary duty to ensure that the anti-poor lending and borrowing patterns of the past are not repeated. Both debtors and creditors need to begin the analytical work to judge the desirable blend of grants and concessional finance to enable low-income countries to manage their future debt burdens.

- In order to reduce the risk that future borrowing will lead to sustainability problems, donors should support building recipient countries' capacity to manage debt. Civil society should be involved in any decisions to contract new debt, and in how those resources are used. This requires greater transparency on the part of official and commercial creditors in new lending agreements.

---

[18] *NEPAD Capital Flows Initiative.*
[19] *See Going the Extra Mile – Eurodad 2002.*
[20] Congressional Bill "United States Leadership Against HIV/AIDS, Tuberculosis, and Malaria Act of 2002" (H.R. 2069)

- Donors, including the World Bank and IMF, should encourage recipient governments to make loan documents publicly available and loan agreements open to wider consultation.

- **Assessments by the World Bank[21] show that full cancellation of debt servicing for the next 3 years in 26 HIPCs would produce an equivalent of 2% of GDP in annual assistance. And analysis by Dollar and Collier suggests that, for countries counted as "good performers" this is likely to result in increases in growth rates of 1.2% and 0.6% for countries with average policies[22]. According to World Bank and IMF figures,[23] such increases in growth would place the good performers, and some of those counted as producing average policies, at around the 7% level of growth needed to halve the numbers of people living in extreme poverty.**

Following their international undertakings in the *Monterrey Consensus,* the G7 and staffs of the World Bank and IMF are obliged to take into account the role debt relief has in meeting the 2015 Millennium Development Goals. Low-income countries in NEPAD and in the UN's Financing for Development process have consistently requested a closer integration of debt relief with broader human development objectives. It is no longer tenable for the G7 as the world's richest countries to resort to their majority shareholding of the World Bank and IMF to resist such calls.

At stake is the credibility of the wealthiest creditors who have pledged to help the world's poorest people attain poverty reduction objectives that they themselves set at modest and achievable levels.

Henry Northover (CAFOD) Paul Ladd, Jane Drapkin (Christian Aid) Sarah Kline (Oxfam GB) Francis Lemoine (Eurodad)

[21] *Financial Impact od the HIPC Initiative First 26 country cases* – World Bank July 2002
[22] Quoted in *The Case for Aid for the Poorest Countries* – HM Treasury March 2002
[23] According to assessments of HIPC GDP figures contained in *The Enhanced HIPC Initiative and the Achievement of Long-Term External Debt Sustainability* – April 15 2002