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Report to the Chairman, Subcommittee on International Economic Policy, Export and Trade Promotion, Committee on Foreign Relations, U.S. Senate

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DEVELOPING COUNTRIES

Status of the Heavily Indebted Poor Countries Debt Relief Initiative

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The Honorable Chuck Hagel
Chairman, Subcommittee on International Economic
Policy, Export and Trade Promotion
Committee on Foreign Relations
United States Senate

Dear Mr. Chairman:

This report responds to your request that we describe the implementation of the Heavily Indebted Poor Countries Debt Initiative and assess the initiative's potential to achieve its stated goal.

We are sending copies of the report to the Secretaries of the Treasury and of State, the President of the World Bank, the Managing Director of the International Monetary Fund, and other interested parties. Copies will also be made available to others on request.

Please contact me at (202) 512-4128 if you or your staff have any questions concerning the report. Major contributors to this report are listed in appendix VIII.

Sincerely yours,

Benjamin F. Nelson

Benjamin F. Nelson, Director
International Relations and Trade Issues

Executive Summary

Purpose

In response to a call from the leaders of the major industrial nations for a comprehensive approach to the debt problems of the poorest countries, the World Bank and the International Monetary Fund (IMF)[1] proposed the Heavily Indebted Poor Countries (HIPC) Debt Initiative in 1996. The initiative reflects concerns of creditors, including the United States, that, even after receiving debt relief through existing mechanisms, some poor countries will have debt burdens that remain too large relative to their ability to pay. The stated goal of the HIPC initiative is to bring countries' debts to levels that are sustainable, meaning that in the future they can make debt payments on time and without rescheduling. As a condition of receiving debt relief, countries undertake economic and social reforms. Expressing concern about whether the HIPC initiative could realistically be expected to solve these poor countries' debt problems and whether they are likely to need further debt relief in the future, the Chairman of the Subcommittee on International Economic Policy, Export and Trade Promotion, Senate Committee on Foreign Relations, asked GAO to review the HIPC initiative. As requested, this report (1) describes the implementation of the HIPC initiative and (2) assesses the initiative's potential to achieve its stated goal. Because it is still relatively early in the implementation of the HIPC initiative, this report presents a preliminary assessment of its likely effects.

To conduct its assessment, GAO obtained access to World Bank and IMF officials and information through the Department of the Treasury, and through the staff of the U.S. members of these institutions' Boards of Executive Directors.[2] GAO discussed the development and implementation of the HIPC initiative with, and obtained data from, officials of U.S. government agencies; other creditors, including France, Germany, the United Kingdom, the Paris Club,[3] the African Development Bank, and the Inter-American Development Bank; governments and private sector

[1]The World Bank promotes economic growth and the development of market economies by providing financing on reasonable terms to countries that have difficulty obtaining capital. The Bank is the world's single largest official source of investment capital for developing countries. The IMF promotes international monetary cooperation and exchange rate stability and provides short-term lending to member countries that experience balance-of-payments difficulties. For poor countries, the IMF also provides medium-term (10-year) loans on concessional (below market interest rate) terms under its Enhanced Structural Adjustment Facility (ESAF).

[2]The Board of Executive Directors of the World Bank is responsible for policy decisions affecting the Bank's general operations and for the approval of all loans. The IMF's Executive Board is the IMF's primary decisionmaking body. Each board comprises 24 executive directors who represent member countries.

[3]The Paris Club is an informal group of creditor countries that meets, as needed, to negotiate debt rescheduling and relief efforts for public or publicly guaranteed loans. In addition to the 18 countries that regularly participate in the Paris Club, other countries are invited to the negotiations on an ad hoc basis if they hold a significant share of the debt being discussed.

institutions in three HIPC recipient nations—Burkina Faso, Côte d'Ivoire, and Uganda; U.N. organizations; and nongovernmental organizations (NGO) in the United States and abroad. GAO analyzed data and internal reports on the design and implementation of the HIPC initiative, as well as data on prior debt relief and restructuring efforts. GAO conducted its assessment based on the implementation of the HIPC initiative through August 1998.

Background

Addressing the debt burdens of very poor countries, in the context of the broad range of development needs they face, constitutes a substantial challenge. The World Bank and the IMF have classified 40 countries as heavily indebted poor countries.[4] Thirty-two of these countries are in sub-Saharan Africa. (See app. I for a list of countries.) Eighty-three percent of these countries are classified by the United Nations as being in its lowest category of human development, based on life expectancy, literacy, and per capita national income. Most receive substantial amounts of development assistance from governments, multilateral organizations, and NGOs. In 1994, foreign assistance represented about 16 percent of national income, using a weighted average, for 36 of these countries for which data is available. Some of the 40 countries, moreover, have recently emerged from—or continue to be engaged in—conflict or civil unrest.

Since the early 1980s many poor countries have had increasing difficulty servicing their debt. Despite several debt relief efforts, the total amount of money owed to external creditors by the 40 countries increased from an average of $122 billion for 1983-85 to $221 billion for 1993-95 (in 1997 dollars). For 1993-95, 73 percent of this debt was medium- and long-term debt owed to official creditors (governments and multilateral financial institutions). The remaining 27 percent was medium- and long-term debt owed to commercial creditors and short-term debt such as trade financing. Of the total debt, 45 percent was owed to governments (bilateral creditors)[5] and 28 percent was owed to international financial institutions (multilateral creditors). By the mid-1990s, much of this debt was not being repaid. During 1993-95, for example, HIPC countries paid about 41 percent

[4]In 1996, the World Bank classified 41 countries as heavily indebted poor countries. In 1998, the number of countries was reduced to 40 because Nigeria was no longer given this classification.

[5]According to the U.S. Treasury, as of August 1998, 31 heavily indebted poor countries owed the United States approximately $6.8 billion in outstanding debt. (See app. II.)

of their scheduled debt payments, with the remainder being rescheduled or in arrears.[6]

Debt relief efforts since the 1980s have been undertaken primarily by bilateral and commercial creditors. Some bilateral creditors have individually forgiven debt owed by poor countries with, for example, the United States forgiving about 37 percent of the debt owed to it by these countries. More often, bilateral creditors have worked together to offer debt relief on increasingly concessional terms, up to 67 percent of eligible debt (Naples terms), through the Paris Club. Multilateral creditors have generally not rescheduled or reduced debt owed them because of their belief that forgiving or reducing debt would diminish assurances of repayment on new lending and, in some cases, hurt their credit ratings.

The HIPC initiative is the first coordinated effort to include all creditors in addressing poor countries' debt problems. Participating creditors include bilateral governments, the major multilateral creditors such as the World Bank and the IMF, and over 20 other multilateral development institutions, including the African Development Bank, the Inter-American Development Bank, and the International Fund for Agricultural Development. (See app. III.)

The World Bank and the IMF made a preliminary determination that 20 of the 40 countries might eventually receive relief based on the initiative's specific criteria concerning income, indebtedness, and reform efforts underway. The World Bank and the IMF currently estimate that the HIPC initiative will provide about $8.2 billion in debt relief in 1996 present value[7] terms, for 20 countries. As of August 1998, the World Bank and the IMF had made specific eligibility decisions for eight countries, with six countries—Bolivia, Burkina Faso, Côte d'Ivoire, Guyana, Mozambique, and Uganda—deemed eligible for relief under the HIPC initiative, and two countries—Benin and Senegal—deemed ineligible because their debts are considered sustainable. One country—Uganda—has completed the HIPC initiative's process.

[6]If Sudan and Somalia, two of the countries with the largest amount of unpaid debt and that are not part of the HIPC initiative's current cost estimates, are not included, GAO estimates that the 38 remaining countries paid an average of 43 percent of their debt service owed during 1993-95.

[7]The amount of debt can be reported in terms of nominal (face) value and present value, also termed "net present value" in HIPC documents. Much of the debt of poor countries is contracted on concessional terms. The present value of debt is a measure that takes into account the degree of concessionality.

The HIPC framework outlines a two-stage process, with each stage lasting up to 3 years. During stage one, a country must implement IMF- and World Bank-supported programs of economic reform, after which eligibility for HIPC debt relief is assessed. At that time, the World Bank and the IMF determine whether (1) existing debt relief mechanisms, such as those offered by the Paris Club, are sufficient to bring a country's debt to a point considered sustainable or (2) the country requires additional relief. In making this determination, they decide whether the ratio of a country's debt (in present value terms) to the value of its exports will be greater than a target ratio set for that country.[8] According to the framework, the target debt-to-export ratio is generally set between 200 and 250 percent.[9] The lower the target level set for a particular country, the greater the amount of debt relief required to reach the target. For example, lowering the ratio of a particular country's debt to its exports from 300 percent to 200 percent requires more debt relief than lowering it from 300 percent to 250 percent. The target set for each country is based on factors affecting the vulnerability of the country's economy, such as the percentage of government revenue required for debt service and whether export earnings are dependent on just a few commodities.

If the World Bank and IMF Boards determine that existing debt relief mechanisms are insufficient to make debt levels sustainable and other principal creditors agree, the debt reduction amounts are decided and the country enters the second stage of the HIPC initiative. During this stage, the country receives some debt relief from bilateral and commercial creditors and financial support from multilateral institutions. The country must agree to continue implementing economic reform programs supported by the IMF and the World Bank and social reforms agreed to with the World Bank. If the country has met the IMF and World Bank requirements, it receives final debt relief under the HIPC initiative at the end of stage two. Official creditors have agreed to share the amount of relief by providing equal percentage reductions of debt owed them (after the full use of existing debt relief mechanisms) and commercial creditors are expected to provide relief comparable to bilateral creditors.

Establishing a comprehensive framework for debt relief required resolving differences among creditors. Some creditors were concerned about the

[8]In this report, discussions of debt-to-export ratios refer to the present value of debt, unless otherwise noted.

[9]Under certain conditions, for countries with very open economies and strong efforts to generate fiscal revenues, the target may be based on the ratio of debt to government revenue. This fiscal indicator can lead to debt-to-export targets below 200 percent.

cost of providing debt relief and about the issue of "moral hazard"—whether the prospect of debt relief would discourage countries from undertaking needed reforms or from pursuing responsible borrowing policies. Key issues negotiated in developing the HIPC initiative included how sustainable debt burdens would be determined, the nature of required reforms, whether debt stocks would be reduced, and how creditors would share in providing relief. Setting a range of values for the primary indicator of whether debts were sustainable, and announcing the framework would be implemented flexibly, left many key decisions to be made in the process of implementing the initiative. Also, some aspects of design, most notably how the shares of debt relief would be divided among creditors, were decided after the basic framework was announced. (See app. IV for additional information on the framework.)

Results in Brief

The HIPC initiative will help reduce participating poor countries' debt burdens, in some cases, substantially; however, many will remain vulnerable to future debt problems even with sound economic policies. The implementation of the HIPC initiative reflects compromise among the major official creditors on issues such as countries' eligibility and the total amount of debt relief to be provided. In recognition of countries' economic vulnerabilities, creditors have generally agreed on relief amounts that are at or close to the upper bounds of what the negotiated framework allows. Nonetheless, in order to avoid further debt problems, countries receiving debt relief through the HIPC initiative are assumed to maintain strong economic performance and continue to receive large amounts of donor assistance. In most cases this assistance includes balance-of-payments support. The HIPC initiative projections assume that countries will maintain sustainable debt levels in part through strong export growth. These export growth assumptions may be optimistic for some countries. Since many HIPC recipients rely upon a few commodities for their export earnings, they are particularly vulnerable to economic events such as a decline in the price or output of a primary export.

Principal Findings

Implementation of the HIPC Initiative Has Involved Extensive Negotiation

The implementation of the HIPC initiative has involved significant negotiation among the major creditors on issues such as a country's eligibility, the amount of debt relief to be provided, and the way in which debt relief is to be shared among creditors. Creditors have generally agreed to provide relief at the upper end of what the negotiated framework provides for five of the first six countries. The total estimated amount of debt relief has increased in part due to creditors' decisions as they have implemented the HIPC initiative. The amount of relief could further increase if, for example, countries that were not included in previous estimates become eligible.

Compromise on Amount and Timing of Debt Relief

Despite considerable debate on the amount and timing of debt relief to be provided, the World Bank and IMF Boards, in conjunction with principal creditors, have generally implemented the HIPC initiative to provide debt relief at the upper bounds of the negotiated framework. This is specifically evident in low debt-to-export targets—which increase the amount of debt relief provided—and shortened second stages of the initiative's implementation—which provide debt relief sooner and can increase relief amounts in some cases. For five of the first six countries, target debt-to-export ratios have been set close to or below the lower end of the target range—205 percent or lower.[10] Countries have expressed different views during the implementation of the HIPC initiative about the extent to which debt-to-export ratios above the lower end of the target range should be used, in part reflecting concerns about costs. The higher relief amounts agreed to reflect concerns that these countries face significant economic risks such as declines in the price or production of their primary exports.

Five of the first six countries approved for relief under the HIPC initiative have been given a shortened second stage despite some countries' belief that the second stage of the HIPC initiative—the period between eligibility and completion—should last 3 years. According to HIPC documents, this shortened period reflects the strong reform records of the early qualifiers (Bolivia, Burkina Faso, Guyana, Mozambique, and Uganda), which have completed successive ESAF programs and World Bank programs and received a Paris Club stock-of-debt operation[11] on Naples terms. A shorter period between the initiative's decision point and the completion point means that countries will receive final HIPC debt relief sooner and may get more relief under certain conditions. In the case of Guyana, GAO estimated that the decision to set the completion point in 1998 rather than the year 2000 (which would have been 3 years between the two stages) resulted in

[10]The fiscal indicator has led to debt-to-export ratios below 200 percent for two countries—Côte d'Ivoire and Guyana.

[11]For the Paris Club, a stock-of-debt operation refers to the total refinancing of the outstanding balance of a country's eligible debt. The stock of eligible debt will be reduced and the remainder will be rescheduled.

a projected increase in the initiative's assistance of about 68 percent, or $103 million in present value terms.

Creditors' Shares of Debt Relief

Determining how creditors will share in providing debt relief has involved significant negotiation since the September 1996 announcement of the HIPC framework. After much negotiation, in July 1997 the creditors broadly endorsed a proportional burden-sharing approach under which bilateral and multilateral creditors are expected to provide debt relief in proportion to their exposure after the use of traditional debt relief mechanisms, including those offered by the Paris Club. Bilateral and multilateral creditors are to provide equal percentage reductions on the remaining debt owed to them, with Paris Club creditors agreeing to provide up to 80 percent relief on eligible debt.

The creditors each determine how they will provide the relief. Creditors may provide relief through several means, such as rescheduling debt payments at lower interest rates, buying back the debt, converting loans into grants, reducing the debt, making debt service payments as they come due, and/or lending new funds on concessional terms to be used to make debt service payments. A creditor's decision about how it will provide debt relief to a particular recipient may be influenced by many factors, such as the amount of outstanding debt and the impact of providing debt relief on the creditor's future budgets.

Multilateral creditors have said that they will not forgive debt outright because to do so may endanger their preferred creditor status.[12] They have stated they intend to provide debt relief in ways that maintain their preferred creditor status such as making countries' debt payments for them as they come due. Much of the debt relief provided by the World Bank will be financed through a special HIPC Trust Fund. Relief through the HIPC initiative is provided on debt owed to the International Development Association (IDA), but the funding for the Trust Fund is provided mainly from income of the International Bank for Reconstruction and Development (IBRD).[13] (See app. IV for additional information on the sources of funding for the Trust Fund). The IBRD has contributed about $750 million from its income to this Trust Fund to buy back or repay debt

[12]The preferred creditor status derives from the debtors' traditional practice of servicing debt owed to the World Bank and the IMF before servicing debt owed to other lenders. The articles of agreement (charters) of these institutions do not address preferred creditor status or debt forgiveness.

[13]The World Bank has two organizations that lend to governments: the IDA lends to poor countries at highly concessional rates, and the IBRD lends to middle-income countries at market rates.

owed to IDA.[14] The IMF is participating in the HIPC initiative through special ESAF grants that are deposited into an escrow account to meet debt service payments owed to the IMF under a predetermined schedule. The IMF is funding its contribution through its own trust fund financed from bilateral (member) contributions and the ESAF reserve account.

Total Estimated Relief Amounts Can Change

The actual amount of debt relief to be provided under the HIPC initiative depends on creditors' decisions during implementation as well as actions taken by debtor countries to implement required reforms. Since reaching agreement on the basic terms of the HIPC framework in September 1996, creditors have made several changes that have contributed to an increase in the estimated amount of relief from $5.6 billion to $8.2 billion (in 1996 present value terms). Much of the increase was due to a change calling for exports to be calculated using an average of 3 years of data rather than 1 year. This was done to provide a more stable measure of exports. In a period of increasing exports, this change results in countries receiving increased relief under the HIPC initiative. The change increased the total estimated amount of HIPC debt relief by about $1 billion, according to HIPC documents. About $600 million of the increase was due to a change in the eligibility criteria that allowed at least two additional countries (Côte d'Ivoire and Guyana) to qualify for the HIPC initiative. Advocates for the expansion of the eligibility criteria were concerned that certain countries with very open economies, and thus relatively low debt-to-export ratios, were improperly characterized as having a sustainable debt burden under the HIPC initiative. Much of the remaining increase in projected debt relief was due to revisions to methodologies and country-specific analyses, most significantly, increased estimates of the amount of the potential relief for the Democratic Republic of Congo.

The amount of total HIPC debt relief could further increase if countries that were not included in previous estimates, such as Liberia, Somalia, and Sudan, establish the track records of reform needed to qualify for HIPC debt relief. Including these countries would increase the total amount of relief under the HIPC initiative, and debt relief for Sudan, in particular, could increase the estimates greatly. The World Bank and the IMF made a preliminary estimate that HIPC debt relief for Sudan could be about $4.5 billion. Conversely, if countries included in the estimates do not undertake required reforms and thus do not receive HIPC relief, the total amount of relief could decrease.

[14]The World Bank's Board of Executive Directors has recommended that an additional $100 million of IBRD income be transferred to the HIPC Trust Fund.

The HIPC Initiative Will Help Countries, but Many Will Remain Vulnerable to Future Debt Problems

The HIPC initiative will provide benefits to recipient countries; however, many will remain vulnerable to future debt problems, even with sound economic policies. In conjunction with existing debt relief mechanisms, such as relief from Paris Club creditors, the HIPC initiative will reduce countries' debts by varying amounts, some substantially. Reductions in the amount of recipient country resources that are used to pay debt service will also vary and are difficult to determine due to prior arrears and the use of donor resources in some cases to help make debt payments. The limited evidence for the particular debt targets in the HIPC initiative suggests that reducing debt-to-export ratios to near 200 percent is not likely to provide countries with a "cushion" to protect against adverse economic events. Strong export growth and substantial donor assistance are important to the HIPC initiative's projections of debt burdens being sustainable. For some countries, those export growth projections may turn out to be overly optimistic. If export earnings are lower than expected, financial support from bilateral and multilateral donors is assumed to increase. This assumption has been questioned by many parties, including some governments and NGOs, given the budgetary pressures of major donor countries. The HIPC initiative has also focused attention on the limited capacity of recipients to manage their debt, with improvements in debt management considered critical to avoiding future debt problems.

Determining the Significance of the HIPC Initiative's Debt Relief Is Complex

The HIPC initiative will reduce the total amount of debt owed, in present value terms, by varying amounts for the first six recipient countries. For example, the present value of HIPC debt relief for these countries ranges from 6 percent of debt for Côte d'Ivoire to 57 percent for Mozambique, with the average reduction 22 percent. However, HIPC debt relief is only one of several factors that contribute to estimated declines in recipient countries' debt burdens, as measured by debt-to-export ratios. GAO's analysis indicates that the amount of projected reduction in countries' debt burdens attributable to the HIPC initiative's relief and the amount attributable to other factors varies greatly across the first six qualifiers for the HIPC initiative. For example, GAO estimates that, for Uganda, 77 percent of the reduction in the debt-to-export ratio between 1995 and April 1998 (Uganda's completion point under the initiative) is due to export growth, with 18 percent attributable to HIPC debt relief and 5 percent attributable to a combination of other debt relief and changes in borrowing.[15] In contrast,

[15]Data available from HIPC documents does not allow GAO to separate out changes in debt-to-export ratios due to debt relief from mechanisms other than the HIPC initiative, such as unilateral debt forgiveness, from changes due to borrowing (new borrowing net of payment of principal on existing debt).

The analysis is sensitive to the initial year chosen. GAO chose 1995 as the base year for this analysis in order to capture the effects of Naples terms on countries' debt burdens.

for Guyana, 56 percent of the reduction can be attributed to a combination of other debt relief and changes in net borrowing, 22 percent is due to HIPC relief, and 22 percent is due to export growth.

Determining how much countries' actual debt service payments will be reduced by HIPC relief is complicated by the fact that some have experienced substantial arrears. For example, the HIPC initiative will reduce Mozambique's scheduled debt service payments by 42 percent from the obligations that remain after Paris Club relief on Naples terms. However, Mozambique was paying only about 30 percent of its debt service originally due during 1995-98. According to IMF data, Mozambique's projected average annual debt service of $98.7 million during 2000-03 will be about 13 percent less than its average annual debt service paid during 1995-98.

A further complexity in assessing the effect debt relief may have on a country's finances is that a substantial portion of the countries' debt service is financed through donor and creditor resources. This is most clearly evident in the case of Uganda. Since 1995, bilateral donors have provided funds directly to service Uganda's multilateral debt, with payments averaging $45 million per year in 1996 and 1997. HIPC debt relief is expected to reduce Uganda's annual debt service by about $30 million per year but, according to Ugandan officials, they will need to continue to receive $15 million per year in assistance from bilateral donors, in addition to other aid flows the country was receiving, to remain in as strong a position after HIPC relief as before. Ugandan officials told GAO they hoped some of that assistance would be channeled into social sector aid, such as education, although an IMF official noted that these funds were approved by donor governments for debt relief and shifting them into other types of aid may not be straightforward.

Evidence for Debt Relief Targets Limited

The limited analytical evidence that is available for the debt targets used in the HIPC initiative suggests that countries with debt-to-export ratios near the bottom of the 200-250 percent range may still have debt burdens that are unsustainable. World Bank and IMF officials cited two internal World Bank studies as support for their debt-to-export targets, but GAO believes that these studies may be of limited relevance for determining target levels of debt for HIPC countries for two reasons. First, their analysis was based primarily on middle-income countries rather than poor countries and, second, they examined debt levels at which countries began to experience debt servicing problems, not when they might emerge from such problems. Other World Bank reports have suggested that debt-to-export ratios above

200 percent indicate potential debt problems in poor countries, and a 1996 World Bank document notes that the debt-to-export threshold of 200 percent only indicates that at this level a country is likely to have difficulty servicing its debt.

The export-based indicators have been criticized by some analysts as narrow, in part because they do not directly consider the overall economic capacity of a country or the particular level of demand for government expenditures. The addition of fiscal, or government revenue, criteria for determining debt sustainability under the HIPC initiative has done little to satisfy critics. Only a few countries are considered likely to meet the fiscal criteria. Moreover, the World Bank and the IMF have stated that the choice of the debt target under the fiscal criteria, a 280-percent debt-to-government revenue ratio, was somewhat arbitrary. World Bank and IMF documents note that if this ratio were set much lower than 280 percent, the overall cost of the HIPC initiative would rise substantially.

Projections of Debt Sustainability Assume Strong Export Growth and Substantial Aid Flows

The economic forecasts used in analyses for the initiative generally assume a steady growth in export revenues for HIPC countries. This assumption is an important element in the initiative's expectation that recipients will have a sustainable debt burden. Exports have grown for most of the recipient countries in recent years. However, projections in HIPC documents assume significantly greater export growth in the years ahead. For example, the first six countries deemed eligible for HIPC debt relief had annual average growth rates in exports of 4.5 percent between 1985 and 1995. HIPC documents project that in years after they receive relief under the HIPC initiative, their annual export growth will average 7.8 percent, a 75-percent increase over the previous period.

Most of the countries that have been approved for debt relief under the HIPC initiative are dependent on just a few primary commodities for a majority of their export earnings. For this reason, their export earnings are considered to be particularly vulnerable to adverse economic events. A significant fall in the price or output of a country's primary export could bring the debt ratios to levels that once again exceed the HIPC initiative's target levels for debt sustainability. For example, about 66 percent of Uganda's export earnings in 1995 derived from one commodity, coffee, whose world price was near a 10-year high. According to HIPC documents, a 20-percent drop in the international price of coffee would raise Uganda's debt-to-export ratio by 30-40 percentage points. World Bank and IMF officials have cited increases in Uganda's export earnings (1995/96 and 1996/97) as evidence that the HIPC initiative's assumptions of countries' increased exports are reasonable when countries undertake necessary reforms. However, Uganda's most recent export data (1997/98) underlines concerns about the volatility of exports, with Uganda's exports declining about 23 percent. Poor weather conditions and the resulting decline in coffee exports are cited as the reason for projected increases in Uganda's debt-to-export ratio from 1997/98 through 1999/2000.

A key element in the HIPC initiative's projection of debt sustainability is that countries receiving debt relief will continue to get substantial foreign aid well into the future. This aid includes not only support for development projects within countries, but also concessional financing, including balance-of-payments support. For example, macroeconomic projections done by World Bank and IMF staff at Uganda's April 1998 completion point show that, with its HIPC debt relief of $347 million in present value terms, Uganda will continue to require donor assistance to meet its external debt and balance-of-payments needs until 2006.

Future donor flows to potential recipients depend, of course, on many factors. However, the assumption that donor support to recipients will continue at current levels and even increase under adverse conditions has been questioned by some governments and NGOs, given that net concessional lending from governments and multilateral institutions to poor countries has declined since 1990. Officials from the U.S. Treasury, other governments, and NGOs have raised questions about whether governments will simultaneously provide debt relief, increased concessional financing, and substantial contributions to replenish the international financial institutions, particularly in light of their own budget constraints.

Many Potential Recipients Have Limited Debt Management Capability

HIPC countries vary greatly in the degree to which they have the technical and governance requirements for effective debt management. According to the World Bank and the IMF, almost every country classified as a HIPC has in recent years received a substantial amount of technical assistance aimed at debt management. Most of this assistance has been concentrated on information management—on improving accounting systems for recording and tracking financial obligations. Two early qualifiers for the HIPC initiative, Uganda and Bolivia, stand out as countries that have relatively well-developed capabilities for tracking and managing debt. Uganda, for example, has been using debt data management software developed by the United Nations since the 1980s. However, the capacity of some HIPC countries to accurately track their financial obligations is still weak. This has resulted in situations where various agencies within a government engage in external borrowing with no central control over, or even complete knowledge of, total debt amounts, according to officials from countries GAO visited.

Even with a system of basic debt data management in place, analyzing how debt and debt reduction can affect a country's overall macroeconomic situation poses a challenge most participants in the HIPC initiative cannot meet, according to officials from the United Nations and recipient governments. This is due both to a lack of accessible modeling techniques and limited technical expertise. World Bank and IMF staff have developed very complex software spreadsheets to conduct debt sustainability analyses for countries potentially receiving debt relief under the HIPC initiative. World Bank and IMF officials acknowledged early in the HIPC initiative process the need for a uniform, documented standard for simulating debt reduction exercises so that countries could participate fully in analyzing their debt situations. The World Bank set as a priority the development of such a model to be made available to interested countries. However, as of August 1998, this software was not generally available for countries' use.

Recommendation

GAO is making no recommendations in this report.

Agency Comments and GAO's Evaluation

The Department of the Treasury and the IMF provided written comments on a draft of this report and the Department of State and the World Bank provided oral comments. These organizations pointed out areas where, although they did not disagree with the findings of the report, they believed more discussion was needed about the overall economic vulnerability of recipient countries and the role of various creditors in prior debt relief efforts. GAO agrees that additional information may enhance an understanding of issues related to HIPC, and has expanded its discussion of these issues. In addition, the IMF stated that the initiative was not intended to replace existing mechanisms, including the ESAF program, for providing resources to these countries. Also, the World Bank stated that the report's conclusion that many countries will remain vulnerable to debt problems could be viewed as an implicit recommendation for increasing debt relief amounts.

GAO agrees that countries participating in the HIPC initiative have economic situations that are vulnerable overall and that the initiative is just one of many programs that provide support. Moreover, existing mechanisms such as ESAF and donor aid exist to support these countries in the case of economic downturns. GAO's analysis, however, shows that HIPC recipients will generally continue to need balance-of-payments support to meet debt servicing and other external financing obligations even under economic assumptions that may prove optimistic. Thus, less favorable conditions will require that these countries receive additional financing beyond that projected. While GAO's analysis concludes that recipient countries remain vulnerable to debt problems, it is not recommending greater relief. Debt relief under the initiative will benefit participants, but the recognition that some countries may once again experience debt problems after receiving HIPC relief highlights the limitations of the initiative and should prove useful in future discussion among those responsible for policy decisions in this area.

Additional information on agency comments, and GAO's response, is presented in the text of this report. Written comments from the Department of the Treasury and the IMF are reprinted in appendixes VI and VII. The Department of the Treasury, the Department of State, the IMF, and the World Bank also provided technical comments and other suggestions that have been incorporated in the report as appropriate.

Contents

Tables

Figures

Abbreviations

DSA	Debt sustainability analysis
ESAF	Enhanced Structural Adjustment Facility
GDP	gross domestic product
HIPC	heavily indebted poor country
IBRD	International Bank for Reconstruction and Development
IDA	International Development Association
IMF	International Monetary Fund
NGO	nongovernmental organization
ODA	official development assistance
UNCTAD	U.N. Conference on Trade and Development

Introduction

The debt problems of many of the world's heavily indebted lowest income countries continue to be a challenge for the international community. Most of these countries' debt is owed to official creditors consisting of other governments (bilateral) and international financial institutions (multilateral). Despite debt relief efforts undertaken largely by bilateral and commercial creditors since the 1980s, the overall debt burden of the poor countries has increased. The debt burdens are of concern for two reasons: they may hamper economic development in debtor countries and they involve the lenders and debtors in a time-consuming pattern of rescheduling debt, providing new loans, and supplying donor assistance. To address the growing debt burden, in September 1996 governments around the world agreed to the Heavily Indebted Poor Countries (HIPC) Debt Initiative developed by the World Bank and the International Monetary Fund (IMF).[1] The initiative was intended to build on existing debt relief efforts and bring together all of a country's creditors to provide debt relief in conjunction with policy reforms to allow countries to exit from the rescheduling process. Establishment of the HIPC initiative involved resolution of differences among creditors concerning the need for expanded debt relief.

Poor Countries' Debt Burdens Have Grown

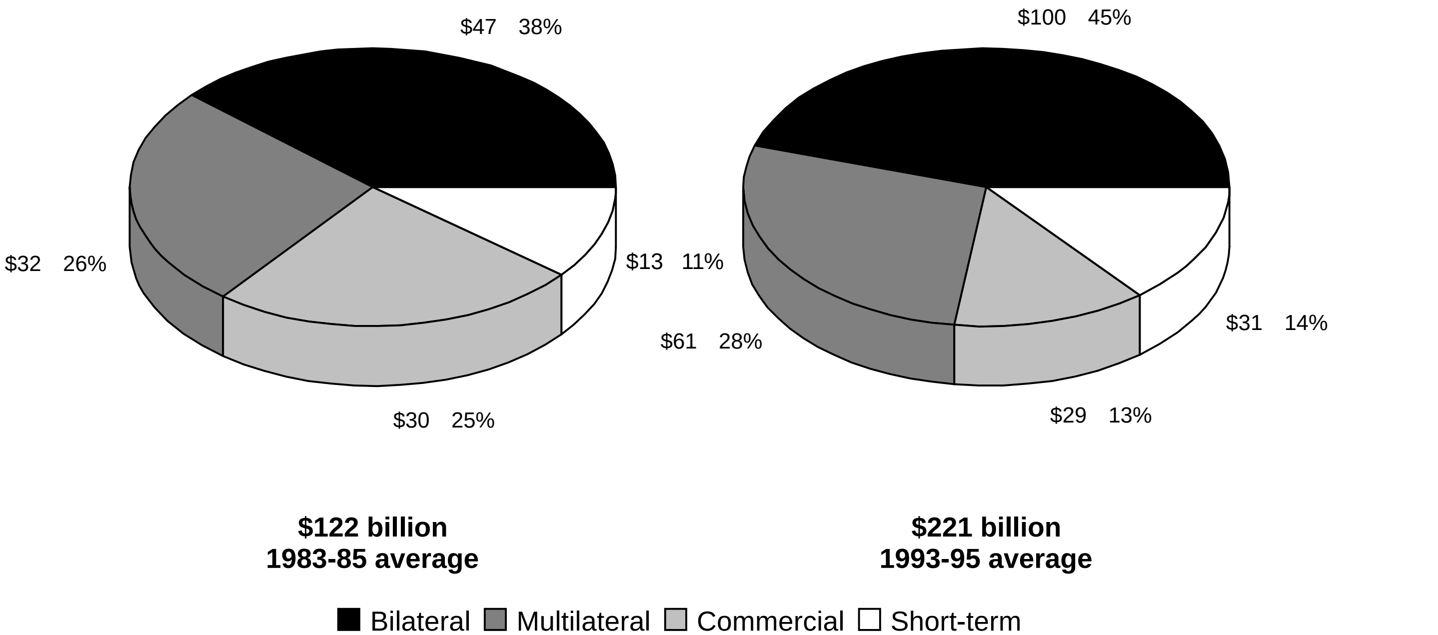
Despite repeated efforts to relieve the debt burden of developing countries, the total amount of money owed to external creditors by the 40 countries classified by the World Bank and the IMF as heavily indebted poor countries[2] increased from an average of $122 billion for 1983-85 to $221 billion for 1993-95 (nominal value, in 1997 dollars). (See app. I for a list of countries.) Figure 1.1 shows the composition of this debt among three categories of medium- and long-term debt, as well as short-term debt.[3]

[1]The World Bank promotes economic growth and the development of market economies by providing financing on reasonable terms to countries that have difficulty obtaining capital. The Bank is the world's single largest official source of investment capital for developing countries. The IMF promotes international monetary cooperation and exchange rate stability and provides short-term lending to member countries that experience balance-of-payments difficulties. For poor countries, the IMF also provides medium-term (10-year) loans on concessional (below market interest rate) terms under its Enhanced Structural Adjustment Facility (ESAF).

[2]In 1996, the World Bank classified 41 countries as heavily indebted poor countries. In 1998, the number of countries was reduced to 40 because Nigeria was no longer included in this classification.

[3]Short-term debt can be owed to either official or commercial creditors. It includes loans with maturities of less than 1 year (often trade financing) and interest arrears. Although the percentage of total debt that is short-term debt increased modestly between the two periods shown, its composition shifted sharply. According to our analysis, interest arrears accounted for 19 percent of short-term debt for 1983-85, and 66 percent for 1993-95.

Figure 1.1: Composition of External Debt for 40 HIPCs, 1983-85 and 1993-95 Nominal Value, in Billions of 1997 Dollars

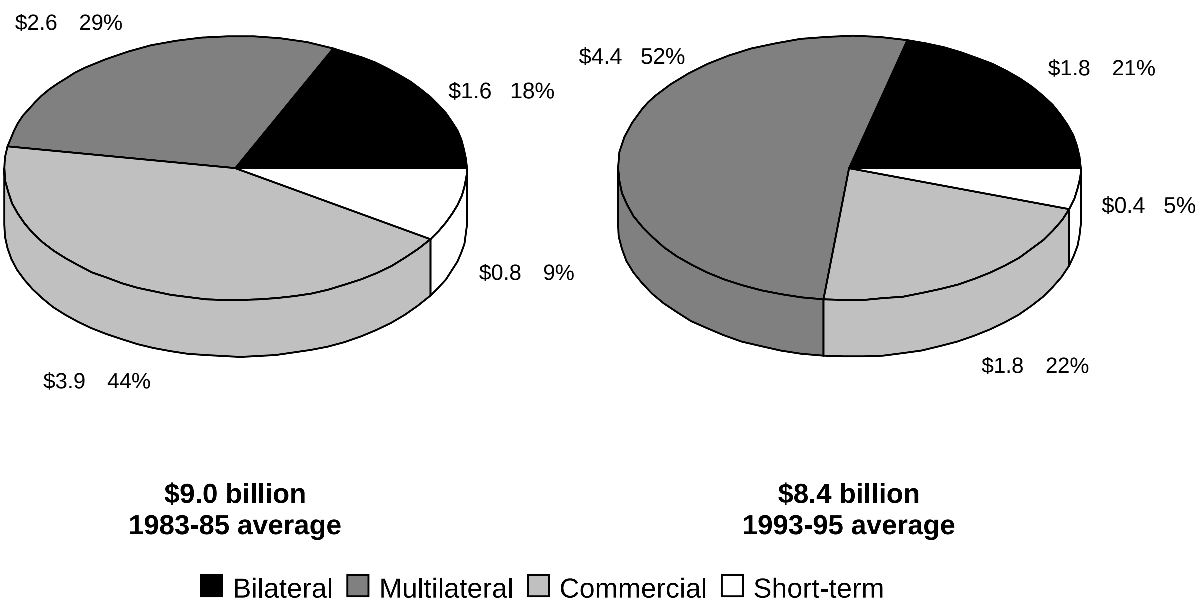


Source: GAO calculations based on World Bank data.

Although total external debt increased substantially between these periods, the amount of medium- and long-term debt owed to private financial institutions (commercial creditors) decreased. Because these countries are seen as high credit risks, they have had limited access to private sector financing. For 1993-95, 73 percent of total external debt was medium- and long-term debt owed to official creditors, with the majority of that amount owed to bilateral creditors. The remaining 27 percent was medium- and long-term debt owed to commercial creditors and short-term debt such as trade financing. Of the total debt, 45 percent was owed to governments (bilateral creditors) and 28 percent was owed to international financial institutions (multilateral creditors). According to the U.S. Treasury, as of August 1998, 31 of the 40 countries had outstanding debt of approximately $6.8 billion to the United States. (See app. II for the amount owed by each country.)

By the mid-1990s, much of the debt owed by the 40 countries was not being paid. According to the World Bank, heavily indebted poor countries made roughly 50 percent of their scheduled debt payments during 1994. We estimated that, during 1993-95, HIPC countries paid about 41 percent of their debt service owed.[4] Although the largest share of the debt during the later period was owed to bilateral creditors, a majority of the debt service paid was to multilateral institutions, due to these institutions' requirement that countries fully service their debt before receiving new lending. Significantly, the share of long- and medium-term debt service paid to multilateral creditors increased from 29 percent to 52 percent of the total, while the share paid to commercial creditors decreased from 44 percent to 22 percent. (See fig. 1.2.)

Figure 1.2: Composition of Debt Service Paid by 40 HIPCs, 1983-85 and 1993-95 Nominal Value, in Billions of 1997 Dollars



Source: GAO calculations based on World Bank data.

[4]If Sudan and Somalia, two of the countries with the largest amount of unpaid debt and that are not part of the HIPC initiative's current cost estimates, are not included, we estimate that the 38 remaining countries paid an average of 43 percent of their debt service owed during 1993-95.

Poor Countries' Debt Burdens Are a Concern

Addressing the debt burdens of very poor countries, in the context of the broad range of development needs they face, constitutes a substantial challenge. Thirty-two of the 40 countries classified by the World Bank and the IMF as heavily indebted poor countries are in sub-Saharan Africa. Eighty-three percent of these countries are classified by the United Nations as being in its lowest category of human development, based on life expectancy, literacy, and per capita national income. Most receive substantial amounts of development assistance from governments, multilateral organizations, and nongovernmental organizations (NGO). We estimated that in 1994 foreign assistance represented about 16 percent of national income, using a weighted average, for 36 of these countries for which data is available. Some of the 40 countries, moreover, have recently emerged from—or continue to be engaged in—conflict or civil unrest.

Although countries may incur external debt as part of their development strategy, development experts, including officials from the World Bank, the United Nations, and NGOs, have cited several reasons why debt burdens of some poor countries are a concern. Some development experts believe that debt levels above a certain threshold amount relative to a country's economic capacity may, in and of themselves, limit economic growth. This has been termed the "debt overhang effect." This effect reflects the view that if a country has substantial debt obligations, the debt will discourage current investment in the debtor country, due to a concern that future income may be highly taxed to pay debt. Other experts question whether debt overhang constitutes a serious obstacle to investment in HIPC countries, in light of additional impediments to investment, such as weak financial institutions and inadequate physical infrastructure, these countries face. Nonetheless, many experts agree that high debt payments constitute a drain on a country's budget, potentially lowering the amount of money available for health and education spending and, for many countries, requiring further loans or grants. For the poorest countries, this can mean an increasing percentage of new aid will go to service existing debt rather than to aid in development. Finally, rescheduling and financing debt payments have been time-consuming for both creditors and debtors. For example, according to Department of State data, potential recipients of HIPC debt relief have concluded about 100 debt negotiations with the Paris Club[5] over the last 10 years.[6]

Prior Debt Relief Efforts Have Not Substantially Reduced Poor Countries' Overall Debt Levels

Debt relief efforts since the 1980s have been undertaken primarily by bilateral and commercial creditors. However, these prior efforts have not resulted in a substantial reduction in the overall debt owed by poor countries. Some efforts aimed at poor countries have actually increased debt levels by, for example, converting interest payment arrears into new debt. Other mechanisms have left the debt of poor countries largely unaffected, notably the Baker and Brady plans[7] of the 1980s. These plans focused on resolving the commercial debt problems of middle-income countries by essentially providing funds for countries to buy back part of their commercial bank debt.

Two instruments have been used to reduce the commercial bank debt of some heavily indebted poor countries. Sixteen countries have received $11.8 billion of debt reduction since 1989, although about one third of this reduction has been for one country, Côte d'Ivoire. These instruments are the Debt Reduction Facility[8] of the International Development Association (IDA), the part of the World Bank that lends to poor countries on highly concessional terms, and, more recently, officially supported debt and debt service reduction programs (Brady operations). According to World Bank data, through the Debt Reduction Facility, 16 countries had retired about $4.2 billion of principal and interest arrears owed to commercial banks, as

[5]The Paris Club is an informal group of creditor countries that meets, as needed, to negotiate debt rescheduling and relief efforts for public or publicly guaranteed loans. In addition to the 18 countries that regularly participate in the Paris Club, other countries are invited to the negotiations on an ad hoc basis if they hold a significant share of the debt being discussed.

[6]Each Paris Club rescheduling requires numerous meetings and work to prepare for the negotiations. Also, after concluding an agreement at the Paris Club, the debtor country must then negotiate a separate agreement with each creditor.

[7]The Baker plan, initiated by then-U.S. Treasury Secretary James A. Baker III and announced at the meeting of the World Bank and the IMF in October 1985, was the first concerted international effort to address the commercial bank debt owed by developing countries. The Baker plan emphasized policy reform and increased finance. It achieved limited success because commercial banks and official lenders were unwilling to supply sufficient new funding. The Brady plan, launched in March 1989 by then-U.S. Treasury Secretary Nicholas F. Brady, was the first comprehensive program that went beyond restructuring of debt to offer reduction of debt. It offered commercial banks a menu of options, including new money and debt buybacks, that would reduce their outstanding loans to developing countries. Creditors, including multilateral institutions, were to lend funds to help finance the buybacks. Since the inception of the plan, nearly one-half of the total commercial bank debt of developing countries, primarily middle-income countries, has been rescheduled.

[8]The Debt Reduction Facility, established in 1989, is financed through (1) contributions from donor countries and (2) earnings from operations of the International Bank for Reconstruction and Development (IBRD), the part of the World Bank that lends to middle-income countries at market rates.

of December 1997. In May 1997, Côte d'Ivoire also received debt reduction through the second mechanism, when Côte d'Ivoire reached an agreement with commercial creditors that resulted in debt reduction of $4.1 billion. The restructuring agreement helped Côte d'Ivoire to clear unpaid interest owed to commercial creditors and ensure that commercial creditors would provide relief at least comparable to that offered by official creditors.

Bilateral creditors have forgiven some debt and renegotiated debt payments by lowering interest rates or extending due dates. Some bilateral creditors have individually forgiven debt owed by poor countries, but these amounts have not been large relative to the total bilateral debt owed. For example, between 1990 and 1997, the United States forgave $2.3 billion, or 37 percent, of the $6.1 billion of debt we estimate was owed by the 40 HIPC countries as of the end of fiscal year 1989. According to an Organization for Economic Cooperation and Development report, since 1989 France has forgiven over $10 billion in official development assistance (ODA) debt owed by countries in sub-Saharan Africa. According to the German government, Germany has forgiven or pledged to forgive about $5 billion in ODA debt owed by poor countries. More often, bilateral creditors have worked together to offer debt relief to poor countries by rescheduling debt payments on concessional terms or reducing debt through the Paris Club. To qualify for Paris Club relief, countries must be in imminent default[9] and reach an agreement with the IMF on a reform program. The Paris Club conditions its debt relief on countries' implementation of economic and structural reforms under IMF-supported lending programs, such as the ESAF.[10] Disbursement of relief is then conditioned on satisfactory implementation of the reform program, generally lasting 3 years.

[9]According to the State Department, "imminent default" is defined as a situation evidenced by the probability that, without debt relief, a country will be unable to meet its scheduled external obligations. A state of imminent default is determined by the Paris Club in close consultation with the IMF and is necessary before the Paris Club will agree to reschedule or reduce a country's debt.

[10]ESAF gives highly concessional loans for balance-of-payments support, that is, to help countries cover their trade deficit or service their debt. Specific ESAF programs of economic adjustment and reform reflect individual country circumstances. According to the IMF, they are intended to raise domestic savings rates; secure macroeconomic stability; liberalize and open economies to foreign trade; reduce government intervention and promote well-functioning markets; reorient government spending and restructure revenues; and mobilize external resources by, in part, reducing debt burdens.

Since 1988, the Paris Club has treated debt[11] owed by poor countries on increasingly concessional terms. In many cases these efforts did not significantly reduce debt but instead mainly focused on helping countries meet debt payments within the short term by altering payment due dates or interest rates, rather than on forgiving debt. Some debtors sought repeated rescheduling. In 1988, the Paris Club became the first group of creditors to offer countries the option of reducing the amount of debt. Under the most recent terms of the Paris Club adopted in 1994, called "Naples terms," countries could receive up to a 67-percent reduction in eligible debt under a stock-of-debt operation.[12] Naples terms broadened the range of eligible debt, elaborated procedures for reducing a country's debt, allowed for a reduction in the amount of debt owed, and were intended to allow the countries to stop rescheduling debt in the future.

Multilateral creditors generally have not rescheduled or reduced debt owed them because of their belief that forgiving or reducing debt would diminish assurances of repayment on new lending. Multilateral development banks were also concerned that forgiving debt would hurt their credit ratings. Instead, multilateral creditors have relied on increased concessional lending and relief from bilateral creditors to enable countries to continue servicing their multilateral debt.[13] Since the 1990s, there has been growing recognition that some poor countries were having increasing difficulty servicing their multilateral debt. For example, during a Paris Club restructuring of Uganda's debt in the mid-1990s, some creditors concluded that debt relief from bilateral creditors would not sufficiently ease the country's debt burden because most of Uganda's debt was owed to multilateral creditors. Moreover, creditors and others were concerned that a greater percentage of new lending was being used to service existing debt rather than for development purposes. These recognitions contributed to the industrialized nations' call for a new approach to

[11]The Paris Club generally limits the debt that is eligible to be rescheduled to nonconcessional debt, such as loans to support exports from the lending country and loans that were incurred before an agreed-upon cutoff date. The Paris Club generally has not reduced concessional debt, such as ODA debt, or recently incurred nonconcessional debt because a majority of countries have already granted extensive reduction of ODA debt. The Paris Club requires members to reschedule any remaining ODA debt.

[12]For the Paris Club, a stock-of-debt operation refers to the total refinancing of the outstanding balance of a country's eligible debt. The stock of eligible debt will be reduced, and the remainder will be rescheduled.

[13]One mechanism to deal with multilateral debt—the Fifth Dimension Program—provided funding from IDA to enable some poor countries to pay interest on debt owed to the IBRD; it was not intended to address debt owed to IDA. In the past 10 years, the program has disbursed more than $1.5 billion to help 20 countries make interest payments on some of their debt owed to the IBRD.

address the debt of heavily indebted poor countries, including that owed to multilateral creditors.

HIPC Initiative Expands on Prior Efforts

The HIPC initiative is the first coordinated effort to include all creditors, most notably the multilaterals, in addressing the debt problems of heavily indebted poor countries. Participating creditors include bilateral governments; the major multilateral creditors such as the World Bank and the IMF; and over 20 other multilateral development institutions, including the African Development Bank, the Inter-American Development Bank, and the International Fund for Agricultural Development. (See app. III.) According to the World Bank, over the past 2 years the Boards of the World Bank and the IMF have met about 30 times each, and about 25 multilateral development banks have been meeting every 6 months under the chairmanship of the World Bank to coordinate the implementation of the HIPC initiative.

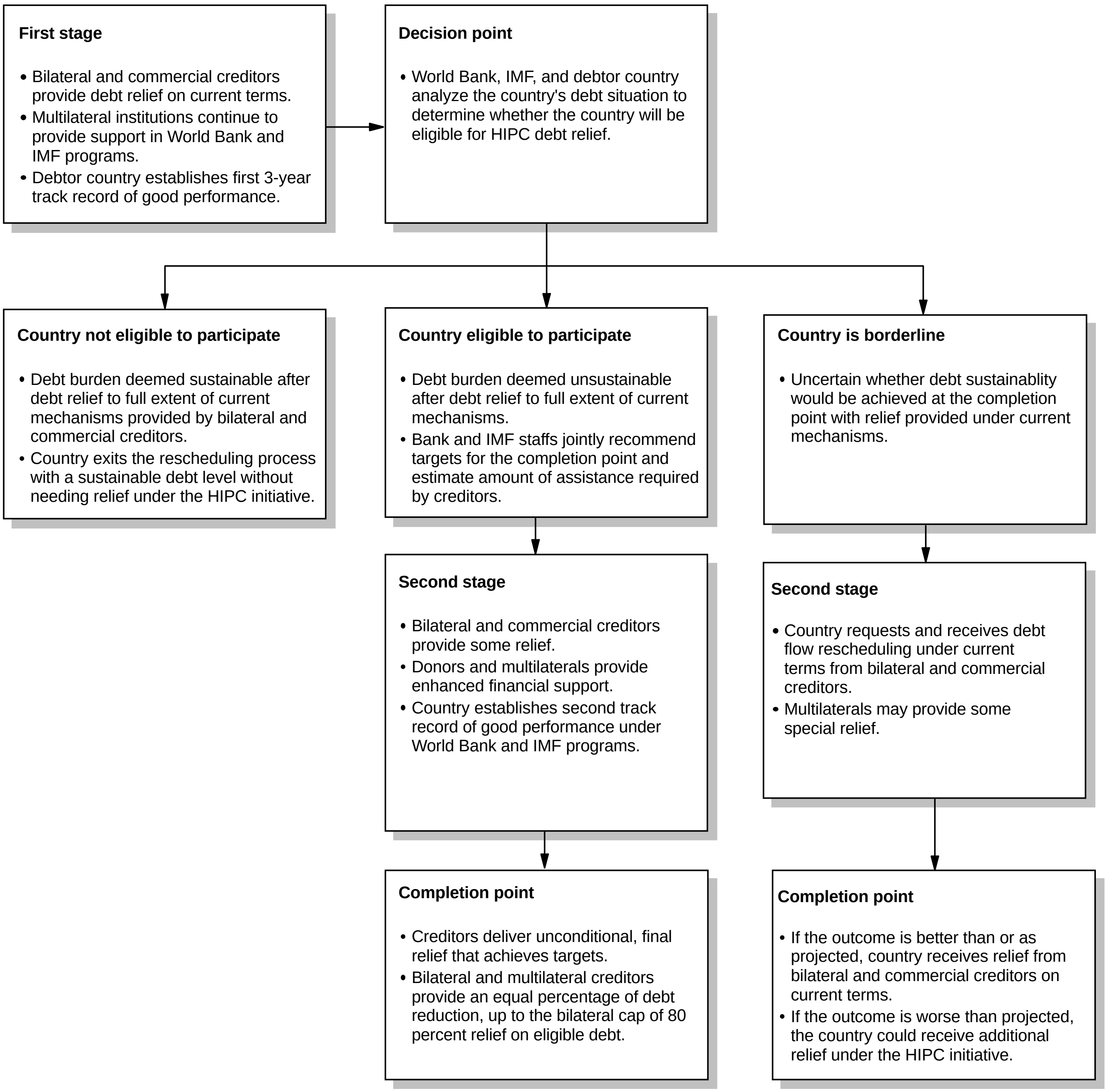
In 1996, the World Bank and the IMF made a preliminary determination regarding which of the 40 countries might eventually receive relief based on the HIPC initiative's specific criteria concerning income, indebtedness, and reform, and identified 20 countries as potential recipients. As of August 1998, the World Bank and the IMF estimated that the creditors would provide debt relief through the initiative to 20 countries, worth about $8.2 billion in 1996 present value[14] terms. Specific eligibility decisions have been made for eight countries, with six countries deemed eligible for relief under the HIPC initiative. One country—Uganda—has completed the process.

The HIPC initiative builds on prior debt relief efforts, most notably those of the Paris Club. The HIPC initiative's goal is to bring countries' debts to levels that are considered sustainable, meaning the countries can make debt payments without incurring loan arrears or requiring debt rescheduling. The basic HIPC framework establishes eligibility criteria based on a country's per capita income, indebtedness, and track record of reform. As shown in figure 1.3, implementation of the initiative involves

[14]The amount of debt can be reported in terms of nominal (face) value and present value, also termed "net present value" in HIPC documents. For the heavily indebted poor countries, the nominal value of the external debt is not a good measure of their debt burdens because a significant part of the debt is contracted on concessional terms. The present value of debt is a measure that takes into account the degree of concessionality. It is defined as the sum of all future debt-service obligations (interest and principal) on existing debt, discounted at the market interest rate. Whenever the interest rate on a loan is lower than the market rate, the resulting present value of debt is lower than its face value, with the difference reflecting the grant portion. According to World Bank data, the present value of external debt at the end of 1995 for 40 HIPC countries was $171 billion compared with a nominal value of external debt of $215 billion.

two stages. Each stage can last 3 years and can be shortened in some cases.

Figure 1.3: Process for Implementing the HIPC Initiative



Sources: World Bank and IMF.

Eligibility for HIPC debt relief is assessed at the end of stage one, following the successful completion of World Bank- and IMF-supported programs. At this point (termed the decision point), the Boards of Executive Directors of the World Bank and the IMF[15] determine whether (1) existing debt relief mechanisms are sufficient to bring a country's debt to a point considered sustainable or (2) the country requires additional debt relief. The determination of whether debt is sustainable is based mainly on a World Bank and IMF assessment of whether the projected ratio of a country's debt (in present value terms) to the value of its exports will be greater than a target value that is set within the range of 200-250 percent.[16] Lowering the target level increases the amount of debt relief required to reach the target. For example, lowering the ratio of a country's debt to its exports from 300 percent to 200 percent requires more debt relief than lowering it from 300 percent to 250 percent. The target level is based on factors affecting the vulnerability of the country's economy, such as the percentage of government revenue required for debt service and whether export earnings are generated by a few commodities. Under certain conditions, for countries with very open economies and strong efforts to generate fiscal revenues, the target may be based on the ratio of debt to government revenue. This fiscal indicator can allow debt-to-export targets below 200 percent.

If the Boards determine that existing debt relief mechanisms are insufficient to make debt levels sustainable and other principal creditors agree, the country enters the second stage of the HIPC initiative. During this stage, the country receives some debt relief from bilateral and commercial creditors and financial support from multilateral institutions. Paris Club creditors have agreed to provide relief up to 80 percent of debt service during the second stage. Multilateral creditors may also provide relief as part of their total commitment under the HIPC initiative during this second stage. The country must agree to continue implementing economic reform programs supported by the IMF and the World Bank and social reforms agreed to with the World Bank. If countries are judged to have met the requirements of these programs, they receive the remaining relief at the end of this stage, called the completion point.

[15]The Board of Executive Directors of the World Bank is responsible for policy decisions affecting the Bank's general operations and for the approval of all loans. Five of the 24 executive directors are appointed by the 5 member governments having the largest number of shares (France, Germany, Japan, the United Kingdom, and the United States). The other executive directors are elected by and represent countries grouped into self-formed constituencies. The IMF's Executive Board is the IMF's primary decisionmaking body, which comprises 24 executive directors who represent IMF member countries.

[16]In this report, discussions of debt-to-export ratios refer to the present value of debt, unless otherwise noted.

Official creditors have agreed to share the costs of HIPC relief by providing equal percentage reductions of debt owed them after the full use of existing debt relief mechanisms, including those offered by the Paris Club. Paris Club creditors have said they will limit relief to up to 80 percent of a country's eligible debt. In exceptional cases, they may negotiate expanded terms. Commercial creditors are expected to provide relief comparable to bilateral creditors. Creditors will each decide how they will provide their share of debt relief to specific countries and which debt will be eligible for relief. Creditors may choose to provide relief through various means, such as rescheduling debt payments at lower interest rates, making debt service payments for countries as they come due, converting loans into grants, reducing debt, and/or lending new funds on concessional terms to be used to make debt service payments. The international financial institutions have said that even under the HIPC initiative they will not forgive debt outright because to do so may endanger their preferred creditor status.[17] Instead, they will use other means. (The HIPC framework is described in more detail in app. IV.)

Establishing a comprehensive framework for debt relief required resolving fundamental differences among creditors. For example, prior to 1995, both the World Bank and the IMF maintained that extraordinary debt relief mechanisms, including debt relief by multilateral creditors, were not necessary except for a handful of countries. Some creditors were concerned about the cost of providing debt relief and about the issue of "moral hazard"—that the prospect of debt relief would discourage countries from undertaking needed reforms and maintaining or strengthening responsible borrowing policies. In June 1995, the leaders of the Group of Seven countries[18] called for the IMF and the World Bank to develop a comprehensive approach to assist heavily indebted poor countries with multilateral debt burdens. Shortly thereafter, a World Bank task force report called for a facility to pay multilateral debt service for a select group of countries. The World Bank and the IMF prepared subsequent analyses, and NGOs worked to influence the terms of the evolving framework.

[17]The preferred creditor status derives from the debtors' traditional practice of servicing debt owed to the World Bank and the IMF before servicing debt owed to other lenders. The articles of agreement (charters) of these institutions do not specifically address preferred creditor status or debt forgiveness.

[18]The Group of Seven consists of seven major industrialized countries that consult on general economic and financial matters. The seven countries are Canada, France, Germany, Italy, Japan, the United Kingdom, and the United States.

Key issues being negotiated during the design process of the HIPC initiative included how unsustainable debt burdens would be determined (with implications for eligibility and relief amounts), the type and length of reforms, whether debt stocks would be reduced, and how creditors would share in providing debt relief. The resulting September 1996 framework reflects creditors' compromise views. However, the use of a range of values of the primary debt sustainability indicator, as well as the announced intention to implement the framework flexibly, left many key decisions to be made during implementation of the initiative. And some aspects of design, most notably how the shares of debt relief would be divided among creditors, had not yet been decided.

The introduction of the HIPC initiative has prompted suggestions for alternative approaches to address the debt burdens of poor countries. Alternatives include fairly straightforward modifications to the HIPC initiative, such as increasing levels of relief, expanding eligibility, and accelerating implementation. Some suggestions call for more fundamental modifications of the HIPC framework and even question the basic structure of the HIPC initiative. Our report does not address the viability of different alternatives or compare them to the HIPC initiative. According to creditors, debtors, and NGOs, negotiating the design of the HIPC initiative has been a very challenging process, and there is a reluctance to significantly modify the HIPC framework.

Objectives, Scope, and Methodology

The Chairman of the Subcommittee on International Economic Policy, Export and Trade Promotion, Senate Committee on Foreign Relations, asked us to review the HIPC initiative. Specifically, we focused our review on (1) the implementation of the HIPC initiative and (2) the initiative's potential to achieve its stated goal. This goal is to reduce select poor countries' debt to sustainable levels; that is, to allow certain poor countries to pay their international debts on time and without further rescheduling.

To describe the implementation of the HIPC initiative, we met with and obtained information from government officials of the United States, HIPC recipient countries, and other creditor countries; and officials from multilateral organizations and NGOs. We met with officials at the Department of State, the U.S. Agency for International Development, the Department of the Treasury, the World Bank, and the IMF. As an agency of the United States, we have no direct authority to review the operations of multilateral institutions. However, we obtained access to World Bank and

IMF officials and information through the staffs of the U.S. members of their Boards of Executive Directors. We also obtained information from and interviewed officials of other creditor organizations, such as the Paris Club secretariat, the African Development Bank, and the Inter-American Development Bank.

To obtain the views of other creditor nations on the implementation of the HIPC initiative, we met with officials from France, Germany, and the United Kingdom, including their representatives to the World Bank and the IMF and officials from their finance ministries, development ministries, and other government organizations. We met with and obtained data on debt and development from representatives of the Organization for Economic Cooperation and Development; and U.N. organizations, including the U.N. Development Program, the U.N. Conference on Trade and Development (UNCTAD), and the U.N. Children's Fund. We also met with and obtained information from academic experts and NGOs, including Oxfam, the European Network on Debt and Development, Debt Relief International, Jubilee 2000, the Center of Concern, the Catholic Fund for Overseas Development, and the Heritage Foundation.

To obtain information from recipient countries about the implementation of the HIPC initiative, we interviewed officials in Burkina Faso, Côte d'Ivoire, and Uganda. We selected recipient countries likely to represent a range of experiences under the HIPC initiative. Within the recipient countries we visited, we discussed concerns about the HIPC initiative with officials of relevant government bodies (for example, the prime minister's office and the ministries of finance, trade, and planning), World Bank and IMF field staff, U.S. embassy and aid officials, local representatives of other donor countries and the European Union, business representatives, and local academics.

To assess the initiative's potential to achieve its stated goal, we met with officials from the U.S. government, other creditor governments, recipient governments, multilateral organizations, and nongovernmental organizations. We examined analytical papers and studies of debt issues from the World Bank and the IMF. Based on information from these studies as well as other sources, we conducted analyses of the HIPC initiative's economic underpinnings and issues that arose during implementation. Within the recipient countries we visited (Burkina Faso, Côte d'Ivoire, and Uganda), we discussed concerns about the HIPC initiative with officials of relevant national and local government bodies (for example, the prime minister's office and the ministries of finance, trade, and agriculture), World Bank and IMF field staff, U.S. embassy and aid officials, local representatives of other donor countries and the European Union, nongovernmental organizations, business representatives, and local academics.

We performed our review from July 1997 to August 1998 in accordance with generally accepted government auditing standards.

Agency Comments and Our Evaluation

The Department of the Treasury and the Department of State commented that the report should provide greater context concerning the extent of prior debt relief efforts, particularly the efforts of bilateral creditors through both the Paris Club process, and unilaterally. We have expanded the report's discussion of the debt relief efforts of bilateral creditors.

Implementation of the HIPC Initiative Reflects Compromise

The implementation of the HIPC initiative has involved significant negotiation among the major creditors on issues such as the eligibility of a country, the amount of relief to be provided, and the way in which relief is to be shared among creditors. As of August 1998, the Boards of the World Bank and the IMF had determined that six countries are eligible for assistance under the HIPC initiative and have agreed upon the amount and timing of relief for these countries. For five of these six countries, the Boards agreed to provide relief at the upper end of what the negotiated framework allows. Bilateral and multilateral creditors have agreed to share the debt relief by providing an equal percentage reduction of the debt owed them (after the full use of existing debt relief mechanisms) and to individually determine how they will provide the relief. The total amount of relief to be provided depends on creditors' decisions as they implement the HIPC initiative, such as the number of countries deemed eligible, as well as debtors' actions to establish the necessary track record of reform. Since implementation began, creditors have made some modifications to the HIPC framework that have expanded eligibility and contributed to increased estimates of relief. The amount of HIPC debt relief could increase further if, for example, countries that were not included in previous estimates become eligible. Conversely, if countries included in the estimates do not undertake required reforms and thus do not receive relief under the HIPC initiative, the amount of relief provided could decrease.

Countries Deemed Eligible for Assistance Under the HIPC Initiative

As of August 1998, the Boards of the World Bank and the IMF had determined that six countries (Bolivia, Burkina Faso, Côte d'Ivoire, Guyana, Mozambique, and Uganda) were eligible for assistance under the HIPC initiative and had agreed upon the amount and timing of debt relief for these countries.[1] (See table 2.1.) One country—Uganda—has completed the process. Projected relief for the six countries represents about $3 billion, or about 36 percent of the total projected HIPC debt relief of $8.2 billion (in 1996 present value terms), as of August 1998.

For two additional countries—Benin and Senegal—the Boards of the World Bank and the IMF determined that debt relief from bilateral creditors on Naples terms would be sufficient to bring their debt to sustainable levels. Thus, they were not deemed eligible for relief through the HIPC initiative.

[1]The Boards have held preliminary discussions on the eligibility of Mali and Guinea-Bissau. According to the World Bank and the IMF, Mali is expected to reach its decision point in September 1998, and Guinea-Bissau will need to be reassessed after the end of the recent conflict.

Table 2.1: Status of First Eight Countries Under the HIPC Initiative

Country	Decision point	Completion point	Debt-to-export target ratio (in percent)
Completion point reached and final assistance provided			
Uganda	Apr. 1997	Apr. 1998	202; actual 196
Decision point reached and assistance committed by World Bank and IMF			
Bolivia	Sept. 1997	Sept. 1998	225
Burkina Faso	Sept. 1997	Apr. 2000	205
Guyana	Dec. 1997	Dec. 1998[a]	107[b]
Côte d'Ivoire	Mar. 1998	Mar. 2001	141[b]
Mozambique	Apr. 1998	mid-1999	200
Debt judged sustainable[c]			
Benin	July 1997		
Senegal	Apr. 1998		
Totals/ranges			
8		1-3 years	107-225

[a]Guyana's completion point is likely to be delayed until early 1999 due, according to an IMF official, to an increased fiscal deficit that delayed Guyana's new ESAF and subsequent review by the IMF Board.

[b]Eligible under fiscal criteria of debt-to-government revenue; present value of debt-to-export target chosen to meet present value of debt-to-revenue target of 280 percent.

[c]Countries whose debt burdens are deemed sustainable will receive a Paris Club stock-of-debt operation on Naples terms but are not eligible for additional assistance under the HIPC initiative. Benin received Naples terms from the Paris Club creditors in October 1996. Senegal received Naples terms from the Paris Club in June 1998. The World Bank and IMF Boards do not consider the Paris Club's operations up to and including Naples terms as part of the assistance provided under the HIPC initiative. As such, the costs for these operations are not included in the total estimated costs of the HIPC initiative. Paris Club relief above Naples terms is included in the HIPC initiative cost estimates.

Sources: World Bank and IMF.

Relief Generally Provided at High End of HIPC Framework Limits

Despite considerable debate on the amount and timing of debt relief to be provided, the World Bank and IMF Boards, in conjunction with principal creditors, have generally implemented the HIPC initiative to provide debt relief at the upper bounds of the negotiated framework. According to HIPC initiative documents, this is in response to the vulnerabilities facing recipient countries. This is specifically evident in lower end debt-to-export targets, which increase the amount of relief provided. In recognition of countries' track records of reforms, the Boards have also generally shortened the second stage of the HIPC initiative, which provides debt relief sooner and can increase relief amounts in some cases. For five of the six countries deemed eligible to date, the expected debt relief amount is at or near the upper levels agreed to under the HIPC framework (Bolivia has a debt-to-export target of 225 percent). Nonetheless, in several cases, the cost of providing debt relief under the HIPC initiative has been a factor in determining the amount of debt relief to be provided.

Lower End of Target Ratios

For five of the six countries for which target debt-to-export levels have been set, the target debt-to-export ratios are near or below the lower end of the 200-250 percent range under the HIPC framework. Two countries have been deemed eligible with debt-to-export ratios substantially below 200 percent (Côte d'Ivoire and Guyana), based on fiscal criteria that compare debt to government revenue rather than exports. The highest debt-to-export ratio set to date is 225 percent for Bolivia.

Some creditor countries have stated that the target should normally be at or near the bottom of the range; others have maintained that the full range should be used. The United States supports a target of 200 percent or lower. According to HIPC documents, for the countries deemed eligible to date, the lower ratios reflect concern about countries' significant economic vulnerabilities, such as dependence on a small number of exports and the resulting potential for volatility in export earnings. World Bank and IMF staff expect country-specific targets to be clustered more toward the bottom half of the 200-250 percent range. In the case of Burkina Faso, some countries argued for a lower ratio because of the uncertainty of the economic projections, particularly of future export prices. Other countries supported a higher range, noting that worker remittances[2] were large in Burkina Faso and provided a cushion against possible risks.

For some countries deemed eligible, such as Bolivia and Uganda, the potential cost of debt relief appears to have influenced their target ratios. In the case of Bolivia, while countries ultimately agreed to a target debt-to-export ratio of 225 percent, several supported a target of 200 percent while others supported a target in, or possibly above, the upper end of the 215-235 percent range. The target agreed to—225 percent—reflects, in part, concern about staying within the Paris Club's limit on the amount of debt the Paris Club will reduce as well as the decision to limit the cost that Bolivia's largest multilateral creditor, the Inter-American Development Bank, might incur in providing HIPC debt relief. The target set for Bolivia also reflects that the country is one of the

[2]"Worker remittances" refer to wages earned in another country and sent back to the home country.

least vulnerable of the potential HIPC recipients. The target debt-to-export ratio of 202 percent set for Uganda reflects, in part, the decision to stay within the Paris Club's limit and within the terms of the burden-sharing arrangement multilateral and bilateral creditors had agreed to.

Shortened Second Stage

As previously mentioned, implementation of the HIPC initiative involves two stages, each of which generally lasts 3 years. The Boards have shortened the length of the second stage for five of the six countries for which completion dates have been set (Bolivia, Burkina Faso, Guyana, Mozambique, and Uganda); four of these countries (Bolivia, Guyana, Mozambique, and Uganda) were given about a 1-year period. The actual length of the second stage could be longer if, for example, countries do not satisfactorily complete the required reforms. Countries' views have differed significantly regarding the appropriate length of the track record of reform required for gaining HIPC debt relief. Some countries—such as the United States and Germany—have generally stressed that a longer time frame is important for ensuring a country's commitment to critical reforms but have agreed to shortened second stages in some cases. Others, such as the United Kingdom, have stated that an overall reform period of 6 years is generally too long; they have supported efforts to give some recipients credit for their track records by reducing the length of the second stage. According to HIPC documents, the five countries with shortened periods are among the strongest performers of the potential HIPC debt relief recipients, and the shortened period reflects these countries' past track records of good policy performance, including completion of successive ESAF and World Bank programs, and receipt of Naples terms from the Paris Club. Nonetheless, members of the Boards have debated the length of the second stage for these countries. There was considerable discussion about whether Uganda should have a second stage at all. According to HIPC documents, the remaining countries will likely require a 3-year period between the two stages—the decision point and the completion point.

A shorter period between the decision point and the completion point means that countries will receive final HIPC debt relief sooner and may get more relief under certain conditions. In the case of Guyana, the decision to set the completion point in 1998 rather than the year 2000 (which would have been 3 years between the two stages) resulted in a projected increase in HIPC assistance of about 68 percent, or $103 million in present value terms.

Determining Creditors’ Shares of Relief Amounts Has Involved Extensive Negotiation

Significant negotiations have occurred on the question of how creditors will share the amount of debt relief to be provided through the HIPC initiative. When the HIPC initiative was announced in September 1996, creditors had not agreed on their shares of HIPC assistance, but Paris Club creditors had agreed to reduce up to 80 percent of the remaining eligible debt. The World Bank and the IMF had proposed an approach under which bilateral creditors would give debt relief up to 90 percent of eligible debt to a country first, with multilateral creditors providing the remainder required for the country to reach debt sustainability. Multilateral creditors sought to limit the type and amount of debt reduction they would provide because they were concerned that it would endanger their financial integrity and preferred creditor status.

Bilateral creditors rejected the approach proposed by the multilaterals. The Paris Club creditors committed to provide relief up to 80 percent of the eligible debt countries owed them, and stated that, in exceptional cases, they may negotiate terms that expand the amount of relief they are to provide. They stated that multilateral creditors should contribute simultaneously with the bilateral creditors and provide a greater share of the total HIPC relief because (1) bilateral creditors had already provided debt relief and (2) servicing multilateral debt was a key part of poor countries’ debt burdens. Furthermore, according to a U.S. government official’s summary of the Paris Club’s position, the preferred creditor status is essentially a political judgment; it does not imply that the multilateral creditors should not provide debt relief. Nonetheless, one of the tenets of the HIPC initiative is to ensure the preferred creditor status of multilateral creditors.

After much negotiation, in July 1997 creditors endorsed a broad burden-sharing arrangement, termed the “proportional approach,” under which bilateral and multilateral creditors would provide debt relief together and provide equal percentage reductions of debt owed them after the full application of existing debt relief mechanisms, including Naples terms. Using the proportional burden-sharing approach, World Bank and IMF staff determine how much debt relief the bilateral and multilateral creditors, as a group, are to provide a particular country. Within the Paris Club, bilateral creditors determine how much of this amount they will individually provide. The World Bank and the IMF determine the share of the debt relief each multilateral creditor is to provide, based on the share of debt owed to them by the recipient.

Applying the proportional burden-sharing approach continues to involve negotiation among the creditors when they determine the specific relief amount for each recipient. Although creditors agreed to provide the same percentage of debt reduction, the dollar amounts of this relief will vary by creditor because creditors are owed different amounts of debt. For example, in the case of Burkina Faso, bilateral and multilateral creditors agreed to provide debt relief valued at about 14 percent of what they are owed. For bilateral creditors, this amounted to about $21 million in debt relief. For multilateral creditors, the same percentage reduction amounted to about $94 million.

In some cases, poor countries' debt levels are so high that the burden-sharing terms agreed to under the HIPC framework will not provide enough relief to reach the target debt-to-export ratio. This was, for example, the case for Mozambique. To reach the 200-percent target debt-to-export ratio, under the terms of the HIPC initiative burden-sharing approach, bilateral creditors were to provide $916 million in debt relief to Mozambique. To provide this relief, bilateral creditors would have to exceed the cap they had agreed to—that they would provide relief equivalent to up to 80 percent of eligible debt. The 80-percent reduction of debt would have provided only $553 million in debt relief. To address the $363 million shortfall, bilateral creditors agreed to provide exceptional amounts of relief beyond those terms, which has been termed "deep relief." However, even after Paris Club creditors agreed to extend their terms and provide relief equivalent to 86 percent of eligible debt, a financing gap of $116 million remained. Individual bilateral creditors and donors as well as the World Bank and the IMF subsequently agreed to use various mechanisms, such as increasing the amount of debt relief or contributing funds, to finance the remaining gap. The agreement for Mozambique entailed significant negotiations among creditors because of the amount of relief needed to bring the debt-to-export ratio to the target level of 200 percent—Mozambique alone represents approximately half of the debt relief promised thus far.

Creditors Provide Debt Relief in Different Ways

Creditors each determine how they will provide their share of the relief. Creditors may choose to provide relief through several means, such as rescheduling debt payments at lower interest rates, buying back the debt, making debt service payments as they come due, converting loans into grants, reducing the debt, and/or lending new funds on concessional terms to make debt service payments. A creditor's decision about how it will provide debt relief to a particular recipient may be influenced by many factors, such as the amount of outstanding debt, the impact of providing debt relief on the creditor's future budgets, the financial policies governing the creditor institution, and the needs of the recipient country.

Multilateral creditors have said that they will not forgive debt outright; rather, they intend to provide debt relief in ways that maintain their preferred creditor status. According to the World Bank and the IMF, most of the multilateral development banks have obtained the institutional approval to participate in the HIPC initiative and defined the means they will use to provide relief, such as buying back debt or paying debt service through the HIPC Trust Fund or similar self-administered trust funds, rescheduling current payments or arrears on concessional terms, and refinancing on grant terms. The World Bank's participation in the HIPC initiative is to be funded solely from the Bank's own resources. Debt relief provided by the World Bank under the HIPC initiative is taking place primarily through contributions to the HIPC Trust Fund from IBRD income. The Trust Fund provides relief on debt owed to IDA, either through buying back some of its concessional debt or providing an unconditional commitment to pay debt service owed to IDA as it becomes due. Some of this relief may be advanced during the second stage when the World Bank could provide part of its lending program in the form of IDA grants instead of IDA credits, which are funded through general IDA resources.[3] The IBRD has contributed about $750 million from its income to the HIPC Trust Fund to buy back or repay debt owed to IDA. The executive directors have recommended the approval of another transfer of $100 million from IBRD income to the Trust Fund. The HIPC Trust Fund has been specifically set up to keep the IDA and IBRD aspects of the World Bank's operation at arm's length.[4]

[3]Most HIPC recipients are projected to continue receiving high levels of assistance from IDA. Thus, the present value of these countries' debt to IDA will continue to rise during and after participation in the HIPC initiative. To mitigate the rise in the present value of debt to IDA during the period between the decision and the completion points, the World Bank will provide a portion of normal credits as grants on a selective basis. By providing grants in place of normal IDA credits, the present value of debt owed to IDA is reduced. Because IDA credits have roughly a 70-percent grant element, replacing those credits with grants reduces the present value of the country's future debt service by an amount equal to about 30 percent of the grant. This reduction in present value also would count as part of the World Bank's contribution toward HIPC relief, provided that the grants are fully disbursed prior to the completion point. Therefore, where IDA operations in qualifying countries have a financing package consisting of a grant portion and a credit portion, the grant portion would be disbursed first. The portion of IDA assistance represented by grants would vary based on the countries' projected debt-to-export ratios—higher ratios mean higher proportions of grants.

[4]While IDA does not incur a cost for providing HIPC debt relief since it is still getting fully repaid by the HIPC Trust Fund and borrowers, the level of IBRD resources available for alternative uses may be affected. These resources may not, for example, be available for lowering the interest rates charged to middle-income borrowers. The IBRD also transfers resources to IDA separate from the HIPC Trust Fund. Between fiscal years 1995 and 1998, these transfers averaged $380 million annually.

The HIPC Trust Fund also receives contributions from other participating multilateral development banks and bilateral creditors that are to be used primarily to help other multilateral development banks, such as the African Development Bank, to finance their share of HIPC debt relief.[5] The multilateral development banks have stressed that the means used to provide debt relief through the Trust Fund should accommodate constraints specific to these institutions, such as policies against debt restructuring or forgiveness. As of August 10, 1998, 16 governments had made pledges or contributions to the HIPC Trust Fund totaling about $204 million. Also, nine countries proposed additional contributions totaling $92 million to relieve multilateral debt through reallocation of their excess resources in the World Bank's Interest Subsidy Fund, which was set up in 1975 with donor contributions to subsidize the interest rates on IBRD loans to the poorest IBRD borrowers. (See app. IV for a list of contributors to the HIPC Trust Fund.)

The IMF is participating in the HIPC initiative through special ESAF grants at the completion point that are deposited into an escrow account to meet debt service payments owed to the IMF under a predetermined schedule. The IMF is funding its contribution through its own trust fund financed from bilateral (member) contributions and the ESAF reserve account. To finance these grants, several countries have contributed or made investments for the benefit of the ESAF-HIPC Trust totaling approximately $46.5 million, as of June 1998. In May 1998, the IMF transferred about $54.5 million to the ESAF-HIPC Trust for fiscal year 1998 and expects to make a similar payment on a quarterly basis to the ESAF-HIPC Trust for fiscal year 1999. The IMF Board has authorized the transfer of up to an additional $332.5 million from the ESAF Trust Reserve Account to meet the IMF's commitments under the HIPC initiative.

Although all creditors will forgo future revenue to provide debt relief, bilateral creditors use different methods to budget for the cost of debt relief. Some creditors, including the United States, adjust for the probability of debtor countries not fully repaying their debt in the budgeting process. The United States has a complex methodology of estimating the market value of outstanding debt owed to it. For U.S. budgetary purposes, the cost of debt relief reflects the difference between the estimated market value of the loan before reduction compared to the value afterwards. Other creditors value the loan at face value at the time of

[5]Since donors' contributions to the HIPC Trust Fund will finance some of the relief provided on debt owed to the African Development Bank, the actual cost to the African Development Bank of providing HIPC debt relief is lower than the amount of relief granted to HIPC recipients on the debt they owe to the African Development Bank.

initial approval. Thus, providing debt relief means they must budget for the face value of the debt when the debt is relieved.

Estimated Amount of Relief Depends on Decisions Made by Creditors and Debtors

Estimates of the amount of relief to be given to countries under the HIPC initiative will continue to be influenced by decisions creditors make as the HIPC initiative is implemented as well as actions taken by debtor countries to establish the necessary track records of reform. The $8.2 billion estimate (in 1996 present value terms) depends on decisions, such as how many recipient countries participate in the HIPC initiative, what debt-to-export targets are established, what amount of time participants have to establish their qualifications for HIPC debt relief, and countries' economic conditions. Therefore, the actual amount of relief to be provided under the HIPC initiative may be higher or lower than estimated. For example, the actual relief provided could be lower if fewer countries participate than anticipated or if target debt-to-export ratios are set higher than the 200 percent assumed in the projections. On the other hand, slower than projected growth in a country's exports could substantially increase the amount of relief provided by the HIPC initiative. World Bank and IMF staff estimated that weaker export growth (2 percentage points lower annually for each country from 1995 onward) could increase the amount of relief provided under the HIPC initiative by about $1 billion in 1996 present value terms.

The amount of relief provided also could increase if more countries become eligible. For example, since implementation of the HIPC initiative began, the Boards have agreed to modifications to the HIPC framework that have increased the number of countries eligible to receive relief and may raise the amount of relief for other countries. The changes contributed to increases in the projected amount of relief from $5.6 billion in June 1996 to $8.2 billion in August 1998 in 1996 present value terms.[6] According to HIPC documents, these changes reflect the desire of some countries to make the plan more inclusive, concerns about the quality of available data on worker remittances, and updated information. A World Bank official said modifications to the HIPC framework respond directly to concerns of debtor countries and help to mitigate the countries' vulnerabilities. Some

[6]These estimates include only debt relief that is additional as a result of the HIPC initiative. They do not include the bilateral debt relief provided to debtor countries as a result of Paris Club reduction on Naples, or previous, terms and comparable reductions by other creditors. In addition, these estimates do not include relief provided by all commercial creditors. Although commercial creditors are expected to provide relief under the HIPC initiative, for the countries deemed eligible to date, only two have had significant commercial debt (Côte d'Ivoire and Uganda). The commercial debt relief of these two countries was provided prior to their HIPC decision points and thus is not considered HIPC assistance or included in the estimate of HIPC relief provided.

countries have expressed concern about increased costs and cautioned that eligibility decisions should not be made before the financial implications of the agreed-to modifications are assessed. For example, expanding the eligibility criteria to specifically take into account government spending (fiscal criteria) allowed countries such as Côte d'Ivoire and Guyana to become eligible for the HIPC initiative and raised projected HIPC relief by about $600 million in present value terms. Advocates for the expansion of the eligibility criteria were concerned that certain countries with very open economies, and thus relatively low debt-to-export ratios, were improperly characterized as having a sustainable debt burden under the HIPC initiative. According to a World Bank official, the fiscal criteria reflect the Boards' desire to maintain the original framework while allowing some flexibility in addressing the debt problems of very open economies. Moreover, the fiscal criteria may increase further the number of countries eligible for assistance. Additionally, changes to country-specific analyses and an increase in the potential assistance offered by the HIPC initiative for post-conflict countries, particularly the Democratic Republic of Congo (formerly Zaire), contributed about $1 billion to increased estimates of HIPC debt relief. According to HIPC documents, the increase for the Democratic Republic of Congo is based primarily on new projections that include slower growth in the volume of mineral exports and lower world prices as well as increased debt due to a buildup of late interest and arrears. The World Bank and the IMF caution that any estimates for post-conflict countries are subject to significant change.

Changes made in 1997 in the way the amount of exports is calculated also have increased the projected amount of HIPC relief. The first change involved agreement that exports would be calculated using an average of 3 years of data, rather than 1 year as assumed in the first cost estimates of the HIPC framework. According to HIPC documents, this change was a compromise between the desire to obtain a recent actual measure for a country's export capacity and the desire to smooth out export fluctuations by providing a longer-term base. While this change in methodology may seem like a small refinement, it increased the total estimated amount of HIPC debt relief by about $1 billion, according to HIPC documents.

A second change involved the evaluation of worker remittances. These were originally intended to be added to exports but are no longer included due to limited data quality and availability.[7] When worker remittances are

[7]When worker remittances make a significant contribution to a country's debt-servicing capacity they will be considered in vulnerability analyses.

not included, the estimated amount of export earnings available for servicing the debt is lowered. Thus, the exclusion of worker remittances increases a country's debt-to-export ratio. The resulting higher ratio allowed at least one country—Burkina Faso—to become eligible and increased projected relief by about $130 million, according to the World Bank and the IMF.

The amount of HIPC debt relief provided will also be influenced by the actions taken by debtor countries to establish the necessary track record of reform. If countries included in the estimates do not undertake required reforms and thus do not receive HIPC relief, the amount of relief could decrease. On the other hand, the total projected amount of debt relief could increase if countries that were not included in the estimates—such as Liberia, Somalia, and Sudan—establish the necessary track records of reform and become eligible for relief through the HIPC initiative. At the end of 1996, in present value terms, Sudan had $15.6 billion of outstanding debt—one of the highest debt levels among potential HIPC recipients. According to preliminary estimates from the World Bank and the IMF, if Sudan qualifies for HIPC debt relief, reducing its debt-to-export ratio to 200 percent would require about $4.5 billion in HIPC debt relief. Providing debt relief to Sudan through the HIPC initiative could, thus, significantly increase the cost of the initiative relative to current estimates. Undertaking the steps necessary to qualify some countries—such as Liberia, Somalia, and Sudan—for the HIPC initiative will involve significant efforts and resources because they have not established the necessary 3-year track record of reform. Further, some of these countries have significant unpaid debt, including debt owed to official creditors. For example, clearing unpaid debt for Sudan, which had arrears of about $6 billion as of year-end 1996, will involve significant financial resources. The IMF reported that Sudan made scheduled payments to the IMF in 1997 and has begun to reduce its arrears to the IMF but has increased its unpaid debt owed to other external creditors.

Conclusion

In agreeing to the HIPC initiative, the IMF and the World Bank Boards established a broad framework for debt relief but left many of the specifics regarding the extent of that relief and how it would be carried out still to be determined. Different creditor country perspectives on matters ranging from burden sharing to required reform track records have required extensive negotiation during the implementation phase. For the first six countries to qualify for relief, the Boards have decided on relief amounts at the upper end of the framework as agreed to, and with shortened reform periods for five countries. The extent to which those decisions establish a precedent for future relief remains to be seen, especially with respect to reform periods, since the early qualifiers have relatively strong reform records. The costs of debt relief have influenced design and implementation decisions. The amount of relief that will be provided through the HIPC initiative is not yet known and is dependent on eligibility, timing, and relief amount decisions still to be made.

Agency Comments and Our Evaluation

The World Bank commented that substantial effort was put forth by creditors in the design and implementation of the HIPC initiative and that an expanded discussion of how the initiative is being financed would be useful. We agree and have expanded our discussion of these issues, including how the HIPC Trust Fund is being financed, and included a listing of the multilateral institutions providing relief through the HIPC initiative (see app. III).

The HIPC Initiative Will Help Countries, but Many Will Remain Vulnerable to Future Debt Problems

The HIPC initiative will provide benefits to recipient countries; however, many will remain vulnerable to future debt problems, even with sound economic policies. In conjunction with existing debt relief mechanisms, such as relief from Paris Club creditors, the HIPC initiative will reduce countries' debts by varying amounts, some substantially. Reductions in the amount of recipient country resources that are used for debt service will also vary and are difficult to determine due to prior arrears and the use of donor resources in some cases to help make debt payments. The limited evidence for the particular debt targets in the HIPC initiative suggests that reducing debt-to-export ratios to near 200 percent is not likely to provide countries with a "cushion" to protect against adverse economic events. Strong export growth and substantial donor assistance are important to the HIPC initiative's projections of sustainable debt burdens. For some countries, those export growth projections may turn out to be overly optimistic. If export earnings are lower than expected, financial support from bilateral and multilateral donors is assumed to increase. This assumption has been questioned given the budgetary pressures of major donor countries. The HIPC initiative has also focused attention on the limited capacity of some countries to manage their debt. Improvements in debt management are considered necessary for them to avoid future debt problems.

Debt Relief From the HIPC Initiative Varies; Reduction in Debt Service Paid Difficult to Determine

The HIPC initiative will reduce the total amount of debt owed, in present value terms, by varying amounts for the first six recipient countries. This is because their initial debt and export levels vary widely. The present value of debt relief for these countries due to the HIPC initiative ranges from a low of 6 percent of debt for Côte d'Ivoire to a high of 57 percent for Mozambique, with the average reduction 22 percent for the first six participants.[1] (See table 3.1.)

[1]Characterizing the percent reduction of the value of the debt owed under the HIPC initiative is complicated by the use of the concept of present value and the different means through which creditors provide debt relief. For example, nominal debt relief as presented in table 3.1 is calculated as the reduction in future nominal debt service.

Table 3.1: Measures of Proposed HIPC Initiative Debt Relief for First Six Countries

Country	Debt-to-export target ratio (percent)	Debt relief (present value, in millions)	Debt relief (nominal, in millions)	Percent reduction in present value of debt	Average percent reduction in debt service over first 4 years
Bolivia	225	$448	$600	13	13.5
Burkina Faso	205	115	200	14	10.5
Côte d'Ivoire	141	345	800	6	3.2
Guyana	107	253	500	25	26.9
Mozambique	200	1,442	2,900	57	42.1
Uganda	202 (actual 196)	347	650	19	24.7

Sources: HIPC documents and our analysis.

Our analysis indicates that the amount of projected reduction in countries' debt burdens since 1995 attributable to the HIPC initiative relief—as measured by the debt-to-export ratio—and the amount attributable to other factors vary greatly across the first six HIPC qualifiers.[2] For example, we estimated that, for Uganda, 77 percent of the reduction in this ratio between 1995 and April 1998 (Uganda's completion point under the HIPC initiative) is due to export growth, with 18 percent attributable to the HIPC initiative debt relief and 5 percent attributable to a combination of other debt relief and net borrowing.[3] In contrast, for Côte d'Ivoire, 58 percent of the reduction can be attributed to other debt relief and net borrowing combined, 39 percent to export growth, and 3 percent to the HIPC initiative.[4] (See app. V for information on the determinants of debt reduction for the first six countries.)

The HIPC initiative is expected to reduce debt service obligations by varying amounts for the countries for which preliminary projections are available, although the reduction in how much countries will actually pay to service their debt is difficult to determine. Table 3.1 shows estimated reductions in debt service owed by HIPC recipients, based on HIPC

[2]This analysis is sensitive to the initial year chosen. 1995 is chosen as the base year for this analysis in order to capture the effects of Naples terms on countries' debt burdens.

[3]Data available from HIPC documents does not allow us to separate out changes in debt-to-export ratios due to debt relief under prior mechanisms, such as Naples terms, from changes due to net borrowing (new borrowing net of payment of principal on existing debt).

[4]In the case of Côte d'Ivoire, the 6 percent reduction in debt due to HIPC relief represents a reduction in the present value of debt, whereas the 3 percent represents the HIPC initiative's share of the total reduction over the period indicated in the debt-to-export ratio.

documents and our analysis.[5] The effective reduction from the HIPC initiative on the debt service actually paid by participants is hard to gauge for several reasons. First, some countries experienced substantial arrears in servicing their debt prior to receiving debt relief. The IMF has estimated how Mozambique's debt service payments will be affected by debt relief.[6] The scheduled annual debt service payments are expected to be dramatically reduced by the combination of the HIPC initiative and existing Paris Club (Naples terms) debt relief. The HIPC initiative itself will reduce scheduled debt service payments in 2000-03 by 42 percent (from $170.5 million to $98.7 million per year) from the obligations remaining after the Paris Club relief. (See table 3.2.)

Table 3.2: Annual Average Debt Service Payments for Mozambique, 1995-2003

Dollars in millions

2000-03 (scheduled debt service)			1995-98	
Without debt relief	After Paris Club (Naples terms) relief	After Paris Club (Naples terms) and HIPC relief	Scheduled debt service	Actual debt service
$486	$170.5	$98.7	$375.3	$113.2

Source: IMF data.

However, Mozambique was paying only about 30 percent of its scheduled annual debt service in 1995-98 ($113.2 million of $375.3 million). Thus, the projection is that the scheduled debt service payment of $98.7 million in 2000-03 will only be about 13 percent less than the annual debt service of $113.2 million Mozambique was actually paying in 1995-98, prior to relief.

A second complexity in assessing the effect of debt relief on a country's finances is that a substantial portion of the debt service paid by these countries is financed through donor and creditor resources. Thus, it is very difficult to determine how a reduction in debt service owed—or even debt service paid—by HIPC recipients will affect the net flow of resources to a recipient country, and we were generally unable to make that determination. This is most clearly evident in Uganda's recent experience.

[5]HIPC documents provide projections for average annual debt service reductions due to HIPC initiative relief for Guyana, Mozambique, and Uganda. For Bolivia, we assumed that HIPC debt relief will be provided to both smooth out and reduce the debt service-to-export ratio to 20 percent, as indicated in HIPC documents. For the two remaining countries (Burkina Faso and Côte d'Ivoire), we estimated this value, assuming relief under the HIPC initiative is spread evenly over 20 years. The reductions in annual debt service are generally similar to the estimated reductions in the present value of debt.

[6]In response to criticism that HIPC initiative debt relief would not actually reduce the amount of debt service Mozambique was paying, the IMF publicly issued the information used in our report.

In 1995, Uganda established a Multilateral Debt Facility through which bilateral donors, primarily Denmark, the Netherlands, Norway, and Sweden, channeled resources directly to pay Uganda's multilateral debt service. Payments to this facility averaged $45 million per year in 1996 and 1997. In contrast, HIPC initiative debt relief is reducing Uganda's annual debt service burden by an average of around $30 million per year. (Because the relief is being "front loaded" at Uganda's request,[7] debt service in the first 5 years will be reduced by about $39 million annually and by about $20 million annually in subsequent years.) According to Ugandan officials, they would need to continue to receive $15 million per year in assistance from these bilateral donors, in addition to other aid flows that were being received, to be in as strong a position after the HIPC initiative relief as before. This assumes that the Facility would continue to be funded at the same level. Ugandan officials told us that they hoped some of the future assistance would be channeled into social sector aid, such as education, although an IMF official noted that these funds were approved by donor governments for debt relief and shifting them into other types of aid may not be straightforward.

HIPC Recipients Will Need Strong Economic Performance and Continued Economic Assistance

Countries receiving debt relief through the HIPC initiative will need to maintain strong economic performance and, in most cases, continue to receive large amounts of donor assistance in order to service their debt. The limited analytical evidence that exists for the debt targets used in the HIPC initiative suggests that countries with debt-to-export ratios near the bottom of the 200-250 percent range may still have unsustainable debt burdens. The HIPC initiative's projections assume that, after completing the HIPC initiative, countries will maintain sustainable debt levels in part through strong export growth. In addition, for most countries, substantial donor assistance is expected to continue, including balance-of-payments support. Finally, the HIPC initiative analysis assumes that, if adverse economic events do occur, such as a significant decrease in the price of a key commodity, the countries' needs for financing will be met with increased donor assistance.

Limited Analytical Basis for Debt Reduction Targets

There is no strong analytical evidence supporting the decision concerning the HIPC initiative's target range of the debt-to-export ratio. The World Bank and the IMF have provided limited support for the conclusion that debt at the 200-percent debt-to-export ratio was sustainable, and no

[7]"Frontloading" debt relief means that countries use more of their debt relief to service their debt in the short term rather than to buy back their debt in later years. Countries request frontloading if, for example, they have large debt payments due in the short term.

analysis to support ratios in the upper end of the target range (250 percent). World Bank reports have suggested that debt-to-export ratios above 200 percent indicate potential debt problems in poor countries, and a 1996 World Bank document noted that a debt-to-export threshold of 200 percent indicates that at this level a country is likely to have difficulty servicing its debt.

World Bank and IMF officials cite two internal World Bank studies as support for their stated debt-to-export ratios.[8] We believe these studies have limited relevance for determining the HIPC initiative's target ratios for two reasons. First, their analysis was based primarily on middle-income countries and, second, they examined debt levels at which countries began to experience debt servicing problems, not when they might emerge from such problems. One study, done in 1990, analyzed 1980-87 data on 111 countries to determine at what level of debt relative to exports countries began to experience problems servicing their debt. The study found that countries that did not experience debt servicing problems generally had debt-to-export ratios below 200 percent. However, 30 percent of the countries that did experience debt service problems had debt-to-export ratios below 200 percent throughout the period. The second study, dated in 1996, examined approaches for predicting when countries would have problems with debt service. It concluded, based on examining Mexico's ability to service debt at the height of its 1984-89 debt crisis, that a debt-to-export ratio above 198 percent could yield debt servicing problems.

Debt-to-export ratios at or slightly above 200 percent are in the upper part of the range the World Bank uses to classify countries as moderately indebted.[9] Our analysis shows that a number of countries classified as moderately indebted have subsequently experienced debt servicing problems. Of the 11 countries classified by the World Bank in 1991 as

[8]John Underwood, "The Sustainability of International Debt," Draft (Washington, D.C.: World Bank, Mar. 1990). This study used a present value measure of debt levels, using broad assumptions about the degree of concessionality of the outstanding amount of nominal (face value) debt. Also, Daniel Cohen, "The Sustainability of African Debt," Policy Research Working Paper 1621 (Washington, D.C.: World Bank, Aug. 1996). The analysis used a debt-to-gross domestic product (GDP) measure, which was then converted to a debt-to-export ratio. A description of the two studies is publicly available in Stijn Claessens et al., "Analytical Aspects of the Debt Problems of Heavily Indebted Poor Countries," in Z. Aqbal and R. Kanbur, External Finance for Low-Income Countries (Washington, D.C.: IMF, 1997).

[9]The World Bank currently uses the ratio of the present value of debt to exports, along with the ratio of the present value of debt to gross national product, in classifying countries as severely, moderately, or less indebted. In 1991, the World Bank used nominal, not present value, debt-to-export ratios in making these classifications, along with three other indicators. The range of debt-to-export ratios used for moderately indebted countries was 165-275 percent, which the Bank has indicated is equivalent to a present value of debt to exports of 132-220 percent, under its assumptions about average concessionality of debt.

moderately indebted low-income countries, four (Benin, Central African Republic, Mali, and Togo) have subsequently had their debt rescheduled through the Paris Club.

In addition to the concerns over the particular levels of the debt sustainability indicators under the HIPC initiative, there is a concern that the indicators are narrow. A particular concern is that the focus on export-based indicators does not directly consider the overall economic capacity of a country or the particular level of demand for government expenditures. For example, critics have argued that the export-based indicators do not reflect the extent to which governments' social spending needs vary across potential recipient countries. A related concern is that since export revenues generally accrue to the private sector, they are not necessarily indicative of resources available to these governments. A recent study commissioned by the IMF to evaluate its ESAF programs cited the above concerns in suggesting that, in general, a more appropriate measure of a country's debt burden would be the ratio of debt to its overall national income.

The addition of fiscal, or government spending, criteria for determining debt sustainability has done little to satisfy critics. To qualify for debt relief under the HIPC initiative's fiscal criteria requires that three conditions be met: a country's present value of debt-to-government revenue ratio must exceed 280 percent, a country's exports-to-GDP ratio must exceed 40 percent, and a country's government revenues-to-GDP ratio must exceed 20 percent. These conditions are likely to be met by just a few countries. The World Bank and the IMF have not provided any economic justification for these particular levels. They have stated that the 280 percent debt-to-government revenue ratio is somewhat arbitrary. The HIPC initiative documents note that if this ratio were set much lower than 280 percent, the overall cost of the HIPC initiative would rise substantially.

Some debt experts have questioned the statement in HIPC documents that the HIPC initiative debt relief will reduce countries' debts to a point that will significantly diminish any debt overhang effect. Whether debt overhang constitutes a serious obstacle to investment in HIPC countries has been debated during the HIPC initiative's implementation, with some officials and analysts doubting its significance and others continuing to cite reduction of debt overhang as a primary benefit of the HIPC initiative. Several analysts maintain that high debt levels do deter investment in HIPC countries but some also question whether the levels of debt reduction under the initiative will significantly reduce that effect. Some experts have observed that the way debt burdens are measured under the HIPC initiative—in present value terms—may not correspond to investors' perceptions about how high a country's debt burden is. Although present value is a useful way of comparing different debt burdens when the degree of concessionality of the debt varies widely, investors are more likely to look at debt in nominal terms, according to one debt expert. He noted that, beyond the creditors, the concept of present value is not widely understood. Since the present value of concessional debt is generally lower than its nominal value, countries will generally be left with debts that are higher in nominal than in present value terms.

Projections of Sustainability Assume Strong Export Growth and Substantial Aid Flows

The economic projections in HIPC initiative analyses generally assume a steady growth in export revenues for HIPC countries. This assumption is an important element in the initiative's expectation that HIPC recipients will have a sustainable debt burden. As exports grow, the indicators of indebtedness steadily improve, for a given level of debt. Exports have grown for most of the HIPC recipient countries in recent years. However, projections in HIPC documents assume significantly greater export growth in the years ahead. The first six countries deemed eligible for debt relief under the HIPC initiative had annual average growth rates in exports of 4.5 percent between 1985 and 1995. (See table 3.3.)

Table 3.3: Comparison of Historical and Projected Growth Rates in Exports for Six Countries

In percent

Country	Annual average growth rate, 1985-1995[a]	Projected growth rate, after completion point[b]	Increase (or decrease) in projected growth rates, compared to historical growth rates
Bolivia	3.2	7.6	134
Burkina Faso	5.5	9.4	69
Côte d'Ivoire	2.5	7.4	200
Guyana	9.2	5.8	–37
Mozambique	6.1	8.5	39
Uganda	0.3	8.2	2,800
Average	4.5	7.8	75

[a]Exports are 3-year averages.

[b]Projection period represents an average of 18 years after each country's completion point.

Sources: Our analysis of World Bank data and HIPC documents.

HIPC documents project that in years after they receive relief under the initiative, these same countries will achieve an average annual growth in exports of 7.8 percent, a 75-percent increase over the previous period. Most of the countries that have been approved for relief under the HIPC initiative are dependent on a few primary commodities for a majority of their export earnings. (See table 3.4.)

Table 3.4: Measures of Export Vulnerability for Six HIPCs

	Percent share of exports, 1995	
Country	**Main product**	**Three main products**
Uganda	66	72
Bolivia	12	32
Burkina Faso	39	55
Côte d'Ivoire	31	49
Mozambique	16	22
Guyana	21	50
Average, 24 HIPCs[a]	34	51

[a]HIPC documents include vulnerability analyses for 24 countries, known as the "reference group," potentially eligible for debt relief under the HIPC initiative.

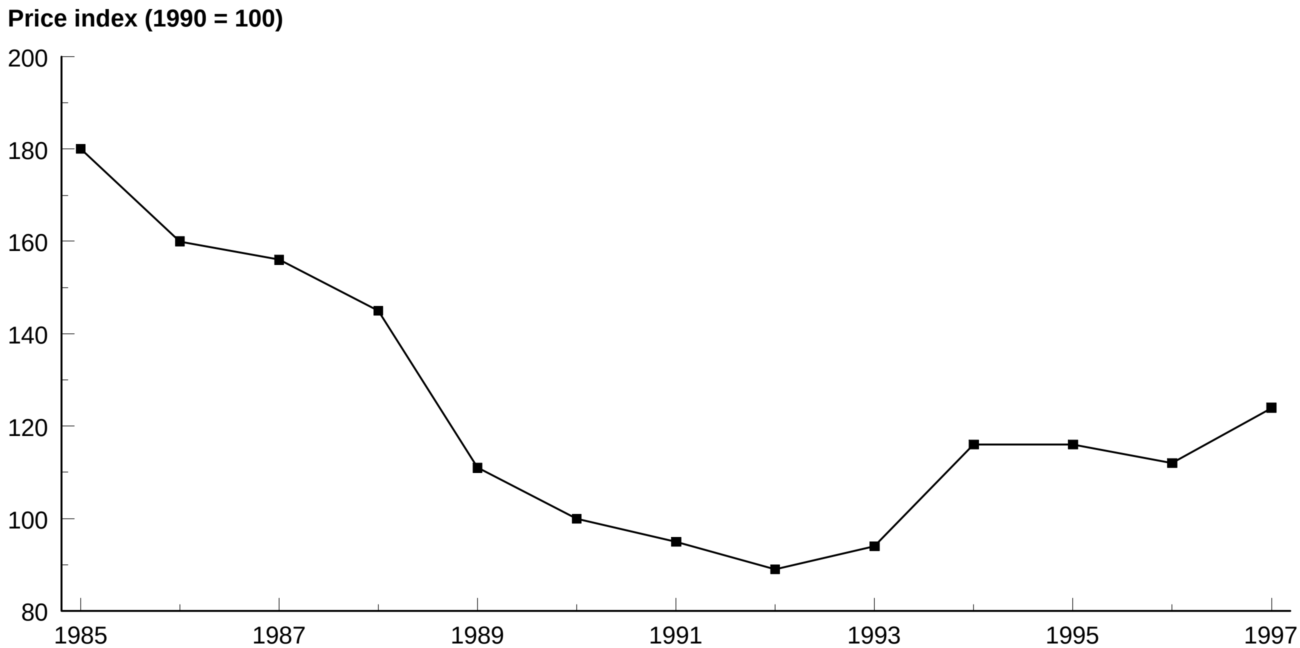
Source: HIPC documents.

For this reason, their export earnings are considered to be particularly vulnerable to adverse economic events. For example, a significant fall in the price or output of a country's primary export could bring the debt ratios to levels that once again exceed the HIPC initiative's target levels for debt sustainability. In the case of Uganda, approximately 66 percent of its export earnings in 1995 derived from one commodity, coffee, whose world price was near a 10-year high. According to HIPC documents, a 20-percent drop in the international price of coffee would raise Uganda's debt-to-export ratio by 30-40 percentage points. (Figures 3.1 and 3.2 illustrate the historical volatility of the world prices of coffee beans and also of cocoa beans, which are the main export commodity of Côte d'Ivoire.) Moreover, Uganda's recent experience illustrates the sensitivity of export earnings to variation in the amount produced. World Bank and IMF officials have cited increases in Uganda's export earnings (1995/96 and 1996/97) as evidence that the HIPC initiative's assumptions of countries' increased exports are reasonable when countries undertake necessary reforms. However, Uganda's most recent export data (1997/98) underlines concerns about the volatility of exports, with Uganda's exports projected to decline about 23 percent. Poor weather conditions in 1997/98 and the resulting decline in coffee exports are cited in HIPC documents as the reason for projected increases in Uganda's debt-to-export ratio in 1997/98 through 1999/2000.

Figure 3.1: World Price Trends for Coffee Beans, 1985-97

Source: DRI-McGraw Hill data.

Figure 3.2: World Price Trends for Cocoa Beans, 1985-97



Source: DRI-McGraw Hill data.

Similarly, a single commodity, cotton, accounts for 46 percent of Mali's exports, and its top three commodities account for 76 percent. According to HIPC documents, any one of three events would put Mali's debt ratios at unsustainable levels through the projection period (2017). These events include (1) a drought similar to that experienced by Mali in 1972-75 and 1983-85, (2) a 15-percent decline in gold prices, or (3) a 20-percent decline in cotton prices. In the case of Burkina Faso, an important element in its projected increase in exports is a steady 10-percent growth in gold exports. However, a recent sharp decline in the price of gold has substantially reduced investment in this sector and, according to a World Bank official, created considerable doubt regarding the likelihood that Burkina Faso will achieve the projected increases in gold production.

A key element in the HIPC initiative's projection of debt sustainability is that countries receiving debt relief will continue to get substantial foreign aid well into the future. This expected assistance includes not just aid to support development projects within countries but also concessional financing, including balance-of-payments support. For example, macroeconomic projections done by the World Bank and IMF staff at Uganda's April 1998 completion point show that, with its HIPC initiative debt relief of $347 million in present value terms, Uganda will continue to require donor assistance to meet its external debt and balance-of-payments needs until 2006. The inclusion of balance-of-payment support by donors within the HIPC initiative complicates the definition of debt sustainability and the establishment of a proper target level, since any level of debt could be considered "sustainable," given a sufficient amount of donor support.

According to World Bank officials, if a HIPC recipient country that is adhering to agreed-on reforms experiences circumstances that result in debt servicing problems, increased donor flows to that country will be forthcoming. A World Bank official cited commitments by some governments, for example, to provide the assistance Uganda needs in order to meet debt servicing obligations after the HIPC initiative relief, provided reforms continue. Future donor flows to potential HIPC recipients depend, of course, on many factors. However, the assumption that donor support of HIPC recipients will continue at current levels and will, under adverse conditions, increase has been questioned, given that net concessional flows from governments and multilateral institutions to poor countries have declined since 1990. Moreover, the World Bank observed in 1998 that the future prospects for official concessional financing worldwide are bleak due to fiscal pressures in Europe and Japan, the largest donor by volume, and to continued public concern over spending on foreign aid in the United States. Additionally, officials from the U.S. Treasury, other governments, and NGOs have raised questions about whether governments will simultaneously provide debt relief, increased concessional financing, and substantial contributions to replenish the international financial institutions, particularly in light of their own budget constraints. Officials we spoke to from other governments, including France and Germany, noted that creditors are likely to continue financially supporting countries, but the amounts are uncertain due to costs and fiscal pressures.

Debt Management Capability Is Limited Within Many Potential HIPC Recipients

The HIPC initiative has focused international attention on the limited debt management capacity of many poor countries. This limitation is a potential hindrance to their ability to emerge from their debt problems and avoid future unsustainable debt levels. Many HIPC participants and debt experts have noted that assistance with debt management has been a significant benefit of the initiative, although some have expressed frustration that the pace of improvement is slow. HIPC countries vary greatly in the quality of their capabilities for tracking and managing debt. Few HIPC countries have the capacity to analyze debt in a broader economic context, according to developing country experts, which limits their ability to participate fully in the analysis of their debt relief requirements under the initiative and to avoid future debt problems. Even for countries with basic debt management systems in place, analyzing how debt and debt reduction can affect their overall macroeconomic situations poses a major challenge.

Debt Data Management

According to the World Bank and the IMF, in recent years almost every country classified as a HIPC has received a substantial amount of technical assistance intended to improve its ability to manage debt. Most of this assistance has been concentrated on information management—on improving accounting systems for recording and tracking financial obligations. These efforts have resulted in significant improvements in many HIPC countries. They have been largely organized by UNCTAD and the Commonwealth Secretariat,[10] both of which have developed and installed debt management software and provided extensive training. In addition, these countries have received significant support from several bilateral donors.

However, countries that are candidates for debt relief under the HIPC initiative vary greatly in the degree to which they have in place the technical and governance requirements for effective debt management. Two early qualifiers for the initiative, Uganda and Bolivia, stand out as countries that have relatively well-developed capabilities for tracking and managing debt. Uganda, for example, has been using the UNCTAD debt data management software since 1985 and operating it independently since 1993. This capability constituted a major challenge for the country, according to government officials, due in part to destruction from 2 decades of civil war that included the burning of the Treasury building. In addition to increasing technical capacity, Uganda moved on the constitutional front, in 1994 giving its parliament all powers to contract

[10]The Commonwealth Secretariat implements many programs of the Commonwealth, a voluntary association of 53 developed and developing nations who work together on a variety of global issues.

new debt. Similarly, according to government officials, Burkina Faso established a centralized committee that would have to approve any new government borrowing.

The capacity of some HIPC countries to accurately track their financial obligations is still weak, however. Many African countries, especially, lack the capacity to maintain accurate loan records and track the timing and amount of debt servicing obligations. This can result in situations where various agencies within a government engage in external borrowing with no central control over, or even complete knowledge of, total debt amounts, according to officials from countries we visited. For some HIPC countries, initial examination of debt data has revealed inconsistencies, according to an official from UNCTAD. In some countries, the division between different agencies of institutional responsibilities for debt management and the inability to retain skilled staff have created problems. Due in part to concern about countries' ability to manage their debt, under IMF-supported programs, ceilings are to be negotiated on countries' new borrowing on nonconcessional terms. According to an IMF official, for heavily indebted poor countries, the ceiling is generally understood to be a low amount. Following receipt of debt relief through the HIPC initiative, Uganda has agreed to limit its nonconcessional borrowing to $10 million annually for the next several years.

Burkina Faso and Côte d'Ivoire are two HIPC countries that are in the earlier stages of receiving assistance with debt management. At the beginning of the HIPC initiative process, the government of Burkina Faso was unable to project the effect of new debt on future debt service. The government asked a private consultant for assistance in understanding and qualifying for the HIPC initiative. Now, with the support of the Swiss government, Burkina Faso is in the process of implementing the UNCTAD debt management system. However, according to donor and recipient officials, improvements in debt management in Burkina Faso are moving very slowly. The country needs to develop up-to-date and accurate debt data, install computer equipment and software to replace the manual records currently being used, and train staff to manage the financial management system before the country can move much further. In Côte d'Ivoire, manual records are generally still used due to budgetary constraints, and the government has yet to receive significant outside assistance on debt management. UNCTAD recently completed a needs assessment, and expectations are that Côte d'Ivoire will have the UNCTAD system by January 1999. In addition to computer hardware and software, training and other related technical support are needed.

Analyzing the Economic Impacts of Debt Poses a Major Challenge for HIPC Recipients

Even with a system of basic debt data management in place, analyzing how debt and debt reduction can affect a country's overall macroeconomic situation poses a challenge most HIPC participants cannot meet, according to officials from the United Nations and recipient governments. This is due both to a lack of accessible modeling techniques and limited technical expertise. World Bank and IMF staff have developed very complex and nonuniform spreadsheets to conduct debt sustainability analyses for countries potentially receiving debt relief under the HIPC initiative. World Bank and IMF officials acknowledged early in the HIPC initiative process that the absence of a uniform, documented standard for simulating debt reduction exercises would make it difficult for countries to participate fully in analyzing their debt situations. The World Bank set as a priority the development of such a model to be made available to interested countries. According to World Bank and IMF documents, this software was to be designed to be easily linked to the debt data management software put in place by UNCTAD and the Commonwealth Secretariat. However, as of August 1998, this software was not generally available for countries' use. According to officials at UNCTAD, restructuring and downsizing at the World Bank has resulted in loss of the expertise needed to complete the software and make it available. According to a Bank official, versions of the software are being tested in some countries.[11]

Other efforts to assist countries in developing the capacity to independently formulate their own debt strategy and debt sustainability analysis include the program undertaken by Debt Relief International, an NGO based in London, with funding from the governments of Austria, Denmark, Sweden, and Switzerland. The program also intends to help governments maximize their ownership and leadership of debt reduction and to demonstrate to the donor and creditor community a high level of debt management. The program is thus driven by recipient countries' requests for it. According to Debt Relief International, it has received requests for assistance from 16 heavily indebted poor countries. The capacity and will to closely monitor future borrowing after completing the HIPC initiative is critical to avoiding further debt problems, according to debt experts and some recipient country officials.

Conclusion

Despite receiving relief through the HIPC initiative and implementing strong economic policies, many recipient countries will remain vulnerable to

[11]A consulting firm in Washington, D.C., has recently developed computer software programs to assist policy makers in analyzing alternative debt strategies. An official from Debt Relief International told us that the IMF and some HIPC countries are using these programs.

future debt problems. Although the HIPC initiative has focused attention on the debt problems of poor countries and is substantially reducing the debt burdens of some, an expectation that all recipient countries that follow sound economic policies will avoid future debt problems is unrealistic. Projections that debt burdens are sustainable for HIPC recipients assume that economic conditions for these countries remain favorable and donors remain committed to assisting these countries in meeting their development goals and debt obligations. These assumptions may prove to be optimistic given the cyclical nature of many of these countries' major exports and recent declines in donor assistance. Furthermore, the expectation that recipient countries will effectively track existing debt and ensure that new debt is affordable may also prove optimistic in some cases.

Agency Comments and Our Evaluation

The organizations commenting on our report emphasized that recipients of debt relief through the HIPC initiative are and will remain vulnerable to economic difficulties. The IMF stated in particular that the ESAF program, as well as other donor support, could be used to help recipients facing economic shocks. Our analysis points out, however, that these countries will generally depend on support from the IMF and other donors to service their debt and cover other external financing needs, even under the HIPC initiative's assumption of favorable economic conditions. Their overall economic vulnerabilities suggest that some are likely to need increased levels of such external financing, even after debt relief.

The World Bank stated that the HIPC initiative recognizes the vulnerability of recipient countries, and this is reflected in the initiative's choice of debt relief targets near 200 percent. The World Bank also stated that the report's conclusion that many countries remain vulnerable to debt problems could be viewed as an implicit recommendation for increasing relief amounts. Our assessment that countries remain vulnerable to future debt problems is based on our analysis of the relief targets used in the HIPC initiative, the high concentration of these countries' exports, and the reliance of these countries on donor flows for continued debt support, separate from their development needs. While our analysis concludes that countries remain vulnerable to future debt problems, we are not recommending greater relief. We recognize that debt relief under the initiative will benefit participants, but conclude that some recipient countries may once again experience debt problems. This assessment highlights the limitations of the initiative and should prove useful in future discussion among those responsible for policy decision in this area.

In addition, the World Bank said that the initiative's export projections derive from estimates made by the World Bank, the IMF, and the recipient country and are higher than the historical average due to the positive effect of sustained policy reform. Our conclusion that the initiative's export projections are optimistic is based on analysis of countries' historical export growth rates and the concentration of these countries' exports. The cyclical nature of the prices of some of the primary export commodities of HIPC recipient countries is not accounted for in the underlying analyses of the initiative. Although sustained policy reform could improve these countries' export prospects, changes in commodity prices and outputs can be outside the influence of individual countries. Our report provides an example of this when poor weather conditions resulted in declining coffee exports and increases in Uganda's debt-to-export ratio in 1997 and 1998.

Characteristics of External Debt for 40 Heavily Indebted Poor Countries

Table I.1 shows for each of the 40 countries classified by the World Bank and International Monetary Fund (IMF) as a heavily indebted poor country (HIPC), the country's total external debt, the percentage of total external debt owed to various creditors, and the ratio of total debt (in present value terms) to exports, as of the end of 1995. The countries are classified based on whether they are included in the World Bank and IMF staffs' estimate of total relief to be provided under the HIPC Debt Initiative of $8.2 billion, as of August 1998. The Boards of Executive Directors of the World Bank and the IMF have made decisions concerning eight countries (Benin, Bolivia, Burkina Faso, Côte d'Ivoire, Guyana, Mozambique, Senegal, and Uganda). The remaining countries may move to another category if, for example, their economic conditions change or more information becomes available. Countries classified as having sustainable debt burdens (17) may receive debt relief under existing mechanisms, but they currently are not deemed to need debt relief under the HIPC initiative. Countries classified as having unsustainable debt burdens (20) are considered potential recipients for debt relief under the HIPC initiative. The three remaining countries—Liberia, Somalia, and Sudan—are not included in HIPC initiative estimates.

Table I.1: External Debt and Debt-To-Export Ratios for 40 HIPCs

	Nominal external debt (end 1995)						
		Composition (in percent)[a]					
Country	Total (billions of U.S. dollars)	Bilateral	Multilateral	Commercial	Short-term[b]	Present value of total debt to exports (end 1995, in percent)[c]
Sustainable-17	**$93.1**	**49.9**	**23.7**	**15.3**	**11.1**	**318[d]**
Angola	11.5	18.4	1.7	63.0	17.0	333
Benin	1.6	39.4	57.4	0.3	2.9	201
Cameroon	9.4	58.5	18.5	11.9	11.1	317
Central African Republic	0.9	21.2	70.9	1.8	6.1	252
Chad	0.9	19.2	78.4	0.2	2.2	199
Congo	6.0	55.3	12.0	15.3	17.5	464
Equatorial Guinea	0.3	38.1	41.1	5.7	15.2	313
Ghana	5.9	19.7	61.8	7.7	10.7	270
Guinea	3.2	44.0	48.1	2.5	5.3	294
Honduras	4.6	32.5	49.5	9.8	8.2	260
Kenya	7.4	31.1	44.5	15.8	8.6	206
Lao People's Democratic Republic	2.2	67.8	31.6	0.2	0.5	188
Senegal	3.8	32.4	57.4	3.3	6.9	173
Sierra Leone[e]	1.2	44.3	47.7	0.3	7.6	514
Togo	1.5	35.3	55.5	3.6	5.7	356
Vietnam	26.5	82.1	2.6	3.4	11.9	441
Yemen, Republic of	6.2	40.8	20.6	27.7	11.0	276
Unsustainable-20	**99.3**	**42.5**	**35.8**	**9.4**	**12.4**	**529[d]**
Bolivia	5.3	34.2	54.0	5.9	5.8	343
Burkina Faso	1.3	11.6	83.6	0.4	4.5	227
Burundi	1.2	14.4	84.2	0.1	1.2	459
Congo, Democratic Republic of[f]	13.1	48.4	21.8	6.7	23.1	807
Côte d'Ivoire	19.0	28.1	22.8	28.2	20.9	445
Ethiopia	5.2	42.0	46.7	7.7	3.6	541
Guinea-Bissau	0.9	38.5	56.8	0.3	4.4	1,235
Guyana	2.1	51.4	38.5	2.9	7.2	268
Madagascar	4.3	44.8	40.9	1.8	12.5	493
Mali	3.1	47.3	50.0	0.1	2.6	392

(continued)

Country	Nominal external debt (end 1995): Total (billions of U.S. dollars)	Composition (in percent)[a]: Bilateral	Multilateral	Commercial	Short-term[b]	Present value of total debt to exports (end 1995, in percent)[c]
Mauritania	2.5	51.4	40.9	0.3	7.5	365
Mozambique	5.8	67.2	26.2	1.8	4.9	1,059
Myanmar[g]	5.8	63.8	23.1	6.4	6.8	453
Nicaragua	9.3	59.0	16.5	10.4	14.1	1,654
Niger	1.6	31.1	56.4	8.2	4.4	369
Rwanda	1.0	13.6	83.0	0.2	3.3	345
Sao Tomé and Príncipe	0.3	28.3	66.0	0	5.6	1,224
Tanzania	7.3	38.8	41.8	5.6	13.7	540
Uganda	3.6	21.6	73.5	2.4	2.6	456
Zambia	6.9	39.9	50.0	2.53	7.6	417
Other-3	**22.4**	**33.1**	**21.6**	**11.6**	**33.8**	**1,589[d]**
Liberia[h,i]	2.1	23.5	37.1	9.8	29.6	294
Somalia[i,j]	2.7	42.5	35.6	1.4	20.6	1,702
Sudan[k]	17.6	32.8	17.6	13.4	36.3	3,339
Total, 40 HIPCs	**$214.9**	**44.7**	**29.1**	**12.2**	**14.0**	**438**

[a]A group's total type of debt as a percentage of the group's total debt; that is, the group's total bilateral debt as a percentage of the group's total debt. Percentages may not total 100 due to rounding.

[b]According to our analysis, $20.3 billion, or approximately 67 percent, of the $30.2 billion in short-term debt is unpaid interest arrears.

[c]Exports are a 3-year average (1993-1995) and exclude worker remittances.

[d]The group's total present value of debt to total exports.

[e]Sierra Leone was initially not expected to require assistance under the HIPC initiative, when assessed prior to the conflict. The World Bank and the IMF note that it appears likely that Sierra Leone's export base has deteriorated, but they do not yet have sufficient information to assess whether Sierra Leone would require HIPC assistance.

[f]Formerly Zaire.

[g]Exports for Myanmar are the average for 1993 and 1994.

[h]Exports from Liberia are based on estimates reported for 1995 in The World Factbook, 1997 published by the Central Intelligence Agency.

[i]Insufficient information.

[j]Exports from Somalia are based on estimates reported for 1994 in The World Factbook, 1997.

[k]No allowance is made for the possible participation of Sudan in HIPC.

Sources: Our analysis, World Bank and IMF data.

Estimated Debt Owed to the United States by 40 HIPCs

According to estimates prepared by the U.S. Treasury, as of August 1998, 31 of the 40 HIPCs identified by the World Bank and the IMF owed outstanding debt to the United States totaling approximately $6.8 billion. (See table II.1.) The figures include outstanding principal and interest arrears. The Treasury's estimates are based on debt figures as of year-end 1995. In calculating the estimates shown in table II.1, the Treasury assumed that concessional and nonconcessional debt grew by 7 percent and 3 percent per year, respectively, as a rough proxy for increased arrears and/or net new lending. This debt is broken down into three categories: concessional, nonconcessional, and guarantees.

Table II.1: Type of Debt Owed to the United States by 40 HIPCs, as of August 1998

Dollars in millions

Country	Concessional	Non-concessional	Guarantees	Total
Angola	$8.9	$9.6	$13.5	**$32.0**
Benin	0	0	0	**0**
Bolivia	6.1	10.9	0.5	**17.5**
Burkina Faso	0	0	0	**0**
Burundi	0	0	0	**0**
Cameroon	0	62.4	6.1	**68.5**
Central African Republic	0	10.9	0	**10.9**
Chad	0	0	0	**0**
Congo	31.1	14.9	0	**46.0**
Congo, Democratic Republic of[a]	436.2	1,937.8	8.7	**2,382.7**
Côte d'Ivoire	88.2	243.7	42.7	**374.6**
Equatorial Guinea	0	0	0	**0**
Ethiopia	85.5	2.6	0	**88.1**
Ghana	0	83.5	355.8	**439.3**
Guinea	113.9	11.1	0	**125.0**
Guinea-Bissau	0	0	0	**0**
Guyana	11.0	10.3	0	**21.3**
Honduras	0	75.8	71.9	**147.7**
Kenya	39.1	108.9	57.1	**205.1**
Lao People's Democratic Republic	0	0	0	**0**
Liberia	200.2	63.2	0	**263.4**
Madagascar	0	41.4	0	**41.4**
Mali	4.1	0	0	**4.1**
Mauritania	0	6.6	0	**6.6**
Mozambique	0	65.6	0	**65.6**
Myanmar	7.5	0	0	**7.5**

(continued)

Dollars in millions

Country	Concessional	Non-concessional	Guarantees	Total
Nicaragua	22.4	82.3	2.2	**106.9**
Niger	0	16.2	0	**16.2**
Rwanda	0	0	2.3	**2.3**
Sao Tomé and Príncipe	0 0	0	0	
Senegal	5.4	20.5	0	**25.9**
Sierra Leone	66.1	16.4	0	**82.5**
Somalia	178.8	190.4	0	**369.2**
Sudan	447.3	566.5	0	**1,013.8**
Tanzania	0	37.0	0	**37.0**
Togo	0	0	0	**0**
Uganda	0	1.6	3.6	**5.2**
Vietnam	265.5	0	0	**265.5**
Yemen, Republic of	106.6	0	10.2	**116.8**
Zambia	166.3	197.2	0	**363.5**
Total	**$2,290.2**	**$3,887.3**	**$574.6**	**$6,752.1**
Percent of total	**33.9**	**57.6**	**8.5**	

[a]Formerly Zaire.

Source: U.S. Treasury.

Multilateral Institutions Participating in the HIPC Debt Initiative

Table III.1 lists the 25 multilateral institutions that have agreed to provide debt relief under the HIPC Debt Initiative.

Table III.1: Participating Multilateral Institutions

Multilateral institution	Location
African Development Bank/African Development Fund	Abidjan, Côte d'Ivoire
Arab Bank for Economic Development in Africa	Khartoum, Sudan
Arab Fund for Economic and Social Development	Safat, Kuwait
Arab Monetary Fund	Abu Dhabi, United Arab Emirates
Asian Development Bank	Manila, Philippines
Banque Centrale des Etats d'Afrique de l'Ouest (Central Bank of the West African States)	Dakar, Senegal
Caribbean Development Bank	St. Michael, Barbados
Caricom Multilateral Clearing Facilities	Port of Spain, Trinidad
Central American Bank for Economic Integration	Tegucigalpa, Honduras
Conseil de l'Entente (Council of the Entente)	Abidjan, Côte d'Ivoire
Corporación Andina de Fomento (Andean multilateral development bank)	Caracas, Venezuela
East Africa Development Bank	Kampala, Uganda
Eastern and Southern African Trade and Development Bank	Nairobi, Kenya
Economic Community of West African States, Fund for Cooperation Compensation and Development	Lomé, Togo
European Union, European Investment Bank	Brussels, Belgium; Luxembourg
Fund for the Financial Development of the River Plate Basin	Santa Cruz de la Sierra, Bolivia
Inter-American Development Bank	Washington, D.C., United States
International Fund for Agricultural Development	Rome, Italy
International Monetary Fund	Washington, D.C., United States
Islamic Development Bank	Jeddah, Saudi Arabia
Nordic Development Fund and Nordic Investment Bank	Helsinki, Finland
Organisation Arabe des Pays Exportateurs de Pétrole (Arab Organization of Petroleum Exporting Countries)	Kuwait City, Kuwait
Organization of Petroleum Exporting Countries, Fund for International Development	Vienna, Austria
West African Development Bank	Lomé, Togo
World Bank	Washington, D.C., United States

Sources: World Bank and IMF.

Design of the HIPC Initiative Framework

The HIPC framework combines debt relief with recipients' continued economic and social reforms. The framework was structured to be flexible and applied on a case-by-case basis to address a country's particular debt problems. The framework is essentially implemented in two stages, each of which generally lasts 3 years. The first stage leads to the decision point (determination of a country's eligibility to participate in the HIPC initiative), and the second stage culminates with the completion point (determination that a country has fulfilled the conditions necessary to receive full debt relief). The key elements discussed during these stages are the recipient's debt situation, the performance expected of the recipient in the second stage, and the participation by all relevant creditors. The timing of the decision point tends to coincide with the timetable of the country's potential eligibility for a stock-of-debt operation on Naples terms[1] from the Paris Club.

Decision Point

At the decision point, the Boards of Executive Directors of the World Bank and the IMF determine whether a country is eligible to participate in the HIPC initiative. World Bank and IMF staff prepare a summary document for each potential candidate that (1) outlines the country's situation with respect to the HIPC initiative's eligibility criteria, (2) proposes target debt-to-export ratios and key performance criteria for the country to achieve at the completion point, and (3) estimates the amount of assistance to be provided by creditors.

The eligibility criteria address a country's track record of reform, income, and indebtedness. As stated in the HIPC framework, a country is considered to have demonstrated a good track record of reform if it has completed a 3-year IMF- and World Bank-supported program of macroeconomic reform and structural adjustment and has a good payments record to creditors. A factor that would help a country to be considered as reaching its decision point is if it has negotiated a Paris Club stock-of-debt operation on Naples terms. The Boards of the World Bank and the IMF make judgments about whether this track record has been established for each country. In making this determination, issues such as whether a country has gone off track during the first 3-year period are considered. To help countries begin establishing the necessary track record, the Boards have encouraged all countries that hope to receive assistance under the HIPC initiative to start IMF- and World Bank-supported programs.

[1]Under a Naples terms stock-of-debt operation, eligible countries may receive up to a 67 percent reduction in eligible debt, in present value terms.

Regarding the criteria of income and indebtedness, the 40 countries that potentially qualify for assistance under the framework are those that are eligible for IMF assistance through the Enhanced Structural Adjustment Facility (ESAF) and World Bank assistance from the International Development Association (IDA) only—the part of the World Bank that lends to poor countries on highly concessional terms—and face an unsustainable debt situation even after the full application of current debt relief mechanisms. These mechanisms include a stock-of-debt operation from the Paris Club on Naples terms involving a 67-percent reduction of eligible debt in present value terms and comparable action from other bilateral and commercial creditors. To assess a country's debt situation, staff from the World Bank, the IMF, and the debtor country prepare a debt sustainability analysis (DSA). The DSA makes certain projections of specific key economic information, such as a country's balance of payments over a 20-year period. Under the HIPC initiative, the sustainability of a country's debt is assessed using the following indicators:

- The ratio of the present value of debt to exports; the present value debt-to-export ratio should be expected to fall within a range of 200-250 percent, or below, by the completion point.
- The ratio of debt service to exports; the debt service-to-export ratio should be expected to fall within a range of 20-25 percent, or below, by the completion point.
- Under some circumstances, for countries with very open economies and strong efforts to generate fiscal revenues, the ratio of the debt, in present value terms, to government revenue. The World Bank and IMF Boards added these indicators to the framework in 1997 to reflect their concern that countries with heavy debt burdens but large export sectors may receive less assistance than countries with similar debt burdens but less open economies. For countries meeting openness and fiscal thresholds,[2] the present value debt-to-export target will be at a level that achieves a 280 percent ratio of the present value of debt to revenue at the completion point.

According to HIPC documents and World Bank and IMF officials, when evaluating a country's debt burden, additional factors that can affect how vulnerable a country's economy is are also taken into account. These factors include the amount of external debt service relative to the government budget, the country's dependence on a single or a small number of commodity exports, the amount of hard currency reserves, and

[2]These are an export-to-GDP ratio of at least 40 percent and a minimum threshold of fiscal revenue in relation to GDP of 20 percent.

other relevant factors. The DSA assumes the recipient country will continue to follow sound economic and financial policies such as macroeconomic stability, deeper structural reforms, and health and education programs.

Based on the results of the DSA, a country's debt situation is classified in one of three ways.

- Debt is considered sustainable after a country receives debt relief on traditional terms from bilateral and commercial creditors. The country is not eligible for assistance under the HIPC initiative but may receive a stock-of-debt operation from the Paris Club.
- Debt is considered unsustainable after the full application of traditional debt relief mechanisms. The country enters into the HIPC initiative's second 3-year phase. During this phase, the international community (1) continues to provide exceptional support,[3] as the country proceeds with agreed-upon reforms, including up to an 80 percent reduction on eligible debt service from the Paris Club; and (2) commits to provide additional relief at the end of the second phase—the completion point—needed to achieve sustainability, if the country continues its sound performance. At the completion point, the combination of the country's reform effort and creditors' debt relief is expected to reduce debt to sustainable levels.
- Debt is considered borderline after the full application of debt relief on traditional terms; that is, there is reasonable doubt about whether current terms would achieve debt sustainability. The recipient country has two options: (1) receive Paris Club stock-of-debt operation on Naples terms and exit from the rescheduling process or (2) defer Paris Club stock-of-debt operation for 3 years and thus leave open the possibility of receiving assistance under the HIPC initiative. Recipients are assured of additional action at the completion point if then needed to achieve debt sustainability.

Countries whose debt burdens are deemed to be either unsustainable or borderline may receive assistance under the terms of the HIPC framework. They receive assistance during the second stage and final assistance at the completion point. In order to receive the debt relief at the end of the program, the recipients must meet performance criteria agreed to at the decision point and implemented under IMF- and World Bank-supported programs. The criteria center on (1) macroeconomic indicators, such as budget deficits and inflation rates; (2) progress on key structural reforms affecting trade, financial, and enterprise sectors, and public expenditure

[3]Exceptional support, such as the ESAF, allows a country to meet its external obligations without experiencing arrears, debt rescheduling, or debt cancellation.

management; and (3) social reforms such as improving basic health care and education and reducing poverty levels. The conditions established under the HIPC initiative are part of the conditions negotiated under World Bank- and IMF- supported programs. The IMF monitors a country's macroeconomic developments, and the World Bank monitors social reforms.

Completion Point

At the completion point, World Bank and IMF staff assess countries' performance and use updated information on the economy to prepare a new DSA and calculate new debt ratios. According to the HIPC framework, the Boards have discretion in determining whether conditions have been met and whether recipients are entitled to debt relief. World Bank and IMF officials noted that the Boards need flexibility if countries undertake positive actions but fall short of numerical targets.

If countries do not meet the economic targets or if they do not sufficiently implement the reforms agreed to at the decision point, the Boards could decide to delay or terminate the assistance under the HIPC initiative. In the case of significant delays, enhanced assistance would end, and the country would restart the decision point process. In the case of delays that did not have a significant adverse impact on the original program objectives, the completion point could be moved further out into the future.

If there is no significant delay in the implementation of the reform program and if the debt-to-export ratio falls into the range established at the decision point,[4] creditors provide the relief promised at the decision point. Debt relief provided at the completion point is to be unconditional, thereby effectively removing that portion of debt owed to creditors from the country's books. As discussed later, creditors provide debt relief through various means, such as rescheduling debt payments, reducing the debt, and/or lending new funds on concessional terms to meet future debt service payments.

[4]If the actual ratio is higher than the projected ratios, the creditors will review the actions needed to achieve debt sustainability. Conversely, if the ratio is lower than projected due primarily to factors beyond the country's control (that is, higher world commodity prices) then creditors' support could be reduced, consistent with achieving the lower end of the original debt-to-export target range. If the lower ratio is due to a country's strong performance, then creditors would implement their initial commitments. If the actual present value debt-to-export ratio is within a 10-percentage point range of the target (higher or lower) then no adjustment to creditor commitments is made.

Means for Providing Debt Relief

Creditors have agreed that they will each choose how they will provide debt relief to specific countries and which debt will be eligible for relief. Creditors provide relief through several means, such as rescheduling debt payments at lower interest rates, buying back the debt, converting loans into grants, reducing the debt, making debt service payments as they come due, and/or lending new funds on concessional terms to meet future debt service payments. Because debt and debt relief are evaluated under the HIPC initiative using the concept of present value, debt relief is considered to take place when interest rates on current debt are reduced or when scheduled debt service payments for concessional loans are moved further into the future, even if the nominal, or face value, of the debt owed is not reduced.

In July 1997, creditors broadly endorsed a burden-sharing formula, termed the "proportional approach," under which bilateral and multilateral creditors would provide an equal percentage reduction of the remaining debt owed to them after the full use of existing debt relief mechanisms, including Naples terms. In calculating the amount of relief to be provided by the creditors, World Bank and IMF staff first determine the total amount of relief needed to lower the recipient's debt-to-export ratio to the target level. Staff then determine the percentage reduction bilateral and multilateral creditors would provide as a group to reach the relief amount. This percentage reduction must meet the bilateral creditors' limitation that they will not provide debt relief beyond 80 percent of eligible debt unless specifically negotiated for exceptional circumstances. Applying the proportional approach continues to involve negotiation among the creditors when they determine the specific relief amount for each recipient. Although creditors agreed to provide the same percentage of debt reduction, the dollar amounts of this relief will vary by creditor because creditors are owed different amounts of debt. For example, in the case of Burkina Faso, bilateral and multilateral creditors agreed to provide debt relief valued at about 14 percent of what they are owed. For bilateral creditors, this amounted to about $21 million in debt relief. For multilateral creditors, the same percentage reduction amounted to about $94 million.

Multilateral creditors intend to provide assistance by either buying back debt, paying debt as it comes due, rescheduling debt, or refinancing on grant terms. The World Bank's participation in the HIPC initiative is to be funded solely from the Bank's own resources. Debt relief provided by the World Bank under the HIPC initiative is taking place primarily through contributions to the HIPC Trust Fund from International Bank for

Reconstruction and Development (IBRD) income. The Trust Fund provides relief on debt owed to IDA, either through buying back some of its concessional debt or providing an unconditional commitment to pay debt service owed to IDA as it becomes due. Some of this relief may be advanced during the second stage when the World Bank could provide part of its lending program in the form of IDA grants instead of IDA credits, which are funded through general IDA resources.[5] The IBRD has contributed about $750 million from its income to the HIPC Trust Fund to buy back or repay debt owed to IDA. The executive directors have recommended the approval of another transfer of $100 million from IBRD income to the Trust Fund. The HIPC Trust Fund has been specifically set up to keep the IDA and IBRD aspects of the World Bank's operation at arm's length.

The HIPC Trust Fund also receives contributions from other participating multilateral development banks and bilateral creditors that are to be used primarily to assist other multilateral development banks, such as the African Development Bank. As of August 10, 1998, 16 governments had made pledges or contributions to the Trust Fund totaling about $204 million. Also, nine countries proposed contributions totaling about $92 million to relieve multilateral debt through reallocation of their excess resources in the Bank's Interest Subsidy Fund, which was set up in 1975 with donor contributions to subsidize the interest rates on IBRD loans to the poorest IBRD borrowers. (See table IV.1.)

[5]Most HIPC recipients are projected to continue receiving high levels of assistance from IDA. Thus, the present value of these countries' debt to IDA will continue to rise during and after participation in the HIPC initiative. To mitigate the rise in the present value of debt to IDA during the period between the decision and the completion points, the World Bank will provide a portion of normal credits as grants on a selective basis. By providing grants in place of normal IDA credits, the present value of debt owed to IDA is reduced. Because IDA credits have roughly a 70-percent grant element, replacing those credits with grants reduces the present value of the country's future debt service by an amount equal to about 30 percent of the grant. This reduction in present value also would count as part of the World Bank's contribution toward HIPC relief, provided that the grants are fully disbursed prior to the completion point. Therefore, where IDA operations in qualifying countries have a financing package consisting of a grant portion and a credit portion, the grant portion would be disbursed first. The portion of IDA assistance represented by grants would vary based on the countries' projected debt-to-export ratios—higher ratios mean higher proportions of grants.

Table IV.1: Bilateral Donor Contributions to the HIPC Trust Fund, as of August 10, 1998

Dollars in millions

Country	Amount
Contributions paid in	**$139.6**
Canada	5.6
Denmark	22.0
Greece	1.0
Japan	10.0
Luxembourg	0.5
Netherlands	38.0
Norway	26.0
Sweden	12.0
Switzerland	14.0
United Kingdom	10.5
Additional contributions pledged for 1998[a]	**$64.0**
Belgium	8.0
Finland	12.0
Italy	To be determined
Portugal	15.0
Spain	15.0
Switzerland	14.0
Proposed contributions through reallocation of Interest Subsidy Fund resources	**$92.3**
Australia	5.3
Belgium	3.7
Canada	22.0
Denmark	3.3
France	20.7
Luxembourg	0.1
Netherlands	22.8
Norway	4.4
United Kingdom	up to 10.0
Total	**$295.9**

[a]Indonesia announced in fall 1997 that it would contribute $10 million.

Sources: World Bank and IMF.

The multilateral development banks have stressed that the means used to provide debt relief through the Trust Fund should accommodate constraints specific to these institutions, such as policies against debt restructuring or forgiveness. The IMF is participating in the HIPC initiative through special ESAF grants at the completion point that are deposited into an escrow account to meet debt service payments owed to the IMF under a predetermined schedule. The IMF is funding its contribution through its own trust fund financed from bilateral (member) contributions and the ESAF reserve account. To finance these grants, several countries have contributed or made investments for the benefit of the ESAF-HIPC Trust totaling approximately $46.6 million, as of June 1998. In May 1998, the IMF transferred about $54.5 million to the ESAF-HIPC Trust for fiscal year 1998 and expects to make a similar payment on a quarterly basis to the ESAF-HIPC Trust for fiscal year 1999. The IMF Board has authorized the transfer of up to an additional $332.5 million from the ESAF Trust Reserve Account to meet the IMF's commitments under the HIPC initiative.

Creditors may provide relief at any time during the HIPC initiative process. At the decision point, bilateral and commercial creditors are assumed to provide debt relief on Naples terms (involving a stock-of-debt operation up to a 67-percent reduction in present value terms) to all debtors. This is not counted as part of the relief provided through the HIPC initiative. After the decision point, bilateral and commercial creditors provide flow rescheduling on enhanced terms (up to a total of an 80-percent reduction in present value terms) between the decision and completion points and may vary the type or timing of their debt relief to meet a particular recipient country's needs. For example, for Bolivia and Uganda, both the World Bank and the IMF intend to frontload the debt service relief because Bolivia has substantial payment obligations early on and because Uganda had a shortfall in export earnings due to unfavorable weather conditions. Creditors may also provide a portion of their assistance before the completion point. Such "interim relief" is considered part of the creditor's total share of assistance.

The case of Uganda illustrates how creditors may use various means to provide debt relief under the initiative to a single country. Our analysis shows that creditors will use five different debt relief mechanisms but rely primarily on paying debt service and buying back debt. (See table IV.2.)

Table IV.2: Creditors' Mechanisms for Providing Debt Relief to Uganda Under the HIPC Initiative

Mechanism	Present value of debt relief (millions of 1997 dollars)	Percent of total
Debt service payment	$127	36.4
Debt buyback	117	33.5
Debt reduction	73	20.9
Grants	24	6.9
Concessional rescheduling	8	2.3
Total	**$349[a]**	**100.0**

[a]During the final debt reconciliation process, claims of two African-based multilateral creditors amounting to $8 million in present value terms were discovered. Their assistance under the HIPC initiative would be about $1.6 million in present value terms.

Sources: World Bank and IMF data.

Factors Affecting Changes in Countries' Debt-to-Export Ratios

Several factors may cause a country's debt-to-export ratio to change. As shown in table V.1, for the first six countries deemed eligible to receive debt relief under the HIPC initiative the net declines in their debt-to-export ratios from 1995 to their completion points are due to four factors: (1) net borrowing that tends to increase the ratio; (2) assumed increase in exports that tends to decrease the ratio since exports are assumed to be growing; (3) normal debt relief mechanisms, including Paris Club Naples terms and comparable actions by other bilateral and commercial creditors; and (4) relief under the HIPC initiative. Table V.1 presents estimates of how much of the reduction in the debt-to-export ratios for the six countries is attributable to these respective factors. (Data available from HIPC documents does not allow separation of the effect on debt-to-export ratios of debt relief through existing mechanisms from the effect of net new borrowing.) The debt-to-export ratios for 1995 are based on World Bank-reported data. These ratios at the completion point are based on HIPC documents' projections of exports and net borrowing; debt relief commitments or actions by some bilateral, multilateral, and commercial creditors; and uncommitted but anticipated debt relief from other creditors.[1]

[1]Uganda is the only country for which actual export values are used in calculating the completion point debt-to-export ratios. According to HIPC documents, although contacted by Ugandan government authorities, a number of non-Paris Club bilateral creditors have not yet agreed to provide the levels of debt relief assumed in these computations.

Table V.1: Changes in Six Countries' Debt-to-Export Ratios Due to Export Growth, Normal Debt Relief and Net New Borrowing, and Relief Under the HIPC Initiative

	Debt-to-export ratio, present value[a]				Amount of reduction and percentage share of total (in parenthesis) due to		
		Completion point					
Country	1995[b]	Projection after normal debt relief	HIPC target	Amount of reduction between 1995 and HIPC target	Growth in exports	Normal relief and net borrowing	HIPC relief
Uganda[c]	456	249 actual 243	202 actual 196	260	200 (77)	13 (5)	47 (18)
Bolivia	317[d]	259	225	92	41 (45)	17 (18)	34 (37)
Burkina Faso	227	238	205	22	48 (221)	–59 (–272)	33 (151)
Côte d'Ivoire[e]	353[f]	147	141[g]	212	82 (39)	123 (58)	6 (3)
Mozambique	1,059	466	200	859	189 (22)	405 (47)	266 (31)
Guyana	268	143	107[g]	161	35 (22)	90 (56)	36 (22)

[a]Ratio of present value of debt to 3-year average of exports. Completion point ratios use projected data as of the year prior to the completion point. Exports exclude worker remittances.

[b]1995 is selected as the base year because the figure for present value of debt for that year does not incorporate any Naples terms debt reduction.

[c]Uganda is the only country for which actual export values are used in calculating the completion point ratios.

[d]For Bolivia, the present value of medium- and long-term debt for 1995.

[e]All figures for Côte d'Ivoire refer to debt owed to official creditors.

[f]For 1996.

[g]Target ratio of present value of debt to exports chosen to meet fiscal criteria for present value of debt-to-revenue target of 280 percent.

Sources: Our analysis of HIPC documents and World Bank data.

Comments From the Department of the Treasury

Note: GAO comments supplementing those in the report text appear at the end of this appendix.

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C.

September 18, 1998

NDER SECRETARY

Mr. Henry L. Hinton, Jr.
Assistant Comptroller General
General Accounting Office
441 G Street, N.W.
Washington, D.C. 20548

Dear Mr. Hinton:

I would like to comment, on behalf of the Treasury Department, on the General Accounting Office's draft report on the Heavily Indebted Poor Country (HIPC) Debt Initiative. The report is an ambitious undertaking to review the HIPC debt initiative and explain it in terms that can be understood by the general reader. The initiative is technically complex and often misunderstood and we hope our efforts and those of the World Bank, IMF and other participants were helpful in explaining the goals and implementation of this important initiative.

We agree with the GAO's conclusion that the HIPC initiative will help reduce participating poor countries' debt burdens. We also agree that the countries that receive HIPC debt relief will need strong economic performance and continued economic assistance and that debt management capability is limited for many of these countries.

See pp. 24-26 and 34.

Nonetheless, in the draft that we were asked to review, there are some areas that need to be expanded and modified. We were very concerned about the limited description of the context of the HIPC debt initiative as part of ongoing debt relief and economic reform efforts directed at the poorest, most heavily indebted countries. It was not clear in the draft report that the United States already had provided debt reduction both unilaterally and through the Paris Club before the HIPC initiative was created. The United States provided $13.6 billion in bilateral reduction in FY 1990-1996, of this $3.2 billion was for the poorest countries, $7 billion was for Egypt, $635 million was for Jordan and $ 2.4 billion was for Poland. In FY 1994-1998, the United States made commitments in the Paris Club, that when fully implemented, will result in 50-67% debt reduction for 22 countries totaling $701 million in face value.

We are concerned that the draft report fails to provide an adequate historical context for the HIPC initiative and that it understates the debt relief efforts being made by the bilateral creditors. The report needs to make it clear that the bilateral creditors prior to the HIPC program, undertook unilateral and Paris Club debt relief actions. Thus bilateral creditors are providing up to 67% debt reduction for a larger number of countries than will become eligible for HIPC debt relief. The HIPC debt relief program, for the first time, includes multilateral creditors, who have agreed to share proportionately in the additional effort of topping up the Paris Club 67% reduction by up to 80%.

- 2 -

The history of bilateral action leading up to the HIPC debt initiative includes the efforts of the Paris Club beginning with the establishment in 1988 of Toronto terms to reduce eligible debt payments by 33%, followed by a deeper "flow reduction" of 50% under London terms in 1991. Naples terms which were agreed upon in 1994, for the first time, provided for reduction in the stock of bilateral debt for a country by 50-67% after three years of debt payment reductions.

See pp. 61-62.

The GAO report concludes that the recipient countries will continue to be vulnerable to external shocks, particularly commodity price declines and some could experience debt problems again. This is, of course, true. The HIPC initiative is not a cure for the poverty of these countries nor will it diversify their economies. HIPC debt relief is not a end in itself but one of many programs to support sustainable development by encouraging appropriate economic policies and by reducing debt overhang in order to achieve sustainable debt servicing.

See comment 1.

Finally, the report should clear up a common misconception about the pace of implementation of this initiative. The speed of HIPC implementation is dependent upon the speed of the debtor reform process and is not being held back by creditors. Indeed, since the initiation of the HIPC program, creditors have made decisions that increased the number of potentially eligible countries and increased the amount of assistance to be provided. G-7 Finance Ministers have fully supported the HIPC initiative saying, "We look forward to determined and speedy extension of debt relief to more countries, in line with the terms of the initiative. We call on all eligible countries to embark on the process as soon as possible, and to take steps to ensure that all can be in the process by the year 2000."

My staff has met with yours and provided detailed technical comments on the report. With the modifications suggested, we believe this report will provide a useful review of an important initiative.

Sincerely,

David A. Lipton

The following is GAO's comment on the Department of the Treasury's letter dated September 18, 1998.

GAO Comment

1. We agree that debtor activities are an important determinant of the speed in which the HIPC initiative progresses. Chapter 1 discusses the requirement that countries must first establish a track record of reform before qualifying for relief under the initiative. As discussed in chapter 2, the projected amount of relief does not include estimates for Liberia, Somalia, and Sudan since these countries have yet to establish the necessary track records of reform.

Comments From the International Monetary Fund

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C.

JNDER SECRETARY

September 18, 1998

Mr. Henry L. Hinton, Jr.
Assistant Comptroller General
General Accounting Office
441 G Street, N.W.
Washington, D.C. 20548

Dear Mr. Hinton:

The IMF was asked to comment on the General Accounting Office's draft report on the Heavily Indebted Poor Country (HIPC) Debt Initiative. Attached is a letter from IMF Managing Director Camdessus to Treasury Secretary Rubin with their comments.

Sincerely,

David A. Lipton

Enclosure

INTERNATIONAL MONETARY FUND
WASHINGTON, D. C. 20431

MANAGING DIRECTOR

CABLE ADDRESS
INTERFUND

September 14, 1998

Dear Secretary Rubin:

Heavily Indebted Poor Countries (HIPC) Initiative: GAO Report to the Chairman, Subcommittee on International Economic Policy, Export and Trade Promotion, Committee on Foreign Relations, U.S. Senate on Debt Relief

I understand this GAO report focuses on the continuing vulnerability of HIPCs to potential debt problems post the HIPC Initiative. I would like to offer some brief comments on this important issue.

See pp. 61-62.

HIPCs are and will remain poor, vulnerable countries. As such, most are and will remain heavily dependent on aid inflows. Relief under the HIPC Initiative reduces but cannot eliminate this vulnerability. Even if all external debt were abolished, most HIPCs would remain dependent on aid inflows and would be vulnerable to any disruption to these inflows and fundamentally vulnerable in their external accounts.

The objective of the HIPC Initiative is to achieve debt sustainability—intended as the ability of the country concerned to service its debts on reasonable assumptions without further rescheduling. This should remove perceptions of a debt overhang and help encourage inflows of foreign direct investment. These assumptions include access to Fund and Bank support under existing mechanisms and continued bilateral support. The HIPC Initiative was never portrayed as replacing these mechanisms. Thus a country that faces an external shock post HIPC assistance could turn to the Fund for support under a new Enhanced Structural Adjustment Facility arrangement and we in turn would, if warranted, seek with the World Bank to catalyze donor support for appropriate policies.

The HIPC Initiative works on top of existing mechanisms, in particular existing mechanisms of debt relief. In return for the promise of exceptional assistance under the HIPC Initiative, the HIPC concerned provides an exceptional strong policy effort which marks a significant step forward to sustainable

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development. Thus the HIPC Initiative reduces—but cannot eliminate—the vulnerability of HIPCs in two ways, namely, through the assistance provided and the stronger policy reforms that this supports.

I hope these comments help put the HIPC Initiative in its broader perspective.

Sincerely yours,

Michel Camdessus

The Honorable
Robert E. Rubin
Secretary of the Treasury
1500 Pennsylvania Avenue NW
Washington D.C.

Major Contributors to This Report

National Security and International Affairs Division, Washington, D.C.

Harold J. Johnson
Celia Thomas
Thomas Melito
Bruce Kutnick
Cheryl Goodman
Claude Adrien
Rona Mendelsohn

Office of the General Counsel, Washington, D.C.

Mark Speight

Denver Field Office

Patricia Foley Hinnen

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