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ECONOMIC DEVELOPMENT IN AFRICA

DEBT SUSTAINABILITY: OASIS OR MIRAGE?*

Summary by the UNCTAD secretariat

Executive summary

It is recalled that, in the São Paulo Consensus adopted by the eleventh session of the Conference, UNCTAD was mandated to "continue to address problems of developing countries arising from… the question of debt sustainability". The present document is a summary of a study of debt sustainability in Africa contained in document UNCTAD/GDS/AFRICA/2004/1, which provides a full technical analysis of the issue. It addresses the debt problems of African countries in the context of achieving the Millennium Development Goals by 2015. The analysis shows that, notwithstanding progress in the implementation of the enhanced Heavily Indebted Poor Countries Initiative, indebted African countries would not find themselves in a sustainable debt situation, and it suggests ways and means of applying alternative criteria in order to ensure a permanent exit solution to the debt overhang.

*The information in this document should not be quoted by the press before 30 September 2004.

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CONTENTS

Page

1. Introduction....3
2. Africa's debt problem....3
3. Debt relief initiatives....4
4. The HIPC Initiative....6
   (a) Pace of implementation....7
   (b) Long-term debt sustainability....7
   (c) Remaining on track after decision point....7
   (d) Interim relief....8
   (e) "Additionality"....8
   (f) Pre-decision point and post-conflict countries....8
   (g) Domestic debt....8
5. Debt sustainability and eligibility criteria....9
   (a) The poverty criterion....9
   (b) Debt sustainability criteria....10
      (i) NPV debt-to-export criterion....10
      (ii) NPV debt-to-revenue ratio....10
6. Post-HIPC debt sustainability....11
7. Do HIPCs actually save on debt service?....11
8. Is HIPC debt relief additional to traditional aid?....12
9. Alternative scenarios....12
10. Conclusions....13

1. Introduction

1. In the context of the Millennium Development Goals (MDGs), the international community has set itself a target of halving poverty by the year 2015. Many observers have now come to the conclusion that on present growth trends, there is very little likelihood that this objective can be achieved at any time close to that date in the poorer countries, including in Africa.[1]

2. In its report on capital flows and growth in Africa (UNCTAD, 2000), as in subsequent annual reports on economic development in Africa, UNCTAD has consistently argued that the annual average growth rate would have to be increased to 7 or 8 per cent per annum and be sustained over a considerable period if poverty reduction targets for the continent were to be met. This would imply doubling the current amount of aid and maintaining it at that level at least for a decade if the continent is to break the vicious circle of low growth and poverty. Such action by the international community, within the context of an appropriate mix of domestic policies, would help generate sufficient savings and investment to place Africa on a sustainable growth path and to enable it to reduce aid dependency in the longer term.

3. The continent's debt problems and its resource requirements are inextricably linked to and impact on the capacity of African countries for capital accumulation and growth. Some time ago UNCTAD called for an assessment of the debt sustainability of African countries by an independent body, not unduly influenced by creditors, with an undertaking by creditors to implement fully and swiftly any recommendations that may be made (UNCTAD, 1998, p. xii). This recommendation did not find favour among the donor community. Instead, the Heavily Indebted Poor Countries Initiative (the HIPCs Initiative), and later its enhanced version, were entrusted with ensuring a permanent exit solution to Africa's debt problems. There now seems to be an emerging consensus that the HIPC Initiative and various actions in the context of the Paris Club have not provided the solution to the debt overhang of many African countries . The fact that even those countries that have reached (or are about to reach) the so-called completion point will soon find themselves in an unsustainable debt situation gives credence to the arguments advanced by critics with respect to the inappropriateness of the criteria applied in the debt sustainability analysis. And the fact that several more debt-distressed African countries are not eligible for HIPC debt relief reflects the lack of objectivity in the eligibility criteria.

4. While there are no absolute measures of debt sustainability, the questions that call for a response are the following: What level of debt is sustainable for countries in which the vast majority of the population lives on under $1 a day per person? Have debt sustainability criteria been based on internationally recognized benchmarks such as those of the MDGs, or on objectively and theoretically verifiable criteria? What is the relationship between Africa's total external debt stocks, and the actual amount of debt serviced? Is complete debt write-off a "moral hazard" or "moral imperative"?

5. The current study tries to put these and other related issues in perspective and makes a number of recommendations on how to deal with Africa's debt overhang , either through the adoption of new approaches or a major revision and improvement of the present debt relief policies.

2. Africa's debt problem

6. Africa's external debt burden increased thirty-fold between 1970 and 1999, while per capita incomes remained stagnant. From just over $11 billion in 1970, Africa had accumulated over $120 billion of external debt in the midst of the external shocks of the early 1980s. Total external debt later worsened significantly, rising sharply during the period of structural adjustment in the 1980s and early 1990s, reaching a peak of about $340 billion in 1995, the year before the launch of the original HIPC Initiative.

7. A major observation is that the continent's worsening external debt crises were underscored by the ever-increasing levels of arrears, an indicator of the inability to service debt obligations on time. In 1995, for example, accumulated arrears on principal repayments had exceeded $41 billion, with the countries of sub-Saharan Africa (SSA) owing almost all of this,[2] which represented one fifth of the total debt stock of SSA. Furthermore, there was a significant increase in the multilateral and official debt components of total outstanding debt during the 1980s and 1990s.

8. A cursory glance at Africa's debt profile shows that the continent received some $540 billion in loans, and paid back some $550 billion in principal and interest between 1970 and 2002. Yet Africa remained with a debt stock of $295 billion (figure 1). For its part, SSA received $294 billion in disbursements, having paid $268 billion in debt service, but remains with a debt stock of some $210 billion.

3. Debt relief initiatives

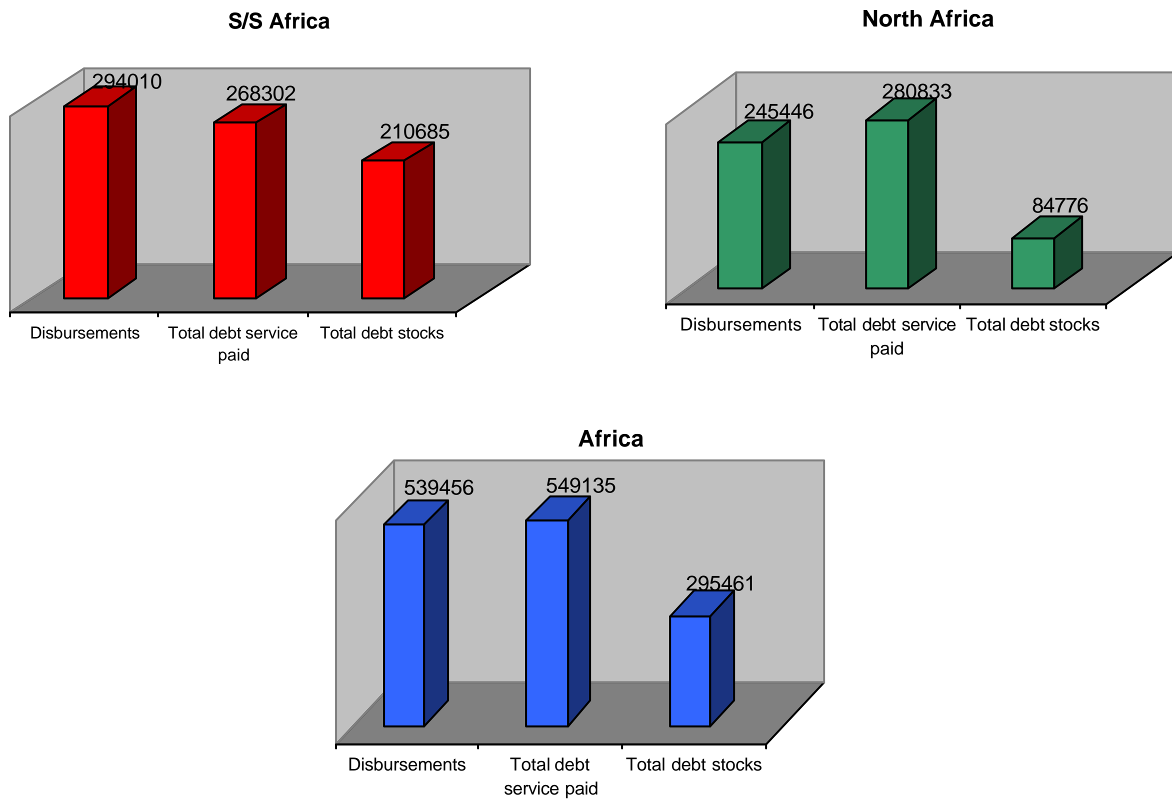
9. The first major coordinated effort of the international community to deal with the debt overhang of the poorest low-income developing countries was the adoption by UNCTAD's Trade and Development Board of resolution 165 S-IX (1978),[3] which translated into debt forgiveness to the tune of some $6 billion for poor countries. For the low-income developing countries, debt relief has traditionally been provided within the context of the Paris Club through rescheduling of principal and interest payments on either concessional or non-concessional terms, most often without any reduction in debt stocks; increasing concessionality and/or write-off of bilateral ODA loans; and new concessional lending. These have normally been within the context of various "terms" agreed by the Paris Club of bilateral donors, such as the Toronto, London, Naples, Lyon and Cologne Terms.[4] The commercial debt of this group of countries was reduced through the IDA Debt Reduction Facility, while special programmes, supported by bilateral donors, were introduced to enable them to meet multilateral debt service obligations. For example, the "Fifth Dimension" programme was introduced in 1988 by the World Bank to enable IDA-only countries to repay interest on past IBRD loans; the IMF introduced the Rights Accumulation Programme in 1990 to enable countries to clear protracted arrears owed to it (for details, see UNCTAD, 1996, p. 49); and in 1997 the African Development Bank created a Supplementary Financing Mechanism, which became operational in 1998, as quick-disbursing concessional assistance to help its member countries meet interest payments on outstanding non-concessional loans (AfDB, 2000, p. 34).

10. The launch of the HIPC Initiative in September 1996 by the Bretton Woods institutions (BWIs) was instigated in response to concerns that many low-income countries would still face unsustainable external public debt burdens after receiving traditional debt relief. Against this background the goal of the HIPC Initiative was to reduce the external public debt burden of all eligible heavily indebted poor countries (HIPCs) to sustainable levels in a reasonably short period of time. As such, the Initiative was to make it possible for all HIPCs to meet their "current and future external debt service obligations in full, without recourse to debt rescheduling or the accumulation of arrears, and without compromising growth" (IMF and World Bank, 2001, p. 4). Bearing in mind that about a third of the outstanding public and publicly guaranteed debt of African countries was owed to the multilateral financial institutions, the Initiative marked a major departure from past practice, which had resisted any reduction of debt owed to multilateral financial institutions (MFIs) on the grounds that this would undermine their "preferred creditor status".

Figure 1

Africa's debt situation (–)

Millions of dollars



Source: UNCTAD secretariat computations based on World Bank, GDF online.

Note: Total debt stocks at 2002 year.
Cumulative disbursements and total debt service paid (–).

4. The HIPC Initiative

11. Only the poorest developing countries are eligible for debt relief under the Initiative. This group of countries is defined as (i) "those that are only eligible for highly concessional assistance from the International Development Association (IDA) and from the IMF's Poverty Reduction and Growth Facility", and (ii) "those that also face an unsustainable debt situation even after the full application of traditional debt relief mechanisms (such as application of Naples terms under the Paris Club agreement)."[5] Once classified, and after a debt sustainability analysis (DSA), a country becomes fully eligible only after successfully implementing macroeconomic stabilization and policy reforms for a period of three years, whereby it reaches decision point (i.e. when the Boards of the IMF and the World Bank formally approve a country's eligibility and the international community commits itself to providing the debt relief required to attain debt sustainability if policy reforms remain on track over the following three years). Thus, a six-year good track record was required under the original HIPC Initiative for reaching completion point and receiving a commitment by the international community to provide "irrevocable" debt relief.[6]

12. Three years after its launch in 1999, it had become evident that the Initiative was not sufficient to provide HIPCs with a permanent exit from repeated debt rescheduling, nor did it provide enough resources to deal with the pressing challenges of poverty reduction. Concerns were expressed about the limited country coverage of the Initiative and the fact that it provided too little debt relief and delivery was too slow. In addition, even with debt relief under the Initiative, beneficiary countries were spending much more on debt servicing than on public health and education. In the light of these concerns and increasing public pressure, including from non-governmental organizations (NGOs) and civil society at large, academics, and some HIPC Governments highlighting the inadequacies of the original Initiative, the IMF and the World Bank formally agreed an enhanced version of the Initiative in September 1999. The main aim of the enhanced HIPC Initiative was to strengthen the link between debt relief and policies tailored to a country's circumstances in order to reduce poverty through the delivery of "deeper, broader and faster" debt relief.

13. The enhanced framework lowered the ratio of net present value (NPV) of debt to exports to a fixed ratio of 150 per cent (replacing the previous range of 200 to 250 per cent). It also lowered the thresholds for the fiscal window to an export-to-GDP ratio of at least 30 per cent (previously 40 per cent) and a revenue-to-GDP ratio of at least 15 per cent (previously 20 per cent). For countries meeting these new thresholds, the NPV debt-to-export target was set at a level that achieves a 250 per cent (previously 280 per cent) ratio of NPV debt to revenues (see table 1). It was estimated that thanks to these changes in the enhanced HIPC debt sustainability criteria, seven additional countries (Benin, Central African Republic, Ghana, Honduras, Lao People's Democratic Republic, Senegal and Togo) would become eligible for HIPC debt relief.[7]

Table 1. Eligibility thresholds: Original and enhanced HIPC

A. Element	B. Original	C. Enhanced
NPV debt-to-export target (%)	200 to 250	150
NPV debt-to-revenue target (%)	280	250
Openness criterion (exports as a % of GDP)	40	30
Revenue threshold (revenue as a % of GDP)	20	15
Debt relief	Fixed at completion point	Interim relief at decision point
Front-loading of debt relief	No	Yes

Source: Gautam (2003).

14. Despite these improvements to the original Initiative, the enhanced HIPC has also been subject to criticism: "… progress has been much slower than expected and the initiative is suffering from problems of under-funding, excessive conditionality, restrictions over eligibility, inadequate debt relief and cumbersome procedures" (United Nations, 2000, p. 2). In particular, the DSA and the overly optimistic assumptions (e.g. GDP and export growth) built into it have been criticized. Also, estimates show that an increasing number of HIPC beneficiaries are not likely to attain sustainable debt levels even after graduating from the Initiative (IMF and World Bank, 2002). Regarding the eligibility criteria, it has been argued that eligibility ratios are not based on a comprehensive measure of poverty or of indebtedness; and as such, neither the poorest nor the most indebted countries are HIPC-eligible. Some of these criticisms are discussed below.

(a) Pace of implementation

15. The implementation of the original Initiative had been slow until the adoption of the enhanced framework in the last quarter of 1999, and once again since December 2000. Within the first three years of its launch (1996 until 1999) only six HIPCs (Bolivia, Burkina Faso, Côte d'Ivoire, Mali, Mozambique and Uganda) reached the decision point. After the adoption of the enhanced framework, there was a commitment by various donor Governments and international organizations that at least 20 HIPCs would receive some debt relief under the Initiative by the end of 2000. Some 22 HIPCs reached their enhanced decision points by the end of December 2000. However, progress has slackened since then, with only four HIPCs (Chad, Democratic Republic of the Congo, Ethiopia and Ghana) having reached the enhanced decision point within the last three years (January 2001 to January 2004). Despite the adoption of a floating completion point, none of the 12 HIPCs that reached their enhanced decision point between October and December 2000 had reached the enhanced completion point by December 2003.

(b) Long-term debt sustainability

16. It is becoming increasingly doubtful whether HIPC beneficiaries could attain sustainable debt levels, based on export and revenue criteria, after completion point, and maintain these in the long term. According to the IMF's and the World Bank's own analysis, some completion point countries (notably Uganda) currently have debt ratios exceeding sustainable levels as defined by the Initiative. There are a variety of reasons for this, including the drastic fall in commodity prices from the late 1990s up to the end of 2002, over-optimistic assumptions about economic and export growth, and in some cases new borrowings (IMF and World Bank, 2002). For example, the World Bank's Operations Evaluation Department (OED) Review reveals that "[T]he overall simple average of the growth rate assumed in DSAs… is more than twice the historical average for 1990–2000, and almost six times the average for 1980–2000" (Gautam, 2003, p. 28). The emergence of this problem highlights the difficulties involved in attaining sustainable debt levels within the context of the Initiative.

(c) Remaining on track after decision point

17. The delays in bringing to completion point some of the HIPCs that have reached decision point since the end of 2000 (as discussed above) have been highlighted by the challenge of ensuring that countries at the interim period (i.e. already past their decision points but not yet at completion point) remain on track with their economic reform and poverty reduction programmes to reach completion point on time. An integral part of this problem is the challenge of maintaining macroeconomic stability and the preparation of a PRSP (Poverty Reduction Strategy Paper), which is a major requirement in the enhanced Initiative, with the prime objective of linking debt relief resources with the promotion of poverty reduction.[8] Finalization of the interim PRSPs has proved particularly daunting. Full engagement of all stakeholders in the participatory process, data collection and analysis, establishing priority objectives and sectoral strategies, and costing these have taken

much longer than expected. Furthermore, difficulties in establishing public expenditure management systems and transparent mechanisms for monitoring debt relief spending, and the paucity of institutional and human resource capacity have militated against the timely preparation of PRSPs[9] (IMF and World Bank, 2003, pp. 15–22).

(d) Interim relief

18. While the increase in interim debt relief is almost certainly an improvement on the original HIPC, the amount of interim assistance remains insufficient to meet the poverty reduction needs in the critical phase of the programme. Under the current arrangements of the major international financial institutions (IFIs), only the IMF could disburse up to 60 per cent of total debt relief as interim relief. The World Bank and the African Development Bank (AfDB) could disburse up to 33 per cent and 40 per cent respectively of total debt relief as interim relief. However, the AfDB, for example, had not met this target in a single case as at the end of 2003.

(e) "Additionality"

19. Dovetailing the above is the issue of whether the Initiative satisfies one of its core principles, namely "additionality". That is, each dollar of debt relief should be *additional* to existing aid budgets. To date, the Initiative appears to have failed in satisfying that core principle. As the World Bank's OED Review shows, there has been close to zero overall additionality, although most recent trends in aid flows indicate some aid reallocations towards eligible HIPCs (Gautam, 2003). The World Bank argues that it is impossible to say conclusively, by looking at data, whether HIPC debt relief is additional because of the problem of the counterfactual. Nevertheless, it concludes that "All in all, the available data indicate a modest rise in total aid resources to HIPCs during the period of the Initiative" (World Bank, 2003, box 6.2, p. 135).

(f) Pre-decision point and post-conflict countries

20. Notwithstanding all the above-mentioned implementation issues, it is the cases of pre-decision point and/or post-conflict countries that might prove to be the Achilles' heel of the Initiative. While the 2004 Spring Summit of the G8 in Sea Island (United States) suggested a top-up of funding for the Initiative, and an extension of the sunset clause by two more years to the end of 2006, it is not yet clear how soon this top-up would be available, and whether it would be enough to cover the costs of debt relief to all pre-decision point countries; the latter are those eligible countries that have yet to be considered for assistance – that is, they have not yet reached their decision points – for a variety of reasons. Current cost estimates do not include the cost of debt relief to some of these countries. Eleven countries fell into this category as at June 2003, with the Lao People's Democratic Republic and Myanmar being the only non-African countries on the list.[10] Almost all of these countries are conflict-affected, are still in conflict or just emerging from conflict; and a few have huge arrears that would have to be settled before reaching decision point.

(g) Domestic debt

21. Some analysts have also contended that any comprehensive debt sustainability analysis of low-income developing countries has to take account of domestic debt since it constitutes a large proportion of total external debt in some of the HIPCs, and has the potential to impact negatively on HIPCs' overall debt sustainability (Beaugrand, Loko and Mlachila, 2002). In addition, domestic debt has wide implications for government budgets, macroeconomic stability, the private sector and overall economic growth performance (*ibid.;* Chirwa and Mlachila, 2004; Fedelino and Kudina, 2003; Debt Relief International, 2003).

22. Even though domestic debt is smaller than external debt, its impact on fiscal debt sustainability could be great. Between 2000 and 2002, for 10 of the 23 African HIPCs at decision or completion point, the stock of domestic public debt as a proportion of total public debt was quite high, ranging from about 17 per cent in the United Republic of Tanzania to 47 per cent in Ghana, and was 48 per cent in Kenya, a country whose external debt is deemed to be sustainable under the HIPC Initiative. The fiscal burden of domestic public debt appears even greater considering interest payments and short maturities. A third of total interest payments by 12 of the 23 African HIPCs is on public domestic debt. Seventy-seven per cent of all interest payments by The Gambia, for example, is on domestic debt. The comparable figure for Kenya is 73 per cent. Thus, domestic public debt could prove a bottleneck for HIPCs in achieving total debt sustainability even if it were possible to reduce their external debt to sustainable levels within the context of the Initiative.

23. In addition to some of the problems cited above, a number of studies have questioned the eligibility criteria of the enhanced HIPC Initiative, and the extent to which the debt "sustainability criteria" are based on objective considerations.

5. Debt sustainability and eligibility criteria

24. There is growing criticism that the HIPC eligibility criteria, defined in terms of NPV debt to exports and thresholds for fiscal sustainability, are arbitrary, lacking in objectivity, and based on debt relief costs to creditors instead of the debt relief needs of HIPCs for sustainable development. Sachs, for example, has argued that official creditors (the Paris Club and multilateral creditors such as the IMF and the World Bank) "have used arbitrary formulas rather than a serious analysis of country needs to decide on the level of debt relief… the so-called debt sustainability analysis of the enhanced HIPC Initiative is built on the flimsiest of foundations" (Sachs, 2002, p. 275).

25. If the goal of the HIPC Initiative is to link debt relief to poverty reduction, a more comprehensive approach is needed in order to provide more sustainable outcomes in terms of both debt sustainability and poverty reduction.

(a) The poverty criterion

26. There is currently a consensus that a monetary measure of poverty is too simple and narrow to capture the multifaceted nature of poverty. Vulnerability factors, which are central to poverty, are excluded from the HIPC conception (Sachs, 2002; Dagdeviren and Weeks, 2001; Gunter, 2003; Drummond, 2004). Poverty should be viewed as "an interlocking web of economic, political, human and sociocultural deprivations, [and] characterised by insecurity, vulnerability and powerlessness" (see UNCTAD, 2002b, for a detailed analysis of the multifaceted nature of poverty). While the HIPC Initiative is supposed to be targeted at the world's poorest countries, it defines those countries in terms of the "IDA/PRGF-only" criterion, which is largely an income per capita-determined criterion.[11]

27. The scope of country selection is regarded as too narrow, as the "IDA-only" criterion disqualifies some otherwise debt-strapped non-IDA countries. This has led some to conclude that political and cost factors were instrumental in setting the debt sustainability thresholds and eligibility criteria (Gunter, 2001; G-24, 2003). An analysis based on data from the UNDP's Human Poverty Index (HPI-1) shows that all African countries for which data is available, except Mauritius, are poorer than the two least poor HIPCs (Bolivia and Guyana).

28. Originally, the Initiative was to address the debt problems of low-income countries, but in its final form it was limited to "IDA/PRGF-only" countries. This implied that a country such as Nigeria became ineligible for debt relief under the Initiative.[12] Undoubtedly, the cost implications of providing HIPC debt relief to such countries would have been much higher.

(b) Debt sustainability criteria

29. As indicated above, there is a strongly argued view in the debt literature that the Initiative's debt sustainability criteria are not objective and lack a robust theoretical justification (see especially Gunter, 2003; Hjertholm, 2003; and Sachs, 2002). However, the World Bank's OED Review (Gautam, 2003) did not consider the debt sustainability criteria to be a major problem, as different indicators have their advantages and disadvantages. On the other hand, the BWIs, by proposing a new methodology for assessing debt sustainability, have implicitly accepted the weaknesses of the enhanced HIPC debt sustainability criteria and the need for some reconsiderations and revisions (see, for example, IMF and World Bank, 2004).

30. The debt sustainability analysis within the context of the HIPC Initiative utilizes two main debt indicators – the NPV debt-to-exports ratio and the NPV debt-to-revenue ratio. Some analysts have pointed to the lack of robustness of these criteria for determining debt sustainability as discussed below.

(i) NPV debt-to-export criterion

31. The debt-to-export ratio criterion has been used for mostly middle-income Latin American countries in the aftermath of the 1982 debt crisis. However, it is difficult to generalize it. A substantial part of Latin American debt was private debt, while exchange rate devaluations following the outbreak of the 1982 debt crisis led to substantial trade surpluses. By contrast, with the exception of four countries (Bolivia, Côte d'Ivoire, Honduras and Mozambique), nearly all of the HIPCs' external debt is public or publicly guaranteed; and second, substantial devaluations cannot be the solution for the debt problems of HIPC economies. This is particularly so because most HIPC economies depend heavily on ODA and imports, and there are very limited options to increase exports of HIPCs under current global realities. In addition, in a few cases, exports of African HIPCs reflect a large proportion of re-exports, but the HIPC framework has not been consistent in either including or excluding re-exports in the calculation of the debt-to-export ratios. This could lead to significant distortions in debt ratios, and problems of comparability of such ratios between different HIPCs.

(ii) NPV debt-to-revenue ratio

32. The NPV total public debt-to-revenue ratio would be a useful indicator of a Government's ability to repay its public debt if domestic public debt were included in total public debt. However, given that the HIPC Initiative has excluded domestic public debt, the indicator loses some of its usefulness, especially as there are considerable differences in the amounts of domestic public debts across HIPCs. Also, there is no theoretical foundation for the required thresholds of the fiscal window. As Martin (2002, p. 3) points out, the NPV debt-to-revenue ratio, which is also commonly referred to as the "Côte d'Ivoire criterion", "was set at a level just low enough to include one country in the HIPC group… but was accompanied by empirically unjustified sub-criteria which exclude many other HIPCs [low-income countries]".

33. Furthermore, 19 of the 27 HIPCs that had reached the enhanced decision point by the end of 2003 are expected to spend at least 10 per cent of government revenues to service public external debt for at least two years during 2003–2005. The Democratic Republic of the Congo, the Gambia, Guinea, Sierra Leone, Sao Tome and Principe, and Zambia were projected to pay more than 20 per cent of government revenues to service their public external debt in at least one of the three years during 2003–2005. Within the group of 27 HIPCs, there is only one country (Burkina Faso) that is projected to spend an average of slightly less than 5 per cent of government revenues to service its public external debt during 2003–2005.

34. In addition to these, there are four generally available and broadly accepted debt indicators that could be used to determine sustainable debt levels of countries: NPV debt-to-gross national income (GNI) ratio; debt service-to-GNI ratio; debt service-to-exports ratio; and debt service-to-revenue ratio.

35. The indebtedness of Africa examined on the basis of these six indicators reveals large differences in debt sustainability across countries and suggests that Africa's debt problem goes far beyond the official group of African countries eligible for the enhanced HIPC debt relief. The analysis suggests that the current HIPC eligibility criteria cover neither the poorest nor the most heavily indebted countries.

6. Post-HIPC debt sustainability

36. Support for the claim that, on the basis of current fiscal policies, debt levels will remain unsustainable for a number of African HIPCs even after they have graduated from the HIPC Initiative has recently come from an IMF Working Paper (Fedelino and Kudina, 2003). It should be noted that assessments of debt sustainability are inherently probabilistic, since by its very nature it is a forward-looking concept.

37. A report by the United States General Accounting Office (GAO, 2004) highlighted the overly optimistic growth assumption of HIPC debt sustainability analysis. The report shows that using the IMF and World Bank's growth rates results in an average probability of achieving debt sustainability in 2020 of 83.9 per cent for the 27 HIPCs that had reached their enhanced decision point by the end of 2003. Using historical growth rates, the average probability of achieving debt sustainability in 2020 drops to 45.1 per cent. Limiting the comparison to the 23 African HIPCs that had reached their enhanced decision points by the end of 2003 results in an even lower probability of 82.5 per cent if the IMF and World Bank's growth rates are used, and a probability of only 41 per cent if these countries' historical growth rates are used. All these data raise serious concerns about the appropriateness of the way in which the amount of debt relief was determined within the HIPC framework.

38. Despite the growing recognition that the use of over-optimistic growth rates has led to misleading conclusions regarding HIPCs' debt sustainability, the HIPC Progress Report (IMF and World Bank, 2003) shows that over-optimistic growth rates continued to be used for some HIPCs' government revenues, and to a lesser degree also for some HIPCs' exports.

39. While more moderate economic growth assumptions have relatively minor implications for the short-run debt ratios, even small differences in the growth assumptions of exports and government revenues have considerable long-term implications, which can easily result in highly unsustainable debt situations as optimistic growth rates affect the HIPC framework's debt sustainability in two ways. First, they have an impact on the debt ratio's denominator, and second, they usually also imply an underestimation of a country's future financing needs. Overestimations of the denominator of a debt ratio and underestimations in the debt ratios numerator would then result in highly unrealistic long-term debt ratios. As an earlier GAO report (2000, p. 15) pointed out, if the United Republic of Tanzania's exports grow at an annual rate of 6.5 per cent (instead of the 9 per cent projected by the IMF and World Bank), that country's debt-to-export ratio could be more than twice what the IMF and World Bank's forecast shows for the projection period.

7. Do HIPCs actually save on debt service?

40. Most of the debt service savings due to the HIPC Initiative are hypothetical, as HIPCs are generally not in a position to fully service their debt. For example, Cohen (2003) has made the suggestion that although the HIPC Initiative has brought the average level of the debt-to-export ratio down from 300 per cent to 150 per cent, it is probable that the reduction from 300 per cent to 150 per

cent merely eliminates the non-payable portion of the debt. Birdsall and Williamson (2002, p. 8) report that the United States Government – which is congressionally mandated to estimate the present value of its loan portfolio – applies a 92 per cent discount to the debt of HIPCs.

41. Indeed, actual debt service payments of the 22 HIPCs were higher in 2001 than they were in 1992, 1993 and 1994 (because of the requirement for all eligible HIPCs to settle all their arrears with the main IFIs before reaching decision point). For a group of 27 HIPCs at decision/completion point, debt service payments have been projected to increase steadily from about $2.4 billion to $2.6 billion between 2003 and 2005.

8. Is HIPC debt relief additional to traditional aid?

42. Comparing the data of the three years before the adoption of the HIPC Initiative (1994–1996) with the data of the three years after the adoption of the HIPC Initiative (1997–99), Gunter (2001) showed that there has been close to zero additionality, even for countries that had reached their completion point. The World Bank's OED Review (Gautam, 2003) concluded that even though there has been close to zero overall additionality, the most recent trends in aid flows indicate some aid reallocations towards eligible HIPCs.[13]

43. Regarding multilateral creditors, in the case of IDA, reflows account for about 40 per cent of current loanable resources, and are projected to increase to about 70 per cent in three decades because of previous agreements among IDA donors not to fully replenish IDA in real terms (for more details, see Sanford, 2004; and GAO, 2004). Furthermore, given that IDA books the actual loss in HIPC loan repayments at the time in the future when the loan payment would have been received, it is pushing these costs to the future, hoping that it will be reimbursed by donors at the time the losses in repayment realize. As of June 2003, IDA already had an unfunded liability of $8.6 billion.

9. Alternative scenarios

44. Some structural variables seem to have gained considerable importance in the process of globalization, particularly with regard to new forms of external financing and emerging new international production structures. These include the import content of exports; the structure of imports; non-debt-creating capital flows, especially foreign direct investment; outflows of profit remittances; and inflows of workers' remittances. Traditional debt indicators cannot capture those variables, although differences in them across countries may imply disparities in the debt-carrying capacity of countries whose debt situation appears quite similar considering debt-to-GDP, debt-to-exports or debt-to-public revenue ratios.

45. The important benchmark for measuring how much debt relief should be offered to HIPCs and other poor debt-distressed countries should be the amount of resources these countries need in order to attain the MDGs, without compromising growth and poverty reduction in the short to medium term. In this regard, it is important to reorient international debt and debt relief policy as an instrument for growth and development in debtor countries within the broader context of international resource transfers for development. Furthermore, national policies would need to underscore the interdependence between external borrowing and debt accumulation on the one hand, and macroeconomic and balance-of-payments management on the other, if unsustainable debt situations are to be avoided in the long term. This would ensure that debt financing is a viable instrument and integral part of national development strategies.

46. This approach to debt sustainability has many advantages. It does not set any arbitrary debt target ratio, avoids the tedious questions related to the additionality of debt relief and the relevance of grants, and entails no negative implications for other equally poor and indebted countries. Most importantly, it integrates debt sustainability issues into an overall assistance and poverty reduction strategy, and provides HIPCs as well as other poor countries with a solid basis to exit from repeated

debt reschedulings. This approach also appears to meet the development needs of very poor developing countries, particularly in Africa.

47. From the viewpoint of heavily indebted poor African countries, the MDG-based approach is the most pragmatic proposal for achieving debt sustainability and the least costly in terms of the opportunity costs of servicing their debt obligations. As noted by Gordon Brown, the British Chancellor of the Exchequer, progress towards key MDGs for 2015 is so slow that in some parts of the world, at current rates, it would take more than a century to achieve them. Specifically, on the target of halving the proportion of people living in extreme poverty in some parts of the world, he said, "Our best estimate is that it will not be achieved in sub-Saharan Africa for more than 100 years". He continued that the first target of the MDGs (i.e. ensuring that by 2015 girls are given the same opportunities in education as boys) would be missed, while targets to establish universal primary education by 2015 would not be met until 2129 (*The Independent*, UK, 17 February 2004).

48. As stated earlier, debt servicing at any level at all by the poorest countries is incompatible with the requirements of attaining the MDGs. Thus, a realistic approach would be a moratorium on debt servicing, while an independent body of experts is constituted to analyse in depth the whole issue of debt sustainability as it applies to the poorest African countries, and to define sustainable debt levels for them (see also UNCTAD, 1998, p. xii), consistent with meeting their development needs, including the MDGs.

10. Conclusions

49. The analysis illustrates the weaknesses of the HIPCs approach with respect to finding a permanent exit solution to the debt crisis of African HIPCs, and highlights the fact that several other equally poor African countries have been left out of the process. On the question of the level of debt deemed to be sustainable for countries the majority of whose population live on less than one or two dollars a day per person, the answer is self-evident: Considering the seriousness with which the international community is addressing the attainment of the MDGs, these targets should be used as a major benchmark for debt sustainability, in which case virtually all of the outstanding debt would need to be written off.

50. It is contended that a write-off of the debt of the poorest countries may represent a "moral hazard" and discourage economic reforms by the debtors, and that it may affect the status that the international financial institutions enjoy as "preferred creditors". However, it could be counter-argued that since the poor countries, particularly in Africa, would have to continue to rely on greatly increased levels of ODA to reduce poverty and attain the MDGs, there is little likelihood of their abandoning economic reform. Furthermore, a write-off of the debt of poor African countries is unlikely to cause financial distress to the IFIs as the amount involved is relatively small compared with their capital and could thus be absorbed through loan loss provisions, as is the practice in the commercial banking sector.

51. In the absence of the political will for debt cancellation, the international community could consider the application of the principles of bankruptcy codes to international debt work-outs corresponding to the notion of insolvency under such codes. For this process not to be unduly influenced by the interests of creditors, it could be undertaken by an independent expert body which would adjudicate on the basis of a more comprehensive set of criteria for debt sustainability, including those of meeting the MDGs.

52. Finally, at issue is whether providing a permanent exit solution to the debt overhang of these poor countries is a moral imperative. To some extent, much of the debt, particularly of countries that were of geopolitical strategic interest, is considered "odious" by many observers. Moreover, a huge increase in multilateral lending has been in the context of structural adjustment policies applied in the

past 20 years, which have failed to engender the expected sustainable growth in Africa. Hence, there would appear to be some need for a shared responsibility towards resolving Africa's debt crisis.

53. That Africa's debt burden has been a major obstacle to the region's prospects for economic growth and investment, and poverty reduction is not in doubt. The continent's debt overhang has frustrated public investment in physical and social infrastructure, and therefore deterred private investment. And by undermining critical investments in health and human resource development, the debt overhang compromised some of the essential conditions for sustainable economic growth and development, and poverty reduction. There is now a consensus that for a permanent solution to the external debt crisis, African countries would need to pursue policies for prudent debt management, economic diversification and sustained economic growth, which would require greater policy space. Equally, there is a consensus that the international community has to support these national policies with concerted and coherent actions in the areas of trade and finance through increased market access, and major reductions, and finally elimination, of agricultural subsidies, combined with international action with respect to commodities, and increased ODA. It is only through this partnership that African countries would be able to achieve sustained high growth rates and development, and implement the necessary poverty reduction strategies in order to meet the development challenges facing the continent, including meeting the MDGs, in particular that of halving poverty by 2015.

Annex

HIPC Initiative: Progress in implementation by country status as of February 2004

Country	Decision point date	Completion point date
Completion point		
Benin	Jul. 00	Mar. 03
Bolivia	*Jan. 00*	*May 01*
Burkina Faso	Jul. 00	Apr. 02
Guyana	*Nov. 00*	*Dec.03*
Mali	Sep. 00	Mar. 03
Mauritania	Feb. 00	Jun. 02
Mozambique	Apr. 00	Sep. 01
Nicaragua	*Dec.00*	*Jan.04*
Tanzania, United Rep. of	Apr. 00	Nov. 01
Uganda	Feb. 00	May. 00
Decision point		
Cameroon	Oct. 00	Floating
Chad	May. 01	Floating
Congo, Dem. Rep. of the	Jul. 03	Floating
Ethiopia	Nov. 01	Floating
Gambia, The	Dec. 00	Floating
Ghana	Feb. 02	Floating
Guinea	Dec. 00	Floating
Guinea-Bissau	Dec. 00	Floating
Honduras	*Jul. 00*	*Floating*
Madagascar	Dec. 00	Floating
Malawi	Dec. 00	Floating
Niger	Dec. 00	Floating
Rwanda	Dec. 00	Floating
Sao Tome and Principe	Dec. 00	Floating
Senegal	Jun. 00	Floating
Sierra Leone	Feb. 02	Floating
Zambia	Dec. 00	Floating

Source: IMF and World Bank (2004, annex II, pp. 9–10).

Note: Countries in italics are non-African countries.

Niger and Ghana have since reached their completion points – in April and July 2004 respectively.

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Notes

[1] Brown and Wolfensohn (2004).
[2] Arrears owed by North African countries amounted to just $288 million in 1995.
[3] "Debt and development problems of developing countries", adopted by the Trade and Development Board at its ninth special session on 11 March 1978.
[4] These terms have reduced bilateral official debt through NPV reductions on debt service or debt stock by 33.3 per cent, 50 per cent, 67 per cent, 80 per cent and 90 per cent respectively.
[5] See the description of the HIPC Initiative on the HIPC website: http://www.worldbank.org/hipc/.
[6] The understanding was that the requirement for the six-year record of satisfactory performance would be implemented on a case-by-case basis flexibly, whereby countries could receive credit for the decision point stage for programmes already under way.
[7] See Perspectives on the Current Framework and Options for Change – Further Supplement on Costing (12 May 1999), table 4; available on the HIPC website.
[8] An interim PRSP (I-PRSP) could serve as a substitute for a blueprint pending the preparation of a full PRSP.
[9] Concerns have also been raised about the stress between ownership of the PRSP process and conditionality, difficulties in linking them to the budgetary process, and the need to improve donor alignment and harmonization around national strategies in order to achieve their successful implementation (see UNCTAD, 2002a, for a further discussion of some of these issues).
[10] The nine African countries are Burundi, the Central African Republic, Comoros, Congo, Côte d'Ivoire, Liberia, Somalia, Sudan and Togo.
[11] While the World Bank Operational Policies stipulate that countries are eligible for IDA on the basis of (a) relative poverty, and (b) lack of creditworthiness, the operational cut-off for IDA eligibility for FY 2004 is a 2002 gross national income (GNI) per capita of $865, using the World Bank Atlas methodology. In exceptional circumstances, IDA extends eligibility to countries that are above the operational cut-off, as has, for example, been done for small island economies.
[12] See, for example, footnote 1 of Claessens, Detragiache, Kanbur, and Wickham (1997) for the original list of HIPCs, which included Nigeria.
[13] The analysis of the 2003 HIPC Progress Report, which examines gross and net flows of official external resources from 1997 to 2002, may be overstated as it includes countries such as the Democratic Republic of the Congo and Rwanda, which owing to civil conflicts had not received much aid in the late 1990s, having become beneficiaries only in the post-conflict period.