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What's Wrong with the HIPC Initiative and What's Next?

Bernhard G. Gunter[*]

This article reviews the problems of the enhanced HIPC initiative and outlines possible steps towards a more efficient debt and poverty reduction initiative. After brief comments on the rationale for debt relief, it analyses some key issues related to the HIPC initiative's aim to achieve debt sustainability, describes other fundamental problems of the HIPC framework, and discusses some less known but still crucial flaws of the initiative. It then proceeds with necessary improvements for an efficient debt reduction programme, possible modifications for a revised HIPC initiative, and some suggestions on how to overcome financing constraints. Apart from being in several respects unfair, the current framework is unlikely to permit a lasting exit from unsustainable debt for many HIPCs, and may lead to a decline in traditional development assistance.

Between 1980 and 1990, the low-income countries' total stock of external debt grew rapidly from US$125 billion (in 1980) to US$419 billion (in 1990). In contrast, gross national product increased only from US$0.9 trillion (in 1980) to US$1.3 trillion (in 1990). In other words, the debt-to-GNP ratio increased from less than 14% in 1980 to over 31% in 1990. Even though the rescheduling terms of the Paris Club (PC)[1] became increasingly concessional for low-income countries,[2] most of them continued to face severe debt-service problems during the 1990s.[3] Owing to increasing evidence that the development prospects of many of the heavily indebted and poor countries (HIPCs)

[*] Consultant for the World Bank and Oxfam America/New Rules for Global Finance Coalition. From 1998 to 2000, the author was an economist in the World Bank's HIPC unit. The views expressed here are the author's own and should not be associated with any position or organisation. He wishes to thank Jo Marie Griesgraber, Eric A. Friedman and Tony Killick for useful comments. For communications, please contact Bernhard_Gunter@altavista.com.

[1] An informal group of creditor governments from mostly industrialised countries that has met regularly in Paris since 1956 to reschedule bilateral debts, see www.clubdeparis.org/en/ for more information.

[2] Following the Group of Seven (G-7) summits in Toronto (1988), London (1991), and Naples (1994), debt relief provided on eligible debt was 33%, 50%, and 67%, respectively, with eligible debt defined as pre-cutoff date, non-ODA (official development assistance) bilateral debt. The cutoff date refers to the date a debtor country first approached the Paris Club for a debt rescheduling. ODA debt was excluded from debt reduction, but was usually rescheduled. Note that Easterly's (1999) argument that substantial debt relief had been provided to heavily indebted and poor countries (HIPCs) before the HIPC initiative is misleading as traditional debt relief provided only temporary relief on largely unpayable debt and was only provided on eligible debt.

[3] Of the 37 low-income countries that have rescheduled their debt with the Paris Club during the last two decades, fewer than one quarter have graduated from the rescheduling process (*IMF Survey*, Supplement, Vol. 29, September 2000, p. 17). For a historical description of debt relief for low-income countries from the Toronto terms to the HIPC initiative, see Daseking and Powell (1999).

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suffer from unsustainable debt, the member governments of the International Monetary Fund (IMF) and the World Bank agreed in the autumn of 1996 to the HIPC Initiative.

This initiative defines a country as 'heavily indebted' if so-called 'traditional debt relief mechanisms'[4] are unlikely to reduce its external debt to a sustainable level, debt sustainability being largely determined by a net present value (NPV) debt-to-export ratio of 200-250% (see more details below). The criterion for being 'poor' is to be an 'IDA-only' country, i.e. a country that relies on financial resources from the World Bank's International Development Association (IDA).[5] The key slogan of the HIPC Initiative was that sustainable development requires sustainable debt, and thus the goal was to reduce the HIPCs' external debt to a sustainable level.[6] Compared with decades of bilateral debt rescheduling, the HIPC initiative was a major break-through with respect to two related issues. First, it was intended to be a comprehensive solution to the HIPCs' unsustainable debt, which would allow HIPCs to exit permanently from repeated debt rescheduling by reducing their external debt stock to sustainable levels. Second, given that more and more external debt owed by the HIPCs was multilateral debt, the HIPC initiative also included a reduction of multilateral debt. The provision of multilateral debt relief was a difficult step for the international community to take.[7]

However, three years after launching the initiative, it was clear that the original HIPC framework was not a sufficient solution, and following public pressure, the IMF and the World Bank formally agreed in September 1999 to enhance the framework. The enhancements provide broader, deeper, and faster debt relief through (i) a lowering of the ratios considered to provide debt sustainability (together with a lowering of the minimum thresholds to qualify for the openness/fiscal criteria),[8] (ii) replacing the, in principle, fixed three-year period between decision and completion points by the concept of a floating completion point (which is reached by the successful implementation of so-called 'triggers for the floating completion point'), and (iii) the provision of interim relief from some creditors between the decision point and the completion point. At the time the new framework was adopted, it was estimated that the original and enhanced HIPC frameworks combined would reduce the public and publicly guaranteed (PPG) debt stocks of the 41 HIPCs by about US$50 million (about US$28 billion in NPV terms).

[4] A net present value (NPV) debt reduction of two-thirds on eligible (see Note 2) bilateral debt (Naples terms).

[5] Originally, Equatorial Guinea and Nigeria were considered to be HIPCs, but have been dropped from the list of HIPCs as they were later considered to be no longer IDA-only countries. The Comoros, The Gambia, and Malawi were added once they satisfied the requirements and asked to be considered for HIPC debt relief. For the current list of HIPCs and a more detailed description of the HIPC initiative, see the World Bank's HIPC website: www.worldbank.org/hipc/.

[6] Based on the original framework, debt relief would be provided irrevocably to each HIPC after reaching its HIPC completion point, totalling for the group of HIPCs approximately US$20 billion in nominal terms (approximately US$13 billion in NPV terms); not a huge amount compared with the more than US$200 billion total debt outstanding at the time the original framework was adopted.

[7] For a description of the politics and economics delaying HIPC debt relief since 1987, see Evans (1999). Given that less than 4% of HIPCs' total external debt was private non-guaranteed (PNG) debt, the architects of the HIPC framework decided to exclude this debt.

[8] Under the enhanced framework, a NPV debt-to-export ratio above 150% (down from 200-250%) is considered to be unsustainable. For countries having an export-to-GDP ratio of at least 30% (down from 40%) and a government revenue-to-GDP ratio of at least 15% (down from 20%), a NPV debt-to government revenue ratio of more than 250% (down from 280%) is considered to be unsustainable.

Furthermore, by linking enhanced HIPC debt relief to the preparation and implementation of nationally-owned participatory poverty reduction strategies – embodied in Poverty Reduction Strategy Papers (PRSPs) – an important step forward has been made in placing debt relief within an overall framework of poverty reduction.[9] However, there are also some problems in linking HIPC debt relief to poverty reduction strategies. It has been argued that the PRSP requirement either delays enhanced HIPC assistance or leads to a lower level/quality of country ownership and civil society participation. Furthermore, evidence is once again mounting that even the enhanced HIPC framework does not provide long-term debt sustainability for many of the poorest countries, and various critiques have pointed out a couple of other problems and flaws of the initiative. Before addressing these critiques that argue that further revisions and enhancements are needed to make the HIPC initiative an effective instrument for poverty reduction, we shall first address briefly some of the key arguments against further debt relief.

Is debt relief needed, and how much?

Though clearly a minority in terms of popular voice, there are some people who believe that no further debt relief should be provided. Some of the key arguments against further HIPC debt relief are (i) that debt relief is not just, since the majority of the world's poor people live in countries that are not eligible for HIPC debt relief; (ii) that excessive debt is not the cause of growing poverty but a symptom of waste; and (iii) that debt service cannot crowd out social expenditures as long as a country receives a multiple of its debt-service payments in terms of new loan disbursements and grants. While all three arguments seem to be correct at first sight, a more careful examination does not support their conclusion against further debt relief.

First, the fact that the majority of the world's poor people live in countries that are not eligible for HIPC debt relief may indicate inappropriate HIPC eligibility criteria, not an argument against debt relief *per se*. Indeed, some of the world's poorest countries have been excluded from the HIPC initiative because – according to the HIPC initiative's narrowly defined debt-to-export and debt-to-revenue criteria – their debt is considered to be sustainable. However, as suggested in Sachs et al. (1999) and in more detail in EURODAD (2001b), if debt sustainability is approached from a human and social development perspective, most of the poorest countries do have an unsustainable debt.

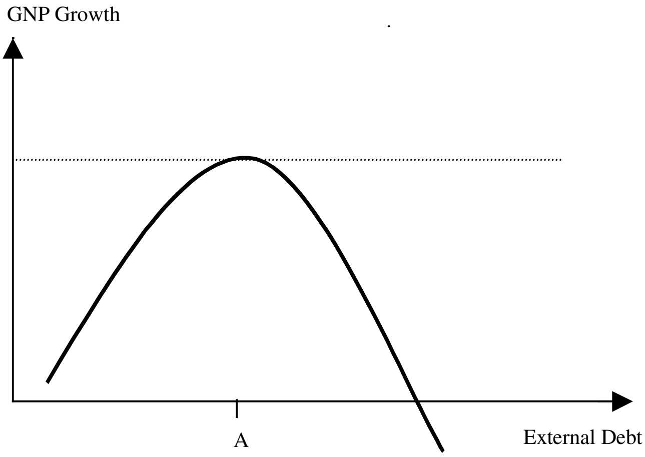
Second, while it is true that excessive debt is the result of failed investments, there are many reasons for these failures. To mention a few: corruption, falling terms of trade, drought, and internal and external conflicts. Only some of these reasons could be considered as waste on the part of the debtor countries, but even then, they also reflect poor lending decisions on the part of creditor countries. As Dittus (1989: 364) pointed out more than ten years ago, 'donors have to shoulder part of the responsibility of assuring that aggregate lending is consistent with debt service capability'. Moreover,

[9] For the latest information on issues related to PRSPs, see the World Bank's comprehensive PRSP website: www.worldbank.org/poverty/strategies/index.htm. For a recent review of PRSP documentation, see Booth and Lucas (2001); for a recent human rights assessment of the PRSP see Cheru (2001); for a human rights assessment of the HIPC initiative, see Friedman (2000).

some reasons for failed investments are beyond the control of either debtor or creditor, and the outcome, had there been no investments, is likely to have been worse. Simply to blame the debtor countries only, and to ask the next generation of debtor countries to pay for the failed investments of earlier decades, does not seem to be appropriate on either moral or economic grounds.

Third, while it is true that, from a static point of view, debt service cannot crowd out social expenditures as long as new loans and grants exceed debt-service payments, social expenditures could be higher if debt service were lower. More importantly, the seminal contributions by Krugman (1988) and Sachs (1989) have shown that debt relief is more efficient than the provision of new loans in cases where debt has accumulated beyond some critical level (point A in Figure 1). Debt accumulated beyond point A constitutes a debt 'overhang' that has a negative impact on private investment, growth and development. In other words, even new loans and increased social expenditures may prove ineffective as long as a country is trapped in a situation of unsustainable debt. Indeed, during the early 1990s, empirical evidence grew that many of the poorest countries had acquired unsustainably high external debt stocks that had a significantly negative impact on investment and growth.[10] The empirical studies showed that unsustainable debt burdens crippled development, especially in sub-Saharan Africa.

Figure 1: Relationship between external debt and GNP growth



Given that there is a trade-off between the provision of debt relief and the provision of new loans and grants, the question that arises is: how much debt relief should be provided? The theoretically simple answer is that debt relief should be provided until the debt overhang is removed, in other words, until debt sustainability is secured. As will be shown in more detail in the next section, the practical answer is more difficult as there is no agreement on what level of debt is sustainable. In any case, there is a problem if debt sustainability indicators are derived based on financing limits for debt

[10] The main initial contributions are Borensztein (1990), Cardoso (1993), Cohen (1993), Faini and de Melo (1990), Greene and Villanueva (1991), Schmidt-Hebbel and Müller (1992), and Serven and Solimano (1993). For more recent evidence see Elbadawi et al. (1997) and Gunter (2001).

relief instead of on empirical analyses. In theory, there is also broad agreement that debt relief should be additional to existing traditional development assistance and that this cannot be achieved without increases in overall development budgets.[11] However, the evidence so far seems to indicate that HIPC debt relief has been deducted from traditional development assistance.[12]

The financing constraints are especially severe for multilateral development banks (MDBs).[13] As the case of the World Bank's IDA shows,[14] multilateral assistance to the HIPC initiative can only be additional to traditional multilateral development assistance if overall budget allocations to MDBs are increased in real terms. Excluding increases earmarked to fight the HIV/AIDS epidemic, there is currently little indication that this will happen.[15] It is thus realistic to assume that HIPC debt relief will reduce traditional multilateral assistance. With non-increasing development budgets, the only possibility of increasing the total assistance to HIPCs would be to cut assistance levels to non-HIPCs. In view of the fact that past aid has flowed to countries that were not committed to poverty reduction, some reallocation of aid may be justified in line with the recent efforts to improve aid effectiveness.[16] However, considering that some of these non-HIPCs are actually poorer than the average HIPC (though less indebted), this could hamper the achievement of the international development goals (IDGs, now also called millennium development goals, MDGs).[17]

Finally, given that the enhanced HIPC framework determines that each creditor's burden-sharing of HIPC debt relief is based on its share in the total NPV debt as of the decision point, it is only logical that some creditors have reduced their traditional

[11] See Culpeper (2001) for a recent analysis of long-term financing needs for the poorest countries.

[12] As shown in more detail in Gunter (2001), comparing the three-year average of 1994-6 with the three-year average of 1997-9, there is a significant decrease in both bilateral disbursements and grants to each of the four HIPCs that had reached their original decision points in 1997.

[13] Some MDBs did not even have enough resources to provide their share of original HIPC assistance. For example, though Uganda had reached its completion point under the original framework in April 1998, it is currently (November 2001) still waiting to receive original HIPC assistance from two sub-regional MDBs (the East African Development Bank and the PTA Bank).

[14] IDA's share of enhanced HIPC assistance will come from two sources, using a pay-as-you-go approach. Initially, IDA's share will be financed through IBRD net income allocated into the HIPC Trust Fund (as was the case in the past). Once these resources are used up, the remaining share of IDA's enhanced HIPC assistance will come out of the then current IDA budget. The World Bank estimates that, from 2005 onwards, an annual US$500 million will need to be taken out of then current IDA budgets. Though the World Bank management stressed that resources taken out of IDA are supposed to be returned in subsequent IDA replenishments, there is a realistic fear (based on struggles over previous IDA replenishments) that donor contributions to IDA may not be increased. Thus, IDA resources used for HIPC debt relief will reduce traditional IDA development projects.

[15] This conclusion is drawn from announcements by various OECD countries, some of which intend to increase their aid budgets (e.g., Germany, see *Süddeutsche Zeitung*, 12 October 2001, p.13) and some of which intend to decrease their aid budgets (e.g., Japan, see *Wall Street Journal*, 7 November, p. A14), and the reactions to the pleas for doubling ODA by World Bank President James Wolfensohn and British Chancellor of the Exchequer Gordon Brown at the Bank-Fund Meetings in Ottawa, 17-18 November 2001 (as reported in *Les Echos*, 20 November 2001, p. 9).

[16] See the World Bank's Aid Effectiveness website: www.worldbank.org/research/aid/ for more information, including the overview of the recent World Bank (2001a) report on *Aid and Reform in Africa*. A useful collection of papers on lessons learnt and future directions can be found in Tarp and Hjertholm (2000). For an extensive study on phasing out Swedish project aid, see Catterson and Lindahl (1999).

[17] For definitions of and progress towards the IDGs, see: www.paris21.org/betterworld/.

development assistance to HIPCs. Once the HIPC decision point is reached, this 'holding back effect' should disappear; however, as long as creditors believe that further debt relief will be required in the future, they have little incentive to provide new loans.

The challenge of achieving debt sustainability

A United States General Accounting Office (US GAO, 2000) report reviewed the HIPC initiative in Spring 2000 and concluded (p.13) that 'unless strong, sustained economic growth is achieved, the initiative is not likely to provide a lasting exit from debt problems'. Like others, it cautions that the growth assumptions used in the country-specific debt sustainability analyses (DSAs) may be over-optimistic. For example, the IMF and World Bank assume that export earnings will grow in excess of 9% every year for 20 years in 4 of the 7 HIPCs the GAO analysed (ibid.: 9).

Over-optimistic growth rates affect debt sustainability in two ways: first, they imply over-optimistic growth rates for a country's exports, and second, they underestimate a country's future financing needs. Given that the HIPC framework defines debt sustainability largely by a debt-to-export ratio, overestimations of exports (which are in the denominator of the ratio) and underestimations of future financing needs/new debt (which are in the nominator of the ratio) result in unrealistically low future debt-to-export ratios, which then indicate unrealistic long-term debt sustainability. As the GAO report points out (p. 15), if Tanzania's exports grow at an annual 6.5% (instead of the 9% projected by the IMF and World Bank), Tanzania's debt-to-export ratio could be more than twice what the joint IMF/World Bank's forecast shows for the projection period.

Recognising this major challenge and the possibility that the HIPC initiative may not achieve debt sustainability, the IMF and World Bank have issued a paper (2001a) on the challenge of maintaining long-term debt sustainability, in which they acknowledge that the NPV debt-to-export ratio is projected to remain above 150% for 10 years or more for at least 3 HIPCs (Bolivia, Malawi, and Niger). However, a EURODAD (2001a) study states that, in 2005, the NPV debt-to-export ratio will be above 150% for at least 5 HIPCs. The IMF/World Bank report (2001a: 22, Fig. 3) also acknowledges that an export growth rate 1% lower than was achieved in the past will again lead to raising debt-to-export ratios above 150%. However, without addressing the broad critique of over-optimistic growth projections, the report concludes that the HIPC initiative provides a good basis for HIPCs to exit from rescheduling.

A detailed analysis of capital flows, structural transformation, and investment and savings rates of HIPCs provided by Gunter (2001) shows that there is little macroeconomic foundation for the high growth projections of HIPC DSAs. Even before the developments following 11 September 2001, the IMF and World Bank Boards recognised that HIPC growth assumptions might be too optimistic, and therefore asked their staffs to clarify when and how to exercise the option of increasing debt relief at the completion point. Based on these clarifications (see IMF/World Bank, 2001c), the Development Committee (meeting on 18 November 2001 in Ottawa) recognised the need to take account of worsening global growth prospects and declines in terms of trade, when updating HIPC initiative DSAs at the completion point.[18]

[18] See the HIPC website (www.worldbank.org/hipc/) for the full statement of the Development Committee.

Finally, there is a widespread criticism that the HIPC initiative uses inappropriate debt sustainability criteria. For example, Sachs (2000) has expressed the view that the HIPC sustainability criteria have nothing to do with debt sustainability in any real sense. Gunter (2001) has shown that the HIPC initiative neglects standard debt-to-GNP ratios and is far too restrictive in the application of the fiscal indicator. As a World Bank (2001b) report shows, at least 4 countries (Guinea, Mauritania, Niger, and Zambia) will continue to pay more than 20% of government revenues as external debt service on PPG debt after enhanced HIPC debt relief.

Other fundamental problems

First, there is a widespread criticism that it was a fundamental mistake to let the creditors, led by the IMF and World Bank, work out the original framework of the HIPC initiative. Though it is acknowledged that the IMF and World Bank had undertaken an extensive consultation process across the world for the 1999 review of the initiative, the enhanced HIPC framework clearly followed the suggestions of the G7 summit of June 1999 in Cologne. As is reflected in recent criticism of the HIPC framework voiced in many NGO circles and some United Nations organisations, developing countries, and especially debtor countries, had little or no say in the final adoption of the enhanced framework of the HIPC initiative. Given that some developing countries are major creditors to some HIPCs, their exclusion from the key decision-making process constitutes a problem.

Second, it is argued that the HIPC initiative has been designed around the concept of what debt reduction is needed according to inappropriate debt sustainability indicators, instead of what debt reduction is needed for sustainable development. This was especially the case under the original framework, which did not have any explicit link to poverty reduction. While the enhanced framework makes a formal link to poverty reduction by requiring HIPCs to develop and implement poverty reduction strategies, enhanced HIPC debt relief is still not calculated on the basis of a country's need for sustainable development.[19]

This brings us to another set of important criticisms related to the linking of HIPC debt relief to PRSPs. It has been argued that such a link implies excessive conditionality that has unnecessarily delayed the provision of enhanced HIPC debt relief. This applied especially to the cases of Uganda and Bolivia, which were required to go through a further round of enhanced decision and enhanced completion points, even though they had demonstrated a highly successful track record on poverty reduction. As is described in more detail in US GAO (2000) and Northover (2000), there is an unacceptable tension between the urgent need for debt relief and the time required to build a genuinely participatory PRSP process. On the other hand, it has been argued that PRSPs do not go far enough in incorporating an analysis of the ethnic, religious, and social tensions which confront the lives of most Africans. Roy (2000) has pointed out that PRSPs should be accompanied by and integrated with measures to infuse peaceful diplomacy, peace-making and peace-keeping. Similarly, Cheru (2001) has argued that

[19] For example, the enhanced HIPC initiative could have provided debt relief based on a strategy to achieve the international development goals which the world's governments have committed to achieve by 2015.

the role of PRSP overseers should not be given exclusively to the IMF and World Bank, but that other, United Nations, agencies should be brought into the process.

Finally, the stated HIPC debt-service savings – comparing actual payments before and after the HIPC initiative – are distorted by the fact that some HIPCs made unusually high debt-service payments shortly before reaching the enhanced decision point in order to avoid any arrears that could have delayed this.[20] Looking at the same issue from a different perspective, we can compare actual debt-service payments in the year before reaching the enhanced decision point with debt-service payments for the year following it. Such a comparison shows that Nicaragua paid US$9 million more in 2001 (US$117 million) than in 1999 (US$108 million), Niger paid US$21 million more in 2001 (US$49 million) than in 1999 (US$28 million), and Zambia paid US$22 million more in 2001 (US$158 million) than in 1999 (US$136 million). All three HIPCs reached their enhanced decision points in December 2000.[21]

Less-known problems with the initiative's framework

Burden-sharing

As mentioned above, the HIPC initiative's burden-sharing concept is – compared with earlier debt initiatives – a major step forward, as all creditors share the costs of the initiative based on each creditor's NPV share in outstanding and disbursed debt. Within the group of some 70 bilateral creditors, the costs for Paris Club members are estimated at nearly US$12 billion; the costs for non-members are estimated at around US$3 billion. However, to understand this breakdown, it is important to note that the PC is not a fixed group of countries, but depends on the debtor country's main creditors. This explains why in some cases, the PC includes some developing country creditors (Brazil, Israel, South Africa, Trinidad and Tobago).

Based on current estimates, the top 12 bilateral creditors include three developing countries (Costa Rica, Brazil and Guatemala; see Table 1). Though the list of bilateral creditors includes in some cases even HIPCs, no provision has been made to exempt creditors that are HIPCs from the burden-sharing of the initiative. So far, the experience has been that it is largely developing country creditors and sub-regional MDBs that have – due to financial constraints – not fully participated in the provision of HIPC debt relief.[22]

[20] Calculations based on the data provided in Table 4a of World Bank (2001b) seem to indicate that this was the case for Guinea, Guinea-Bissau, Malawi, Mauritania, Nicaragua, Rwanda, and Zambia, where actual debt-service payments in the decision-point year increased by 30%, 117%, 26%, 11%, 17%, 90%, and 24%, respectively, compared with actual debt-service payments in the year before the decision point. Excluding these increases, the actual annual debt-service savings of the enhanced HIPC initiative are at least US$140 million less.

[21] Calculations based on data provided in Table 4a of World Bank (2001b).

[22] The HIPC initiative does not constitute international law. HIPCs are therefore obliged to pay their debt service in full until bilateral agreements have been signed with each bilateral and multilateral creditor.

Table 1: Bilateral and multilateral creditors with the largest HIPC costs (US$ bn, in 1999 NPV terms)

Bilateral creditors	**14.6**	**Multilateral creditors**	**14.0**
of which		of which	
Japan	2.8	World Bank	6.2
France	2.3	African Development Bank/Fund	2.3
Germany	1.4	IMF	2.2
Russia	1.1	Inter-American Development Bank	1.1
Italy	1.0	Other MDBs	2.2
Spain	0.7		
United Kingdom	0.6		
Costa Rica	0.4		
Portugal	0.4		
United States	0.3		
Brazil	0.3		
Guatemala	0.3		
Other bilateral creditors	6.0		

Source: HIPC Review 2000: *The Enhanced Initiative for Heavily Indebted Poor Countries – Review of Implementation, September 2000* (available on the HIPC website: www.worldbank.org/hipc/); data for multilateral creditors are based on Table 6; data for individual bilateral creditors are estimates based on combining Tables 6, 10 and 11.

Currency-specific discount rates

A second, less frequently cited problem is related to the fact that the HIPC framework uses currency-specific discount rates to calculate the NPV debt (which provides the basis for HIPC assistance). The discount rates used are the currency-specific commercial interest reference rates (CIRRs) averaged over the last six months before the reference date of the DSA. CIRRs are provided by the OECD for its member countries' currencies, based on commercial lending rates.[23] The way the HIPC framework decided to use these CIRRs entails four problems:

- currency-specific CIRRs imply an unfair burden-sharing;[24]
- the averaging of CIRRs over 6 months enforces the unfair burden-sharing and causes a high volatility in estimations of assistance and costs;[25]

[23] The CIRR of the Special Drawing Right (SDR) is calculated based on its composite currencies' CIRRs.

[24] Currency-specific discount rates imply a highly unfair burden-sharing whereby booming creditor countries get rewarded and creditor countries facing or recovering from recession get punished. This is because booming economies generally have higher CIRRs than countries in or recovering from a recession.

[25] As interest rates are changing over time, any change in the DSA reference date implies changes in the discount rates and thus represents changes in NPV debt and HIPC assistance. As Uganda's reassessment under the enhanced HIPC initiative showed, high discount rates and over-optimistic export projections can make a country's debt look sustainable, even though it is not. (Based on Uganda's original completion point DSA, Uganda's NPV debt-to-export ratio at end-June 1999 was supposed to be 207%; however, as the enhanced decision point DSA showed, the actual NPV debt-to-export ratio was 240%.) Together with volatile exports (or volatile government revenues), this methodology results in highly unpredictable numbers for HIPC assistance and HIPC costs.

- the averaging of CIRRs over 6 months implies that HIPCs assessed during a period of relatively high world interest rates will, *ceteris paribus*, receive less HIPC assistance than countries assessed during relatively low interest rates;
- the gap in clear rules as to what CIRR to use for non-OECD currencies has led to arbitrary uses of discount rates in some cases.[26]

All four problems imply arbitrary results on assistance levels and costs of the HIPC initiative. The impact of differences in discount rates on the NPV is illustrated by the following comparison. Consider a US$10 million loan repayable at an interest rate of 4% over 40 years (including 10 years' grace). Using a discount rate of 6% results in an NPV of US$7.5 million. Using a discount rate of 2% results in an NPV of US$13.9 million (nearly twice as much). In other words, in this example, every percentage point difference in the discount rate implies a change in the NPV of about US$1.6 million (or about 16%).

The impact of different discount rates on a country's HIPC assistance depends on (a) the size of the difference in discount rates, (b) the share of NPV debt affected by differences in discount rates, and (c) the level of indebtedness. If a HIPC's debt level is close to what is considered to be sustainable, differences in discount rates could determine the country's eligibility under the initiative.

As the comparison of the costs for Japan and the United States shows, the impact of different discount rates also has important implications for the creditor country. Among other factors, especially Japan's larger exposure, the large difference in discount rates at the time of the HIPC cost calculations between the US dollar (6.23%) and the Japanese Yen (2.22%) partly explains why Japan's costs of the HIPC initiative are so much higher (US$2.8 billion) than those of the United States (less than US$0.4 billion).[27] As Oxfam International (2000: 10) reports, the Japanese government had threatened some HIPCs (Ghana, Malawi, and Laos) with a withdrawal of future aid should they ask to be considered for HIPC debt relief. In addition to Japan's high exposure to these three countries, it is likely that the unfair burden-sharing implied by the Yen's low discount rate triggered Japan's action. In any case, partly through mediation and partly based on a cost-benefit analysis, Malawi decided in Summer 2000, and Ghana in Spring 2001, to request HIPC assistance.

Debt rescheduling

Given that the key goal of the HIPC initiative is to provide a lasting exit from repeated debt rescheduling, it does not make sense for some HIPC debt relief to be provided through debt rescheduling. However, following previous Paris Club arrangements, official development assistance (ODA) was to be rescheduled over 40 years (including 16 years grace) at original interest rates.

[26] This arbitrariness is reflected in various HIPC documents. For example, the Preliminary HIPC document of Tanzania (prepared in October 1999) used the SDR's CIRR for all currencies which do not have their own CIRR; however, the Guinea document (prepared in December 1999) used the US dollar's CIRR (6.23%) for the Chinese Yuan, the French Franc's CIRR (5.35%) for currencies pegged to the French Franc, and the SDR's CIRR (5.25%) for the other currencies which do not have an established CIRR.

[27] CIRRs are six-month averages of July-December 1998, as used for most 1999 DSAs.

In most cases, the ODA debt rescheduling does not provide much NPV debt reduction, and thus, large debt reductions in non-ODA had to compensate for the insufficient NPV reduction from the ODA rescheduling. In cases where the original ODA debt interest rate is higher than the discount rate, the ODA rescheduling actually increases the NPV of ODA. The case of Tanzania's Naples terms stock of debt reduction (67% reduction in NPV terms) shows how strong this impact of ODA debt rescheduling can be. Even though some non-ODA debt gets cancelled, it still turns out that total debt service during fiscal years 2000 to 2018 is higher after the Naples terms stock of debt reduction than before these terms stock.[28] Note that this example does not even take into account the additional increases in debt service for the fiscal years after 2018. This implies that even though a HIPC can obtain a relatively high debt reduction in NPV terms, its nominal debt-service payments (spread over time) can actually increase.

The delivery of HIPC debt relief through debt reschedulings applies also to some MDBs. A variety of MDBs claim that their charters do not allow them to cancel debt stock or debt service. Given these legal constraints (or the inability/unwillingness to change charters) and the HIPC framework's gap in defining how HIPC assistance will need to be provided, IMF and World Bank staff have left it to each creditor to decide on how to provide its share of NPV debt relief. While concessional reschedulings can provide the NPV assistance required under the HIPC initiative, the actual benefit to the debtor country may be marginal. The simplified example in Annex 1 illustrates this point.

Necessary improvements

Based on the above analysis, an efficient debt reduction programme would benefit from various improvements.[29] With regard to HIPC DSAs, (i) DSA growth projections would need to be based on realistic growth assumptions, which, for example, take into account the negative impact of AIDS, (ii) debt sustainability indicators would need to focus on sustainable development instead of on inappropriate debt sustainability criteria, which also implies that (iii) the amount of debt relief would need to be based on globally agreed debt sustainability indicators that include a debtor country's fiscal constraints in achieving the international development goals. With regard to HIPC debt relief, it should (i) not be deducted from traditional (bilateral and multilateral) development assistance, and (ii) not be provided through debt rescheduling. Furthermore, (i) solutions need to be found for current financing constraints as well as for any further enhancements of the initiative, (ii) mechanisms need to be designed to provide faster debt relief without calling into question the efficiency of debt relief, and (iii) modifications are needed with regard to the use of currency-specific discount rates in order to make the initiative fairer, more predictable, and even simpler. Finally, to avoid donors holding back their assistance to countries that have not yet reached their decision

[28] Table 11 of Tanzania's Enhanced Decision Point Document (published on the HIPC website) compares the average external debt service before and after a Naples Terms stock of debt reduction. It shows that the average annual debt service for fiscal years 2000 to 2009 decreases after the Naples terms stock of debt reduction (from US$283m. to US$255m.), but increases by more than that for fiscal years 2010 to 2018 (from US$345m. to US$379m.).

[29] A more Jubilee 2000-oriented set of suggestions for solutions can be found in Roodman (2001).

points, assistance levels should be based on relative shares in NPV debt as they existed before creditors adjusted their new lending.

Possible modifications

There is a wide range of suggestions on how to improve the enhanced HIPC initiative. At one end of the spectrum are suggestions for further marginal improvements in the enhanced framework, like the acceleration of the provision of HIPC relief. At the other end are suggestions to replace the initiative, for example, with an international bankruptcy court (see Raffer, 1993). Even though the IMF has recently agreed to work out a sovereign bankruptcy scheme that would allow countries to seek legal protection from creditors that stand in the way of restructuring, it is unlikely that a completely new framework will replace the HIPC initiative. It is more likely that further enhancements may be adopted over time. Most of the enhanced HIPC framework could be used as a first round of country-specific debt reduction. A second round, using a modified framework, could concentrate on how more debt-service cancellations would be needed to achieve the international development goals.

The following are some suggestions for possible modifications. They should not be understood as a blueprint for the next level of the HIPC initiative. The next set of modifications should be based on extensive consultations, whereby the voice of developing countries should have more influence in the outcomes than they have had up to now. Given the dominance of industrial countries in the decision-making of the IMF and World Bank, a series of conferences organised by the United Nations (like those organised in the first half of the 1990s for the definition of the international development goals for 2015) may provide a better organisational setting, especially as debt sustainability would need to be discussed in the context of achieving the international development goals. It is not yet clear how much attention will be given to debt reduction at the March 2002 International Conference on Financing for Development, as the emerging synthesis seems to be that debt reduction is only one of many possible actions and instruments to support poverty reduction strategies.

Possible modifications in the HIPC framework

Unify discount rates All of the problems related to currency-specific discount rates could be avoided by adopting a single fixed discount rate for all currencies, all creditors, and all debtors. For example, a ten-year (1990-9) backward-looking average of the SDR's CIRR could be used to establish a simple and consistent discount rate.

Apply efficient debt sustainability criteria Evidence is growing that the only useful debt sustainability criteria for HIPCs have to be related to fiscal indicators. The NPV debt-to-government-revenue indicator could, together with poverty levels and other country-specific vulnerability factors, be used for the assessment of long-term debt sustainability. A debt-service-to-government-revenue indicator could, together with necessary investments for anti-poverty programmes, be used to determine the maximum annual debt service due. In any case, there should be no minimum thresholds to apply these fiscal indicators. Furthermore, countries should not be discouraged from improving their revenue collection and should at the same time not be punished (in the form of lower HIPC assistance) for improvements in government revenue collection.

Thus, the reference revenue components should be based on long-term backward-looking averages ending with the year before the modification is adopted as a framework, not the country-specific decision points. An international agreement on some limits of debt-service payments (defined as long-term debt-to-government-revenue ratios) could help to avoid the effects of debt overhang.

Adjust burden-sharing according to economic power The non-participation of some creditors and the comparison of burdens across countries[30] indicate that the HIPC initiative's burden-sharing concept will need to be revised at some time. The current burden-sharing concept may be acceptable for industrialised country creditors, but is less acceptable for developing country creditors, which are sometimes not much better off than the debtor. The initiative's burden-sharing makes sense for relatively resource-rich multilateral institutions, but is less convincing for regional MDBs which depend on non-regional bilateral donor support in order to be able to provide their share.[31] Though the HIPC initiative has attempted to co-ordinate the donor assistance to MDBs through the HIPC Trust Fund, there is no obligation for an industrialised country to contribute its 'fair' share (what fair means would need to be defined). This implies a co-ordination failure of donor contributions and results in an under-funding of the HIPC Trust Fund.

A possible modification could be to adjust the bilateral burden-sharing according to the creditor's economic power.[32] In the case of burden-sharing among multilateral creditors, it could be made dependent on the availability of industrialised country shareholders.[33] An economic power-adjusted burden-sharing also makes sense based on the further integration of debt relief and poverty reduction.

Apply country-specific vulnerability factors Another modification could be to take country-specific vulnerability factors, especially poverty levels, into account in determining the amount of debt relief. Country-specific vulnerability factors were used

[30] For example, based on the current burden-sharing concept, costs for Costa Rica (US$358m.) are higher than those for the United States (US$347m.). Looking at the current initiative's burden-sharing in terms of per capita costs, each person in Costa Rica, Kuwait, and Trinidad & Tobago is supposed to contribute around $100, while the highest per capita costs for industrialised countries are around $40. For the United States, the per capita costs of the enhanced HIPC Initiative are just over $1.

[31] Cline (1997) has suggested that not even the IMF and World Bank are supposed to use their resources for HIPC debt relief, but that the bilateral creditors should cover their shares, as they are the shareholders of the multilateral institution. See especially Cline's interesting section on Peter or Paul.

[32] Unfortunately, the Paris Club has recently gone in the other direction. Instead of shifting the burden of HIPC assistance from the poor creditor countries to the rich creditor countries, a change in the methodology of how to share the costs among the bilateral creditors in late 1999 shifted the burden towards the non-PC countries. Under the original framework, the costs among bilateral creditors were calculated based on the NPV of pre-cutoff date and non-ODA debt. Under the new framework, the burden-sharing among bilateral creditors is based on total NPV debt outstanding at the decision point. Comparisons between the two methodologies show that the bilateral costs have been shifted towards non-PC creditors as they have relatively more post-cutoff-date debt than the PC creditors.

[33] An interesting point is that the resource-richest MDB, the World Bank's IBRD, has asked bilateral donors to provide its share of HIPC assistance. In contrast, the IBRD has used part of its net income to support the World Bank's IDA. The reason for these manoeuvres and accounting tricks is that the IBRD fears negative impacts on its creditor ratings if it were to provide its own HIPC assistance. Yet, most other MDBs do not constitute two legally separated entities and are asked to use their own resources as far as possible to provide their HIPC assistance.

in the original framework but were dropped in the enhanced framework, as Bank and Fund staff often disagreed on specifics. Instead of dropping these useful considerations and adopting a Joint Bank-Fund Implementation Committee of the HIPC initiative in Summer 2000, it might have been more efficient to divide some HIPC implementation tasks as well as some PRSP assessments according to each institution's comparative advantage.

Ease eligibility criteria Once debt sustainability indicators and debt relief are based fully on fiscal indicators that take account of the need for expenditures on poverty reduction, it would make sense to extend the debt initiative to all IDA-only countries as long as they spend the debt-service savings on poverty reduction. Furthermore, it might be more appropriate to exchange the current nominal income-related eligibility criterion with one based on purchasing-power-adjusted income.

Possible modifications related to debt relief

Accelerate HIPC debt relief One way to accelerate HIPC debt relief would be to reduce permanently the requirements for reaching the enhanced HIPC decision point. Following a suggestion of Oxfam International (2000), the enhanced decision point could be reached once a government produces an Interim Poverty Reduction Strategy Paper that provides some details on the workings of a poverty fund.[34] Indeed, partly related to a temporary lowering of requirements, which was due to the IMF's and World Bank's promise that 20 countries would reach the enhanced decision point by the end of 2000, 15 countries reached their enhanced decision points between July and December 2000. In contrast, between January and June 2001, only one country (Chad) reached the enhanced decision point.

Once the decision point has been reached, another way to accelerate HIPC debt relief would be to front-load the relief. Much rhetoric has surrounded the front-loading of HIPC debt relief, but the facts are different. Based on data provided by the World Bank (2001b), for the 23 countries that had reached their enhanced decision point by the end of June 2001, the average annual debt-service savings during 2001-3 are only 5% (US$1.7 billion) of the total HIPC debt-service savings (US$34 billion) for these 23 countries. In other words, assuming that all HIPC debt-service savings will be provided within 20 years of reaching the enhanced decision point, there is (at the aggregate level of these 23 HIPCs) zero front-loading of HIPC debt relief. With regard to our discussion on a possible strengthening of requirements to reach the HIPC completion point, this may only be acceptable if interim relief were to be more front-loaded.

Base annual amounts of debt relief on economics The profile of HIPC debt relief should be based on a combination of development needs and the debt profile, instead of on fixed rules established independently by each creditor. Given that interim relief may not be provided by all creditors, the World Bank could revise its interim assistance rules to cover for this shortfall when it is most needed to reach the completion point. Note that this would not imply any costs to the Bank, as HIPC assistance is determined in NPV terms except, of course, if another round of HIPC debt

[34] The main purpose of the poverty fund would be to ensure that debt-service savings are spent on poverty-reducing activities that are additional, compared with poverty-related expenditures of previous years.

relief (HIPC-3) is expected and HIPC-3 assistance were to be based on a new round of HIPC-3 decision points.

Cancel ODA debt Some creditors have already indicated that they intend to provide debt relief beyond what is required under the enhanced HIPC initiative, especially with regard to existing ODA debt. The cancellation of ODA debt is long overdue, especially as a United Nations resolution called for the cancellation of all ODA debt more than twenty years ago. Some countries followed the UN resolution by cancelling all their ODA claims many years before the HIPC initiative. The fact that only some creditor countries had cancelled contributed to the current burden-sharing concept of the HIPC initiative. If all creditors were to cancel their ODA claims, it might also be easier to revise the HIPC initiative's burden-sharing concept to include a component related to a creditor's economic power.

Overcoming financing constraints

Some of the most serious deficiencies of the HIPC framework can be related to financing constraints and the mind-set that a sparrow in the hand is better than two in the bush. Financing constraints have led to the adoption of an inadequate framework, (a) in terms of achieving definitive debt sustainability, and (b) in terms of the time it will take HIPCs to reach the enhanced completion point. Yet, even the enhanced framework implies financing constraints, especially for developing country creditors and regional and sub-regional MDBs. Given the existing financing constraints, it seems unrealistic to demand further enhancements without making some suggestions as to where these additional resources could come from.

Building public support for debt reduction

If debt relief were seen as part of an overall strategy to eradicate extreme poverty worldwide, the burden-sharing concept would need to be related to economic power. While this would eliminate the financing gap for the poor creditors, it would increase the financing requirements of the rich creditors. Given that the 21 Development Assistance Committee (DAC) members of the OECD spend, on average, only 0.24% of their gross national product on official aid for developing countries and multilateral aid institutions,[35] the financing constraints of the DAC members seem to be more political than real. A coalition of governments, MDBs, NGOs and church groups, all working together to persuade the public that debt relief and poverty eradication are a necessity based on moral as well as on economic grounds, could lead to broad-based support to increase the development budgets in the most delinquent industrialised countries to at least financing the eradication of extreme poverty worldwide. Indeed, a recent IMF/World Bank (2001b: 5) statement indicated that the heads of the IMF and World Bank 'would gladly join a campaign to convince industrial countries to move to the longstanding UN target for official development assistance of 0.7% of GNP within ten years'.

[35] See Prof. Thirlwall's letter to the editor of the *Financial Times, 25* July 2001, p.12.

A more comprehensive poverty reduction strategy

It is crucial to integrate debt relief into a global poverty reduction strategy and not to suggest an unconditional write-off of all HIPC debt. An unconditional write-off will neither foster growth nor help the poor, since no country will achieve sustainable growth without internal and external peace, progress towards which can only be made by improved governance, covering a broad range of policies that aim at enhancement of the rule of law, the establishment of property rights, less corruption, an improvement in the overall legal system, and an uncorrupted public leadership. However, in cases where it is obvious that a country is serious about reducing poverty but has not reached the completion-point triggers because of factors beyond its control (such as, for example, a flood), reaching the enhanced completion point should not be based on checking off completion-point triggers.

New global taxes or reallocations of existing budgets

There are two ways to increase development budgets worldwide. The more familiar one would be to introduce a global tax, like a global Tobin tax[36] on cross-border currency transactions or a global tax on carbon-emitting fossil fuels. The other way would be to reallocate funds from expenditures that are a waste from a global point of view to expenditures aimed at development assistance. What comes to mind is a cut in world military expenditure. Unfortunately, neither suggestion is currently feasible owing to a lack of political support (though the Tobin tax has gained some attention, especially in Europe, over the last few months). However, given that a one-off 1% cut in industrialised countries' defence budgets would be enough to cancel 100% of the external debt of all IDA-only countries over the next twenty years, more of such maximum solutions should be considered.[37] Finally, besides increasing development budgets, steps are also under way to increase the efficiency of current donor programmes and the poverty reduction programmes of recipients.[38]

Conclusion

Compared with other debt initiatives implemented over the past two decades, the HIPC initiative represents a huge step forward. It was a breakthrough in terms of (a) its aim to provide a lasting exit from unsustainable debt and achieve debt sustainability and (b) its approach to including multilateral creditors in sharing the costs related to debt relief. The HIPC initiative is to be commended for providing more debt relief to HIPCs than the sum of all previous debt reschedulings. The enhanced initiative has also started to link debt reduction to poverty reduction.

[36] See the Tobin Tax Initiative website: www.tobintax.org for more up-to-date information.

[37] The annual defence expenditures of the industrialised countries are estimated to be about US$650 billion; the total external debt of all IDA-only countries is estimated to be about US$125 billion (in NPV terms).

[38] As Lancaster (2000: 80) has pointed out, at the end of the 1990s, there were more than 40 poorly co-ordinated aid agencies working in numerous African countries, pursuing their own priorities, and expecting their own separate administrative and procurement requirements to be met. This has overwhelmed African officials and disrupted government budgets.

However, the enhanced HIPC initiative (a) is unlikely to achieve a lasting exit from unsustainable debt for many HIPCs, (b) suffers from some fundamental flaws in its design, (c) continues to face considerable financing constraints, (d) applies an inappropriate burden-sharing concept, and (e) may lead to a reduction in traditional development assistance. The first and last problems are certainly the most critical ones in determining the success of the initiative in terms of long-term poverty reduction and the achievement of the international development goals. As the IMF/World Bank (2001b) statement has pointed out, 'a decline of just 10% in new flows would wipe out the benefits of HIPC debt relief'.

A first step towards reaching debt sustainability would require the IMF and World Bank to stop praising the current HIPC framework and acknowledge the need for further enhancements. This would allow their staff to join others in the search for better solutions. At a broader level, this requires primarily a rethinking towards a long-term interdependence between rich and poor countries. To reduce poverty is a shared responsibility of all countries.

Finally, the costs of debt relief and poverty reduction programmes should not be seen as an economic burden but as investments in the future. Experience from the past (for example, the 1953 debt relief provided to Germany after World War II) shows that debt relief can pay for itself in terms of political stability and contributions to world growth. It should not be surprising that political instability, ethnic conflicts and war are re-occurring in poor countries facing unsustainable debt (see also Collier and Hoeffler, 2000). A marginal cut in world military expenditures allocated to a global poverty reduction strategy would boost global peace and reduce the costs of future peace-keeping efforts around the globe.

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Annex 1: The impact of debt reschedulings

Assume that a highly indebted poor country exports goods and non-factor services to the amount of US$30 million a year, growing at an annual real growth rate of 5%. The country's bilateral and multilateral debt stock amounts to $96m. each. Assume that all debt is highly concessional (with an interest rate of 1% and repayable over 20 years). Applying the original HIPC initiative's debt-service-to-export indicator of 20-25%, the country's debt is not sustainable. Given this situation, all bilateral creditors agree to grant the country a reduction in its debt stock of more than 80% in NPV terms, reducing the nominal debt to bilateral creditors to US$18m. This reduces annual debt-service payments to bilateral creditors to about US$1m. The country's multilateral creditors have also agreed to provide more than 80% debt relief in NPV terms, though not through a reduction in debt stock, but by the cancellation of all interest payments and a rescheduling of the outstanding principal over 60 years, including 20 years' grace. To keep the example simple, assume that all creditors have agreed to provide all new financing in the form of grants. Let us look at the country's situation in 20 years' time: a) all bilateral debt will have been repaid, b) all interest on multilateral debt will have been been cancelled, c) there are no debt-service obligations related to new debt, and d) the country's exports may have grown to US$80m. (assuming an optimistic annual real growth rate of 5%). Yet the country still faces unsustainable principal payments on multilateral debt, amounting to US$24m. a year.

Note that an 80% reduction in debt stock in NPV terms on multilateral debt would have provided debt sustainability, but that a more than 80% reduction in NPV terms through rescheduling and interest cancellation does not. The intuitive explanation is that a debt rescheduling does not solve the problem but simply pushes it into the future. There is no guarantee that the country will be able to pay currently unsustainable debt in the future. However, as long as the discount rate is higher than the interest rate, every grace year implies a reduction in NPV terms. In cases where the discount rate is lower than the interest rate, debt rescheduling increases the NPV.

Finally, note that debt rescheduling does not usually imply a cancellation of interest, and thus the nominal sum of interest and principal repayments increases with every grace year. If a country remains insolvent after the debt rescheduling's grace period, it is actually worse off since it has wasted resources on interest payments without achieving long-term debt sustainability.