

G-24 Secretariat Briefing Paper

on the

Heavily Indebted Poor Country (HIPC) Initiative

(March 2003)

I. Introduction

The Highly Indebted Poor Country (HIPC) Initiative was launched by the International Monetary Fund (IMF) and the World Bank in fall 1996 with the goal to provide a permanent exit from repeated debt reschedulings of HIPCs. There remains broad agreement that the removal of a “debt overhang” is a pre-condition for growth and sustainable development. Three years after the start of the HIPC Initiative, it was clear that the original HIPC framework was not sufficient to provide HIPCs with a permanent exit and at the 1999 Annual Meetings, the HIPC Initiative was enhanced. As of February 2003, 26 countries have reached the enhanced HIPC decision point of which six have reached their enhanced HIPC completion point.¹

II. The Framework of the Enhanced HIPC Initiative

The principal objective of the HIPC Initiative is to bring a poor country’s debt burden to a sustainable level. The HIPC framework is limited to external debt that is public and publicly guaranteed; hence it excludes all domestic debt and all private debt that is not publicly guaranteed. The criterion for being “poor” is to be an “IDA-only” country, which is defined as a country that relies on highly concessional financing from the World Bank’s concessional lending-arm, the International Development Association ((IDA).

The enhanced HIPC Initiative considers a country’s debt to be sustainable if the net present value (NPV)² debt-to-export ratio is maximal 150 percent, based on the debt sustainability analysis at the enhanced HIPC decision point. In cases where a country has both (a) an export-to-GDP ratio of at least 30 percent and (b) a government revenue-to-GDP ratio of at least 15 percent, the enhanced HIPC framework considers also a fiscal

¹ The HIPC Initiative involves two stages. The first stage is a three-year period during which a HIPC works in coordination with the support of the World Bank and the IMF to establish a record of good economic policies and sustained poverty reduction. At the end of this three-year period the World Bank and the IMF determine whether a country’s debt level is sustainable. For those countries whose debt burden remains unsustainable after full use of traditional debt relief mechanisms, a package of debt relief is identified. This is known as the Decision Point. While full HIPC debt relief will be provided at the Completion Point, some creditors might provide interim debt relief (the period between the Decision Point and the floating Completion Point). Under the enhanced framework, the completion point is “floating” as it is tied to the implementation of key structural reforms and poverty reduction policies.

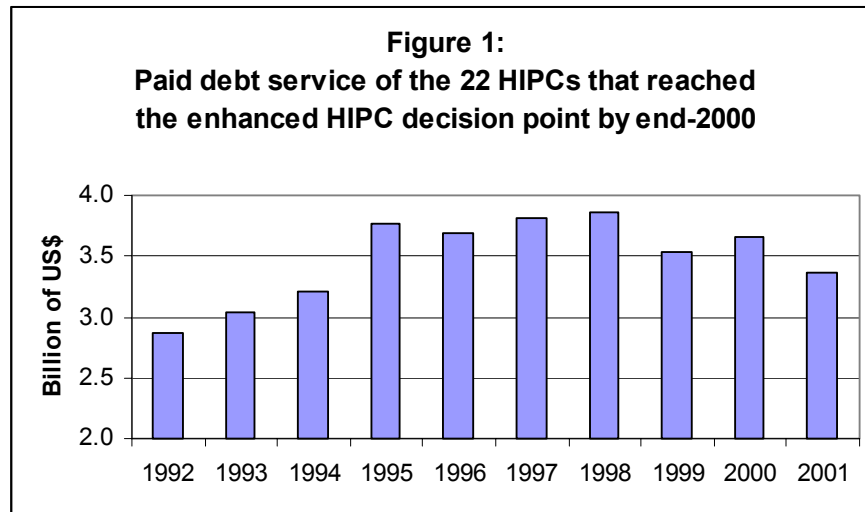
² The net present value (NPV) is the sum of all future debt service discounted by currency-specific discount rates. Although most HIPC debt is concessional, the net present value (NPV) of HIPC debt is lower than the nominal value.

window, whereby it is assumed that a country's debt is sustainable if the NPV debt-to-government revenue ratio is maximal 250 percent.

For HIPC with unsustainable debts, the enhanced HIPC Initiative provides debt relief calculated on the basis of debt sustainability analysis made at the decision point, to be delivered irrevocably at the HIPC completion point, though some creditors provide interim debt relief in the period between decision and completion points. The enhanced HIPC Initiative retains flexibility to review a country's debt conditions at the completion point if unforeseen events beyond the debtor's control justify additional debt relief (so called completion point "topping-up" of debt relief).

III. Financial Impact of the Enhanced HIPC Initiative

According to Bank/Fund calculations, overall debt service of the 22 countries that entered the HIPC program by end-2000 have been cut by roughly one-third, compared with actual payments in the immediate years prior to receiving HIPC debt relief. However, this calculation neglects the fact that actual debt service payments in the years immediately prior to reaching the HIPC decision points have been higher than in earlier years, as HIPCs were not allowed to accrue arrears prior to reaching the HIPC decision point. As Figure 1 shows, comparing the actual payments after reaching the HIPC decision point with actual payments of the early 1990s show that recent payments are still higher than during the early 1990s. Nevertheless, it is clear that countries that have entered the HIPC program have increased their spending on health and education, largely due to (a) policy changes required to reach the HIPC decision points, (b) spending requirements for use of HIPC debt service savings, and (c) policy changes adopted in the PRSPs.



Source: World Bank, Global Development Finance (GDF) 2003.

IV. Shortcomings of the Enhanced HIPC Initiative

A review of the recent debt relief documentation indicates that the enhanced HIPC Initiative suffers from a variety of shortcomings.

One of the most crucial criticisms is that the HIPC Initiative uses inappropriate eligibility criteria and inappropriate debt sustainability indicators, which could be addressed by replacing the current eligibility criteria with more poverty-focused and more fiscal sustainability-based ones. Specifically, it has been suggested to replace the theoretically inappropriate and politically charged “IDA-only” eligibility criterion with a more poverty-focused criterion (like the UNDP’s Human Poverty Index), to eliminate the two threshold ratios for the applicability of the fiscal criterion, and to take other vulnerability factors (like export concentration and export price volatility) into account. It is also suggested that eligibility criteria re-focus on debt service in addition to the current focus on debt stocks. There are currently many countries that are equally poor and equally high indebted than the HIPCs, yet, these countries are—due to inappropriate eligibility and debt sustainability criteria—excluded from the group of HIPCs.

Second, it is recognized that the HIPC Initiative has used unrealistic growth assumptions and a non-transparent methodology for projections on future debt levels. The case of Uganda clearly shows how persistently wrong HIPC debt sustainability projections can be. Though Uganda has undergone two decision and two completion points (one each under the original and enhanced HIPC framework), recent declines in coffee prices have led to the conclusion that Uganda’s NPV debt to export ratio will remain well above the 150 percent level for at least the next 10 years, for some years even above 200 percent, and this without even taking into account that 13 of Uganda’s creditors have not yet agreed to provide HIPC debt relief. Thus, suggestions have been made to use lower bounds of realistic growth assumptions and to improve the transparency of the methodology underlying debt projections.

Third, given that more than half of the 20 countries currently in the HIPC interim period (i.e., they have reached the decision point but not the completion point) are projected to have debt ratios in excess of the HIPC sustainability thresholds at the time of their completion points, it has been suggested that the provision of interim debt relief should be stepped up. Furthermore, it has been proposed that domestic debt service obligations should be taken into account when determining the delivery of HIPC debt relief (though domestic debt would not need to increase overall HIPC debt relief). More generally, given the current projections on the evolution of long-term debt indicators, HIPC debt relief needs to be more front-loaded. Moreover, HIPC debt relief should not be allowed to be provided through mere debt reschedulings.

Fourth, the inflexibility in the allocation of HIPC resources is a major concern voiced by debtor-countries. In order to provide a better balance among development priorities, it has been recommended to relax the current requirement to spend all the savings from debt service solely on social expenditures.

Fifth, while some of the shortfalls in creditor participation and financing problems go beyond the control of the HIPC Initiative, a variety of suggestions have been made to take the financing constraints of some bilateral and multilateral creditors into account by making some marginal adjustments in the burden sharing concept.

Sixth, while policy performance standards may have been lowered to allow 22 countries to reach their enhanced decision points by end-2000 (the so-called Millennium-rush), developments since then indicate a slow implementation of the HIPC Initiative as indicated by the fact that only four HIPCs have reached their decision points during the last 26 months. It is also important to promptly engage with authorities of countries that have not yet benefited, including countries in protracted arrears, to bring them rapidly to the decision point.

Finally, given that there is no objective way to predict the long-term values of currencies, it would make sense to use one fixed discount rate for the NPV calculation of all debt for all HIPCs. This would also eliminate the problems related to the current use of currency-specific discount rates, which results in (i) unfair burden sharing, (ii) unfair assistance levels, (iii) a high degree of volatility in the calculation of HIPC assistance and HIPC costs, and (iv) a theoretically and practically inconsistent rule of what discount rate to use for non-OECD currency denominated debt.

V. Concluding Remarks

Since the HIPC Initiative has not been able to secure long-term debt sustainability there might be some advantages to shifting the goal to achieve long-term debt sustainability from the HIPC Initiative to the PRSP process. However, this might prove ineffective in cases where countries exit the HIPC process before they have reached debt sustainability in the short-term. Private investors are unlikely to invest in a country as long as there are doubts that the country has achieved debt sustainability. Consequently, the country will continue to grow far below its potential. Hence, it is crucial that the HIPC Initiative provides sufficient debt relief to convince private investors that countries will remain able to achieve growth and meet debt service for the foreseeable future. Unfortunately, this is not the case for a number of poor and highly indebted countries.

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