

6

Debt Relief and Sustainable Financing to Meet the MDGs

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In its mid-term assessment of progress toward meeting the Millennium Development Goals (MDGs), the World Bank concluded that “at the country level, on current trends, most countries are off track to meet most MDGs” (World Bank 2008, p. 22). This assessment—mirroring the “development emergency” declared by world leaders at Davos, Switzerland, in January 2008 in issuing the MDG Call to Action—highlights the need to accelerate progress across the developing world.

In June 2008, a high-level panel, the MDG Steering Group for Africa—the region that has made the least progress toward achieving the MDGs—costed out the requirements to meet the MDGs (MDG Africa Steering Group 2008). The total public external financing needed from all sources was estimated at \$72 billion by 2010, \$62 billion of which was requested in the form of official development assistance (ODA). The remaining \$10 billion could come from donors that do not belong to the Development Assistance Committee of the Organisation for Economic Co-operation and Development (OECD), such as China and India, and from private aid.

Financing at such levels represents a significant increase over the current amounts of ODA being provided. In 2006, net ODA to Sub-Saharan Africa was about \$40 billion, of which \$13 billion was debt relief and \$15.5 billion was in the form of development projects and programs being implemented in the country.¹ With debt relief providing such a substantial portion of external assistance, it is natural to ask what contributions the debt-relief program has made in accelerating development.

Debt relief can affect development through several channels. First, by reducing interest and principal payments, it can free up domestic

resources for spending on development programs.² For a given path of future revenues, one would expect to see countries that receive debt relief running significantly higher primary deficits on their budgets than countries that still must service their debt. Of course, increasing expenditures is not the only option that governments are facing. Instead of increasing expenditures, a government could reduce taxes or the rate of public debt accumulation. Given the link between the enhanced Heavily Indebted Poor Countries (HIPC) Initiative and poverty reduction and the small tax basis, however, it seems unlikely that HIPC Initiative resources are used to cut taxes.³

The evidence on the effect of the HIPC Initiative on poverty-reducing expenditures is mixed. Dessy and Vencatachellum (2007) find that debt relief provided to African countries between 1989 and 1993 increased expenditures on public education and health in countries that had improved their institutions. In contrast, Chauvin and Kraay (2005) find no significant effect of debt relief on expenditure on health and education, and Crespo Cuaresma and Vincelette (2008) conclude that the effect of debt relief on educational expenditure is not statistically significant.⁴

Second, debt relief eliminates a significant “overhang” from countries’ balance sheets. Previous literature, mostly associated with commercial borrowing in the 1970s, suggests that countries with high debt levels experience lower investment, because private businesses face greater uncertainty over future tax increases that could be required to service public debt (see, for example, Cohen and Sachs 1986; Krugman 1988). In these circumstances, debt relief can have an indirect benefit on growth by inducing more private investment. Public investment can also be negatively affected if the returns go largely to repay foreign creditors.

Arslanalp and Henry (2005, 2006) find that, unlike the Brady Plan, debt relief provided under the HIPC Initiative had little impact on either investment or growth. They argue that the key constraint to investment in HIPCs is not tax uncertainty but the absence of functional economic institutions that provide the foundation for a profitable private sector. Raddatz (2009) provides evidence that the market values of firms operating in countries that benefited from debt relief under the Multilateral Debt Relief Initiative increased when that initiative was launched. Using vector autoregressive techniques, Cassimon and Van Compenhout (2006) find a positive effect of debt relief on overall investment spending in African HIPCs.

Third, debt relief can open the way for additional borrowing to generate resources for MDG-related programs. There is considerable controversy about this channel. On the one hand, the objective of debt relief is to make countries creditworthy, but doing so has value only if countries borrow and spend more. On the other hand, if countries end up overborrowing—and the fact that they got into debt problems in the first place suggests that there is a proclivity to do so or at least an absence of institutional checks

to prevent overborrowing from occurring—then the benefits of debt relief can be quickly eroded.⁵ If those benefits result from the removal of the debt overhang, as suggested above, then new borrowing will quickly eliminate the investors' confidence in a stable future tax regime.

Fourth, debt relief has been provided in a structured way, focusing on countries that adopt specific programs of reform designed to improve their development prospects and governance capabilities. Even absent new resources, such reforms could generate significant benefits for growth and poverty reduction. From this perspective, debt relief serves as the grease to move the internal political economy of a recipient country toward more liberal reform. The impact therefore depends on whether the reform program is appropriately designed and implemented. Debt relief could also have a negative effect on reform if, for example, the softening of the budget constraint provided an opportunity to relax tax collection efforts (as discussed above, this scenario is unlikely).

This chapter first examines comprehensive international agreements for debt relief. It then reviews the four channels through which debt relief can have an impact on poverty reduction and growth. Specifically, it asks whether countries receiving debt relief have had larger flows of net ODA than countries that did not receive debt relief; whether debt dynamics improved significantly in these countries; whether debt relief affected HIPC's access to finance; and whether reforms were implemented more rapidly as a result of programs that are part of the debt-relief package. The analysis is based on new data on the budgets of debt-relief countries, published in annual debt sustainability analyses.⁶

Providing Funds through Debt Relief: Comprehensive International Agreements

After almost two decades of repeated debt reschedulings for low-income countries, it was clear that debt problems needed to be resolved in a comprehensive way. Therefore, in 1996, the HIPC Initiative was launched. It differed from previous debt-relief initiatives, providing deeper debt relief than did traditional mechanisms and involving debt relief from multilateral financial institutions for the first time.⁷ It was thus the first (and to date, remains the only) internationally agreed-on framework for providing comprehensive debt relief to low-income countries. Although the HIPC Initiative is based on the principle of equal burden-sharing, participation in the initiative is voluntary. While some creditors provide debt relief beyond what is required under the initiative, participation of some creditor groups is limited.

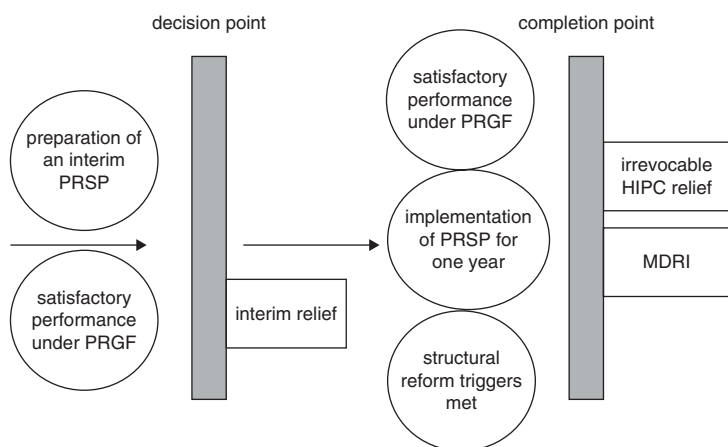
In 1999, the HIPC Initiative was enhanced to provide faster, deeper, and broader debt relief to eligible countries. Debt relief was front-loaded, and the amount to be provided was increased. Moreover, debt relief to

countries would only become irrevocable once they implemented satisfactory policy reform programs that would demonstrate their ability to put the resources freed up through debt relief to good use.⁸

By 2005, it was evident that countries could not expand development programs fast enough to meet the MDGs. The Multilateral Debt Relief Initiative (MDRI) was introduced to reduce further the debts of HIPC. Under the MDRI, three multilateral institutions—the World Bank Group’s International Development Association (IDA), the International Monetary Fund (IMF), and the African Development Bank’s African Development Fund (ADF)—agreed to provide full debt cancellation on eligible credits to countries that reached the HIPC completion point. In 2007, the Inter-American Development Bank announced the IADB-07 Initiative, which parallels the MDRI by providing 100 percent debt relief on eligible IADB credits to post-completion point HIPCs.

The debt-relief process consists of several stages (figure 6.1). Once a country satisfies the eligibility criteria, the executive boards of the IMF and IDA formally decide on its eligibility for debt relief. At this “decision point,” the international community commits to providing debt relief in amounts established under the enhanced HIPC program. Immediately after the decision point, the country starts receiving interim relief on its

Figure 6.1 Description of the HIPC Initiative Process



Source: Authors.

Note: MDRI = Multilateral Debt Relief Initiative; PRDF = Poverty Reduction and Growth Facility; PRSP = Poverty Reduction Strategy Paper.

debt service from major creditors. It implements a program of reform to develop a satisfactory track record of development progress. A *satisfactory* track record is defined as (a) satisfactory performance under the IMF's Poverty Reduction and Growth Facility (PRGF), (b) implementation of the action plan in a Poverty Reduction Strategy Paper (PRSP) for one year, and (c) meeting specified structural reform triggers. After the executive boards of the IMF and IDA approve the country's track record, the country is deemed to have reached a "completion point." At that time, creditors' debt-relief commitments under the HIPC Initiative become irrevocable, and MDRI debt relief is approved and implemented shortly thereafter. Forty countries currently participate in the HIPC Initiative (table 6.1).

After a slow start, the past 12 years have witnessed significant progress in the implementation of the HIPC Initiative. As of April 2009, 35 countries have passed the decision point. Of the 35, 24 have reached the completion point and qualified for irrevocable debt relief under the HIPC Initiative and the MDRI. The overall assistance expected to be provided to the 35 post-decision point countries amounts to \$85 billion in end-2008 net present value terms, including \$28 billion in end-2008 net present value terms under the MDRI. This assistance represents, on average, about 50 percent of these countries' 2007 GDP. The debt burden of HIPCs is expected to fall by about 90 percent after completion point is reached.

Most HIPC debt relief has already been delivered. Total HIPC costs are estimated at \$74 billion in end-2008 net present value terms, of which about half accrues to post-completion point countries. Debt relief to pre-decision point countries is estimated to cost \$17 billion in end-2008 net present value terms. Most pre-decision point countries face tremendous

*Table 6.1 Pre-Decision Point, Interim, and Post-Completion Point HIPCs
(as of April 2009)*

<i>Pre-decision point countries (5)</i>	<i>Interim countries (11)</i>	<i>Post-completion point countries (24)</i>
Comoros, Eritrea, Kyrgyz Republic, Somalia, Sudan	Afghanistan, Central African Republic, Chad, Côte d'Ivoire, Democratic Republic of Congo, Guinea, Guinea-Bissau, Haiti, Liberia, Republic of Congo, Togo	Benin, Bolivia, Burkina Faso, Burundi, Cameroon, Ethiopia, The Gambia, Ghana, Guyana, Honduras, Madagascar, Malawi, Mali, Mauritania, Mozambique, Nicaragua, Niger, Rwanda, São Tomé and Príncipe, Senegal, Sierra Leone, Tanzania, Uganda, Zambia

Source: IDA and IMF, various HIPC documents.

challenges to satisfy the HIPC Initiative criteria. Almost half of pre-completion point countries have been affected by war in recent years, and many remain at high risk for conflict and/or political instability. With limited state capacity, these countries have particular difficulties in developing and implementing appropriate reform programs.

Reviewing Net ODA Flows to HIPCs

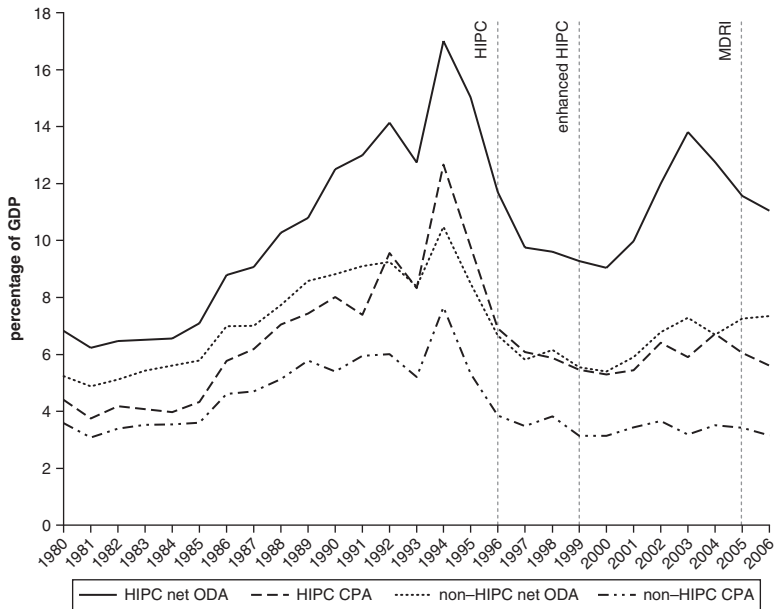
When the enhanced HIPC Initiative was introduced, in 1999, the IMF and the World Bank emphasized that “to be effective, the proposed enhanced (HIPC) Initiative needs to be reinforced by . . . increased aid flows—preferably in grant form—in support of such policies” (IDA and IMF 1999, p. 24). This aspect of additionality was reiterated in 2002, when stakeholders met in Monterrey, Mexico, to agree on common goals for financing development. The consensus reached there was that the “enhanced (HIPC) Initiative . . . should be fully financed through additional resources” (United Nations 2002).

The MDRI was intended to go further than the HIPC Initiative, by providing full debt relief in order to free up additional resources to help countries reach the MDGs. But unlike HIPC Initiative relief, MDRI debt relief does not change the net flows provided by some international financial institutions, because it reduces their annual allocation to a low-income country by an amount corresponding to the debt-service relief provided up front by the MDRI in that year.

Low-income countries experienced a sharp increase in external borrowing during the 1970s and 1980s. Having largely restricted access to private finance, they often contracted loans, either directly from the government or government export credit agencies or through private loans insured by an export credit agency. Unlike private creditors, who typically reduce their exposure when a country enters into payment difficulties, these official creditors responded in the form of “flow reschedulings” by the Paris Club as well as through new lending from multilateral agencies and some additional creditors from the export credit agencies. Moreover, some bilateral creditors (in particular, the then Soviet Union) continued to provide substantial financing to countries with which they had close ties.

Although payment difficulties of many low-income countries started in the 1980s, aid flows to HIPCs (net ODA) peaked in 1994, at about 17 percent of GDP (figure 6.2). Non-HIPCs also saw an increase in aid, with aid reaching about 10 percent of GDP at the mid-1990s. Thereafter, aid to HIPCs and non-HIPCs alike began a decline that was not reversed until after the Monterrey conference on financing development in 2002. Since then, aid (in particular, to HIPCs) has rebounded, but it has still not reached the levels of the early 1990s.

Figure 6.2 Net ODA to Low-Income Countries, 1980–2006



Source: OECD 2008.

Note: CPA = country programmable aid; ODA = official development assistance; MDRI = Multilateral Debt Relief Initiative.

The pattern of net ODA in HIPCs and non-HIPCs is very similar (see figure 6.2). Countries that later became eligible for HIPC Initiative relief received more aid on average than did non-HIPCs during the 1980–2006 period.

The finding that before the launching of the HIPC Initiative, HIPCs were larger aid recipients than non-HIPCs is not surprising. After all, the reason they became eligible for the HIPC Initiative is that they were heavily indebted. Between 1996 and 2000, under the original HIPC Initiative, the gap in net aid received by countries receiving debt relief and those that did not remained virtually unchanged. HIPCs received more aid—on average, about 4 percentage points of GDP—than did non-HIPCs. This is about the same as the gap during the five years before HIPC Initiative relief but considerably more than the gap between these two groups in the early 1980s. Only after the enhancement of the HIPC Initiative did this gap widen somewhat.

Before trying to infer whether the HIPC Initiative has resulted in a greater aid transfer to eligible countries, it is useful to look at an alternative concept of aid. Country programmable aid (CPA) is a measure that is closer than net ODA to the cash flow available for development projects and programs in a recipient country. It is defined as total net ODA less debt relief, technical assistance, humanitarian and food aid, and interest payments made to creditors. Like net ODA, CPA for HIPC countries has systematically exceeded CPA for non-HIPCs, but the gap between these two series has remained roughly constant, at 2 percent of GDP since 1990. There is little visual evidence in figure 6.2 to support the notion that the HIPC Initiative has resulted in a larger transfer of resources to participating countries.

It may be the case that the HIPC Initiative prevented a decline in resource transfers that might have occurred in its absence. There is some evidence to support this. Both interim countries and post-completion point countries continued to receive significant amounts of aid, both net ODA and CPA, since the start of the HIPC Initiative (figure 6.3a and b). While participating in the HIPC Initiative did not halt the aid decline, from which all low-income countries suffered after 1994, post-completion point and interim countries still received more than 6 percent of GDP in aid, comparable to levels they had received in the mid-1980s.

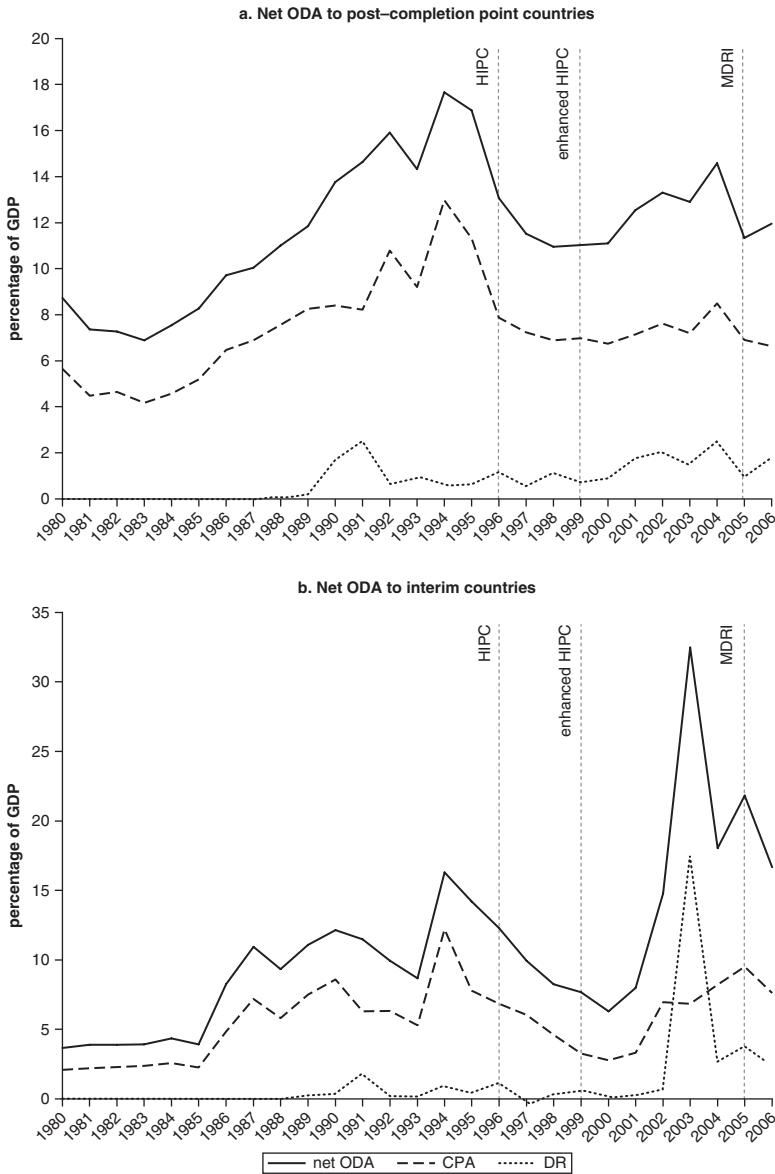
This pattern is in sharp contrast to that of pre-decision point HIPCs, many of them so-called fragile states (figure 6.3c; see chapter 4 for a definition of fragile states). In these countries, aid flows have collapsed since 1994. CPA is down to 2 percent of GDP, half the level of 1980. These countries still receive humanitarian and technical assistance, but donors no longer contribute extensively to development projects and programs.

In summary, participation in the HIPC Initiative has not caused a shift of donor resources toward HIPCs and away from non-HIPCs. But some HIPCs did face the prospect of a rapid decline in aid flows as a result of their debt-service obligations. Thanks to the HIPC Initiative, donors were able to flexibly respond to country needs through debt relief and maintain resource flows at historical levels.

At first sight, it may seem surprising that the billions of dollars allocated to debt relief have not resulted in greater cash flows to the countries on the receiving end. To understand this better, one must understand the details of aid accounting.

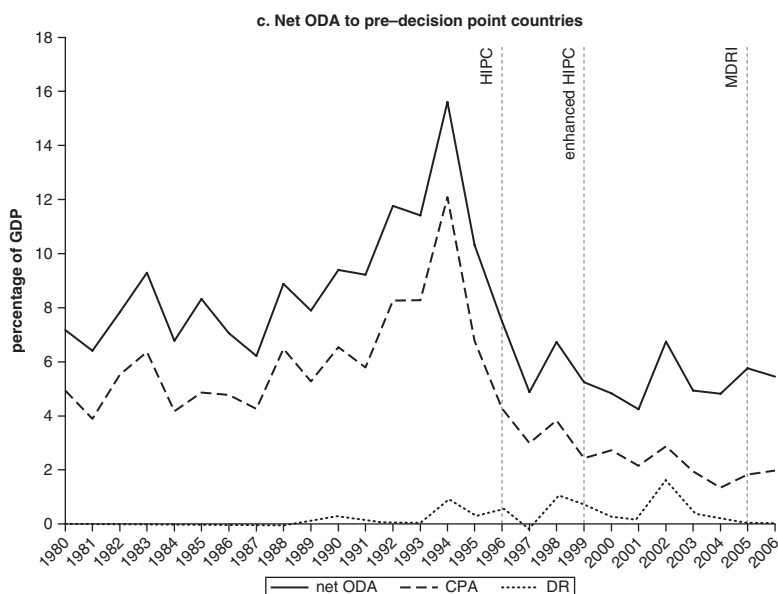
Aid is registered by OECD's Development Assistance Committee whenever a developing country receives a cash flow with a concessional element greater than 25 percent. Some aid is in the form of grants, but much aid has been in the form of low-interest credits. In aid accounting, no difference is made between receiving a grant of \$100 and a credit for \$100; in both cases, aid of \$100 is recorded. In economic terms, the grant is clearly worth more to the recipient country, but this is not captured by the aid statistics until the repayment of the credit starts. At this point, the

Figure 6.3 Net ODA Flows to Post-Completion Point, Interim, and Pre-Decision Point Countries, 1980–2006



(continued)

Figure 6.3 (continued)



Source: OECD 2008.

Note: ODA = official development assistance; CPA = country programmable aid; DR = debt relief.

repayment of the credit in a given year is subtracted from disbursements of new ODA grants and credits.

When debt relief is provided on a credit, it raises problems for accounting. If the debt payment forgiven is counted as more aid, then there is doubling counting: a country would be said to receive “aid” of \$100 on receipt of the initial credit and again when the repayment was forgiven. To prevent double counting, therefore, an offset is recorded for concessional aid forgiveness.

The implication of this offset is that high levels of debt forgiveness may not translate into high levels of net ODA. In fact, MDRI does not affect ODA at the time of its implementation at all, because all the debt being forgiven was already counted as aid. However, everything else being equal, future net ODA flows will be higher, because debt-service payments from MDRI recipients will be lower. This explains the apparent discrepancy between the large numbers recorded as “debt relief” and the much smaller numbers recorded as net ODA.

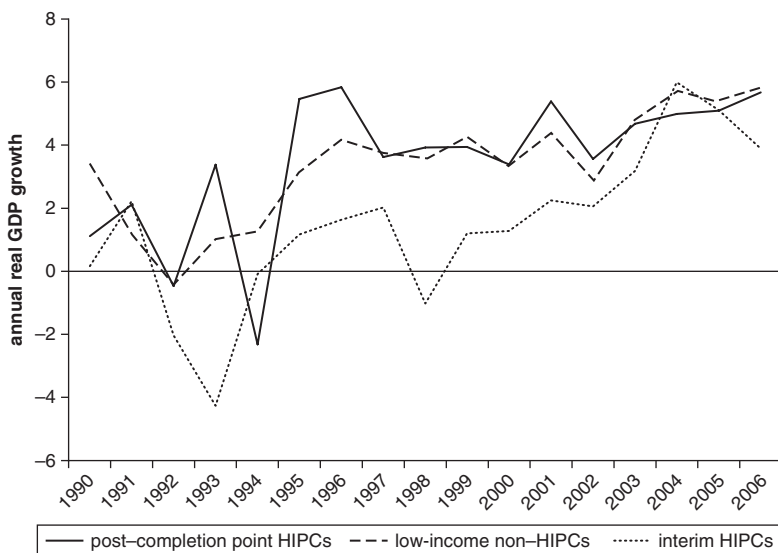
The Impact of Debt Relief

Debt relief can affect development through several channels. It can (a) alter the debt dynamics and free up domestic resources; (b) eliminate debt overhang, thus enhancing investment and ultimately growth; (c) pave the way for additional borrowing; and (d) improve institutional quality as a result of the conditional policies associated with the HIPC Initiative process.

Growth

Did debt relief boost growth by eliminating the debt overhang? Answering this question is complicated by the fact that many factors affect growth. The period 2002–07 was a period of very rapid global growth and extraordinary movements in the terms of trade. Looking at growth over time by countries receiving debt relief does not give an accurate portrayal of the effect of debt relief on growth, because growth in all three groups of countries—post-completion point countries, interim countries, and non-HIPCs—rose during much of this period (figure 6.4).⁹ Average

Figure 6.4 Annual Real GDP Growth in Post-Completion Point HIPCs, Interim HIPCs, and Non-HIPCs, 1990–2004



Source: World Bank 2008.

growth in non-HIPCs, however, accelerated most rapidly. There appears to have been little difference between the growth trends in interim and post-completion point countries in recent years.

Several studies look at the effect of debt relief on growth. Chauvin and Kraay (2005) find no significant effect on public spending, investment, or economic growth. Cordella, Ricci, and Ruiz-Aranz (2005) find a negative marginal relationship between debt and growth for countries with an intermediate level of indebtedness, but they do not find a significant effect for countries with a very high level of debt. They conclude that countries with good policies and institutions face a debt overhang when debt rises above 15–30 percent of GDP but that the marginal effect of debt on growth becomes irrelevant above 70–80 percent.

Debt Dynamics

The enhanced HIPC Initiative and particularly the MDRI led to a substantial debt-stock reduction in post-completion point countries. Debt dynamics, however, are driven by more than just the stock of debt. Critical variables include growth, the interest rate on new debt, changes in the real exchange rate over time, the level of the primary surplus, and a variety of contingent liabilities. If fundamentals driving debt are not fixed, then reduced debt levels will not be sustainable and debt will start to rise again.

To understand the contribution of debt relief to improving debt dynamics, we look at detailed budget data for each HIPC. If we assume that all borrowing is external, the fundamental drivers of debt D expressed in local currency can be expressed

$$\dot{D} = iD - PS + C - S + xD, \quad (6.1)$$

which states that the change in net debt is given by the new borrowings needed to fund interest payments on debt (iD , where i is the nominal interest rate on dollar debt) minus the primary surplus (PS) plus any contingent liabilities (C) the government may take on minus seigniorage (S) (interest-free high-powered money creation).¹⁰ The term xD is the capital gain/loss on dollar-denominated debt, where x represents the percentage change in the nominal exchange rate expressed in local currency per dollar, so that smaller (larger) than x connotes a depreciation (appreciation). Contingent liabilities C are typically off-budget items. In some cases, they represent bailouts of the financial system, during which governments step in to protect bank deposits. In other instances, they are payments made by governments to bail out companies that are too big to fail or payments tied to a previously guaranteed level of activity. Private toll roads and utilities are examples of projects on which many developing country governments have had to pay unanticipated amounts

to private companies. Corruption, unrecorded expenses, court-ordered judgments, payment of arrears, and other items enter into contingent liabilities. For developed countries, contingent liabilities tend to be very small, particularly when expressed as a percentage of GDP. But for developing countries, especially those with weak budget institutions, contingent liabilities can be very large.

It is convenient to express equation (6.1) in terms of the debt-to-GDP ratio, d , and to recognize the fact that debt for most low-income countries is denominated in foreign currency whereas GDP is in local currency. Thus, when the real exchange rate depreciates, the debt-to-GDP ratio tends to rise. In equation (6.2), r is the real dollar interest rate on debt (i – U.S. inflation); e is the depreciation of the real exchange rate (defined in local currency per dollar so that e larger than (smaller than) 0 means a real depreciation (appreciation)); and g is the real growth rate of GDP:

$$\dot{d} = d(r + e - g) - ps + c - s. \quad (6.2)$$

The lower case letters ps , c , and s represent the variables PS , C , and S expressed as percentages of GDP.

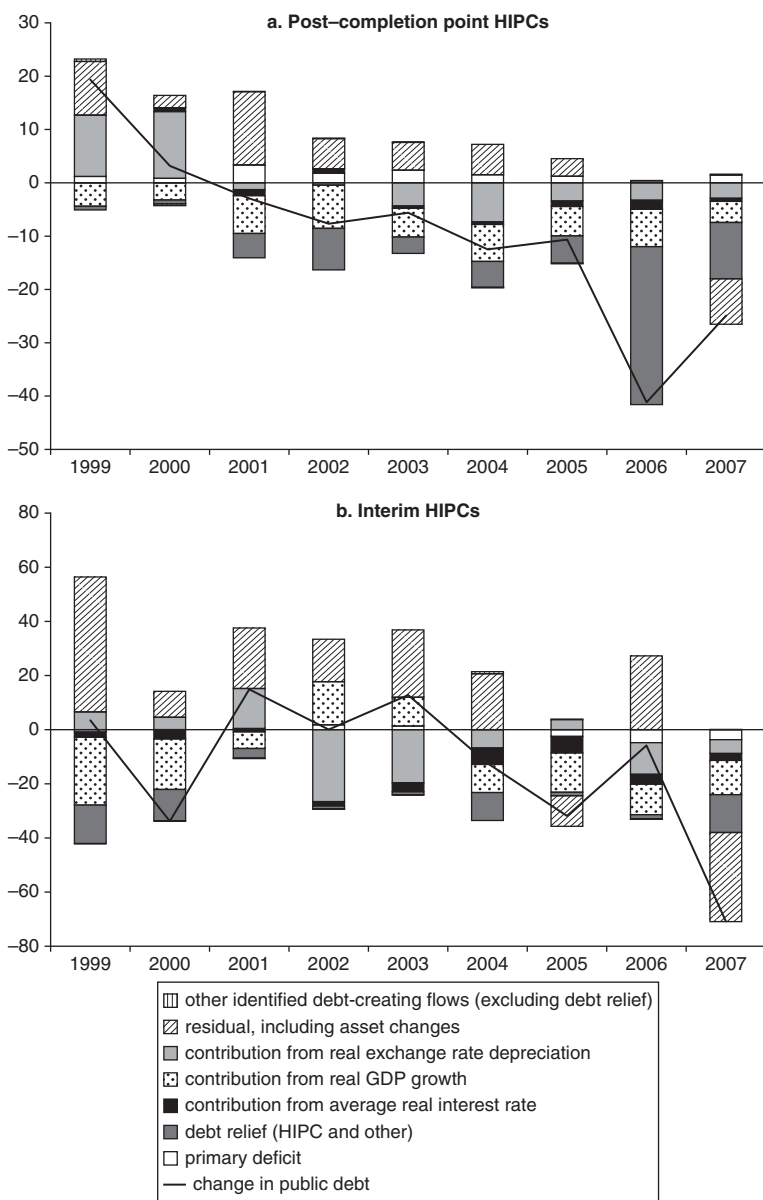
Equation (6.2) shows that debt relief can fundamentally change debt dynamics when the sum of the interest rate and the rate of depreciation of the real exchange rate exceeds the growth rate of the economy. Thus, debt relief is particularly useful for slow-growing countries, for countries that face high interest rates, and for countries that face major pressures on their exchange rates because of difficulties in expanding exports and attracting private capital flows.

Equation (6.2) also highlights the role of the primary surplus and contingent liabilities. If significant borrowing is required to fund these items, then the debt ratio will rise even if debt stocks have been reduced to low levels.

There is also concern that countries that have received debt relief will start to borrow on commercial terms, increasing the effective interest rate they pay on debt. Any increase in interest rates would worsen debt dynamics. In order to understand the quantitative dimensions of the variables expressed in equation (6.2), we look at the change in the debt-to-GDP ratio for 41 low-income countries, using the same sample used in the previous section.

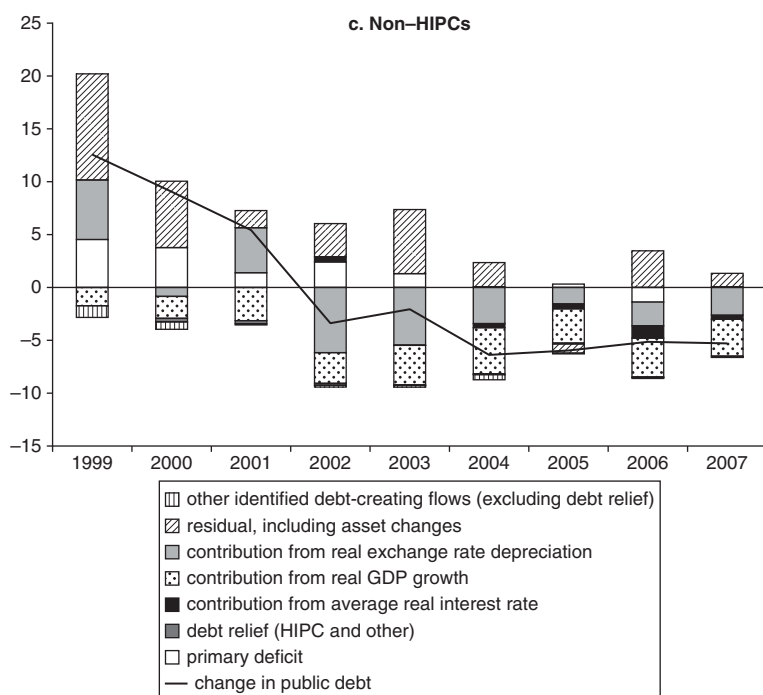
Debt relief has indeed had a sizable impact on the debt-to-GDP ratio of both post-completion point and interim countries. Among post-completion point countries, the debt-to-GDP ratio has fallen by very substantial amounts (figure 6.5). The overall decline in the debt ratio is much higher than the decline attributable to debt cancellation, suggesting that these countries would have shown a marked reduction in their debt ratios even in the absence of debt relief (assuming that debt relief does not affect growth).

Figure 6.5 Debt Decomposition in Post-Completion Point HIPCs, Interim HIPCs, and Non-HIPCs, 1999–2007 (percentage of GDP)



(continued)

Figure 6.5 (continued)



Source: Joint World Bank-IMF debt sustainability analyses for low-income countries.

The main additional factors behind the decline in debt in post-completion point countries are higher growth and the real appreciation of the currency, caused in part by strong commodity prices in recent years. These factors reduced the debt-to-GDP ratio by about 10 percentage points each year between 2001 and 2007.

Interim countries show the same pattern. There, too, debt ratios declined dramatically, but debt levels nevertheless remained high, with debt-to-GDP ratios in countries like Guinea and Haiti exceeding 350 percent.¹¹ The sharp reduction in debt in 2007 is attributable to the clearing of arrears for Liberia. In addition to debt relief, however, growth and the real exchange rate also contributed very significantly to the decline in the debt burden.

In interim countries, large contingent liabilities have been major drivers of debt buildup in the past. These countries often have weak public

management systems, so it is not surprising to see them faced with obligations that do not pass through the budget. Debt relief by itself cannot halt such claims; improved institutional structures are needed. Non-HIPCs also experienced declines in their debt ratios during this period: thanks to growth and real exchange rate appreciation, their average debt-to-GDP ratio fell to less than 50 percent.

Investment and New Financing Options

According to the debt overhang argument, debt relief should lead to increased private investment. Some researchers, such as Arslanalp and Henry (2005), argue, however, that debt relief provided to HIPCs had little impact on either investment or growth, because the key constraint to investment in these countries is not tax uncertainty but the absence of functional economic institutions. As discussed above, there is evidence that generous ODA helped HIPCs service their external debt. Still, markets may perceive debt relief positively. Raddatz (2009) concludes that the MDRI had a positive impact on the financial assessment of firms operating in countries benefiting from debt relief, but he argues that this may have been caused by exchange rate effects and improved growth prospects for the firms themselves rather than by debt relief.

Improved macroeconomic performance by some Sub-Saharan African countries combined with debt relief led to increased interest by foreign investors: private capital flows to Sub-Saharan Africa rose sharply, from very low levels in 2002 to up \$50 billion in 2007 (IMF 2009). These private capital flows are still mainly equity foreign direct investment (FDI) in the mineral sector, but there is an increase of inflows to other sectors, such as banking and telecommunications, as well.

The improvement in policies and institutions in HIPCs reinforces the improvement in creditworthiness brought about by debt relief. Some studies show a direct link between strong policies and a stronger capacity to carry debt (Kraay and Nehru 2004). In the Debt Sustainability Framework for Low-Income Countries of the World Bank and the IMF, countries with better policies are permitted higher indicative debt thresholds.

These two channels of improved creditworthiness—the decrease in absolute debt levels and the higher debt-carrying capacity associated with reforms—have led some countries to explore new forms of borrowing, including on commercial terms. Four Sub-Saharan African countries, two of which are HIPCs, have successfully tapped international capital markets: Ghana issued a \$750 million bond in September 2007, and the Republic of Congo (an interim HIPC) issued a \$478 million bond in December 2007 to replace defaulted London Club debt. Gabon, which is not a HIPC, issued a \$1 billion bond in December 2007 in the context of debt relief provided by the Paris Club. Other countries plan to follow.

A better policy environment and a boom in commodity prices have also made Sub-Saharan African countries more attractive to nontraditional creditors. While these creditors offer funds that allow countries to address large investment needs, the terms they offer are often nonconcessional, causing some concern that countries may return to situations of debt distress.

There is some hope that this time around new borrowing will be more beneficial to development than it was in the past. There is already talk that Africa represents a new frontier for financial markets (Nellor 2008). In a comparison between eight African “emerging markets” today and members of the Association of Southeast Asian Nations (ASEAN) in 1980,¹² just before an acceleration of their growth and mobilization of external resources, Nellor (2008) finds that the African economies compare favorably with the ASEAN economies on six of eight categories important to investors (inflation, financial depth, foreign exchange reserves, debt, FDI inflows, and portfolio inflows).¹³ What is important for debt dynamics is the use to which the new flows are put.

In past years, several HIPCs have tried to develop local-currency bond markets. Local-currency bonds involve no currency risk for the borrower, improve the flexibility of financing, can be a means of developing local financial markets, and help sterilize aid flows. Domestic debt represented more than 30 percent of GDP in Ethiopia and Sierra Leone and about 20 percent of GDP in Cameroon.

Several African countries with solid growth performance and a benign debt sustainability outlook have succeeded in selling treasury bills in their own currency to foreign investors. Foreign investors have also been attracted by high-yield earning opportunities. For commodity-exporting countries, such as Nigeria and Zambia, rising commodities prices have raised expectation of future currency appreciation. Moreover, the relatively low correlation between African markets and other markets can provide opportunities for reducing portfolio risk and volatility.

Foreigners held about 11 percent of Ghana’s domestic currency government debt, estimated at more than \$400 million, at the end of June 2007. This share is reportedly even higher in Zambia, and foreigners seem to hold significant shares of domestic currency-denominated government debt in Tanzania and Uganda. All four countries have passed the HIPC completion point.

Overborrowing

Evidence from recent debt sustainability assessments confirms that debt sustainability is a concern in all pre-completion point HIPCs and in more than a third of low-income non-HIPCs (see chapter 5). Despite the significant decline of debt burdens thanks to debt relief, less than half of post-completion point HIPCs had low risk of debt distress in 2008. To prevent

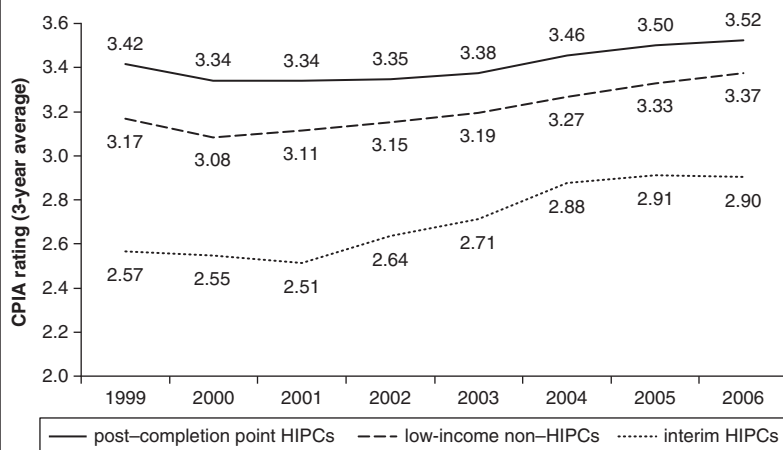
low-income countries from overborrowing, major creditors now provide a higher level of grants to countries with an elevated risk of debt distress under the Debt Sustainability Framework for Low-Income Countries. Still, several factors, including changes in the financial environment, have contributed to an increase in the risk of debt distress of completion point HIPCs. There is evidence of deterioration in the distribution of ratings, with the number of countries with high risk ratings increasing from two to four between 2007 and 2008.

Policy and Institutional Improvements

Countries receive debt relief only after developing a track record of a satisfactory reform program. If debt relief is the “sweetener” to encourage significant reform, the benefits from debt relief may be felt in longer-term institutional development and growth.

Among low-income countries, post-completion point countries have the best policies and have seen significant improvements in their policy performance over the past few years (figure 6.6).¹⁴ That progress is consistent with the requirement that they implement satisfactory programs of reform.

Figure 6.6 CPIA Index for Low-Income Countries, 1999–2006



Source: World Bank staff.

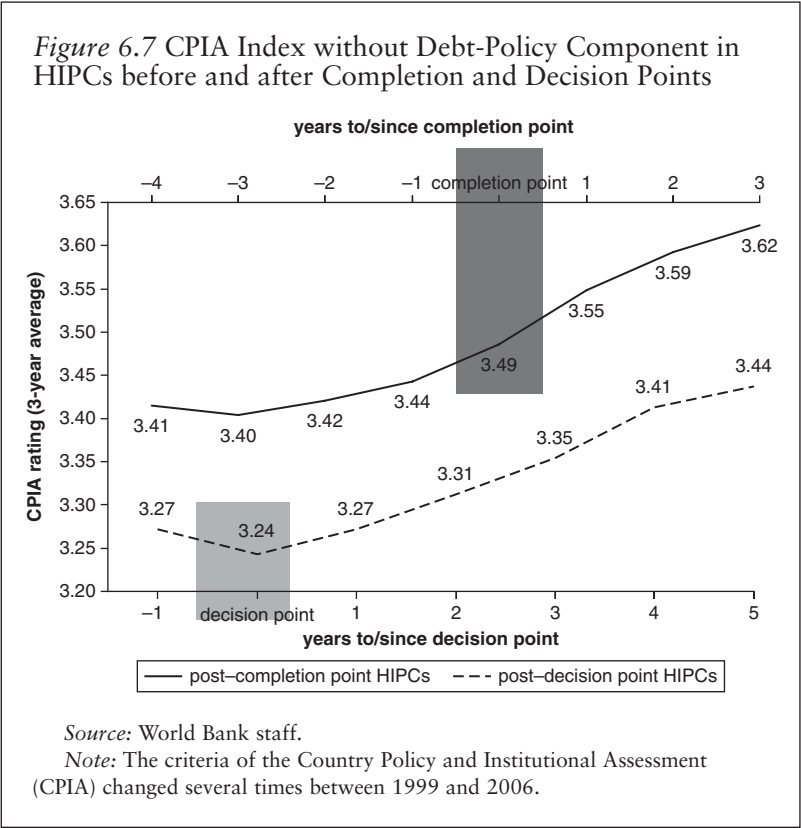
Note: The criteria of the Country Policy and Institutional Assessment (CPIA) changed several times between 1999 and 2006.

Interim countries also seem to have improved their policies, albeit in a less smooth fashion. A period of poor policy performance until 2001 gave way to a spate of reforms, but the years between 2004 and 2006 appear to have seen stagnation in policies.

Non-HIPCs also show sustained policy improvement during this period. In fact, the gap between these countries and post-completion point HIPCs has narrowed in recent years.

The link between policy improvement and debt relief is more clearly seen when policies are compared before and after the completion and decision points (figure 6.7). Strong gains in policy performance are evident in the three years before completion point, and the momentum of these reforms seems to carry through to the years after the completion point has been reached.

A similar rate of improvement can be seen for countries after reaching the decision point. In fact, despite the fact that today's interim countries

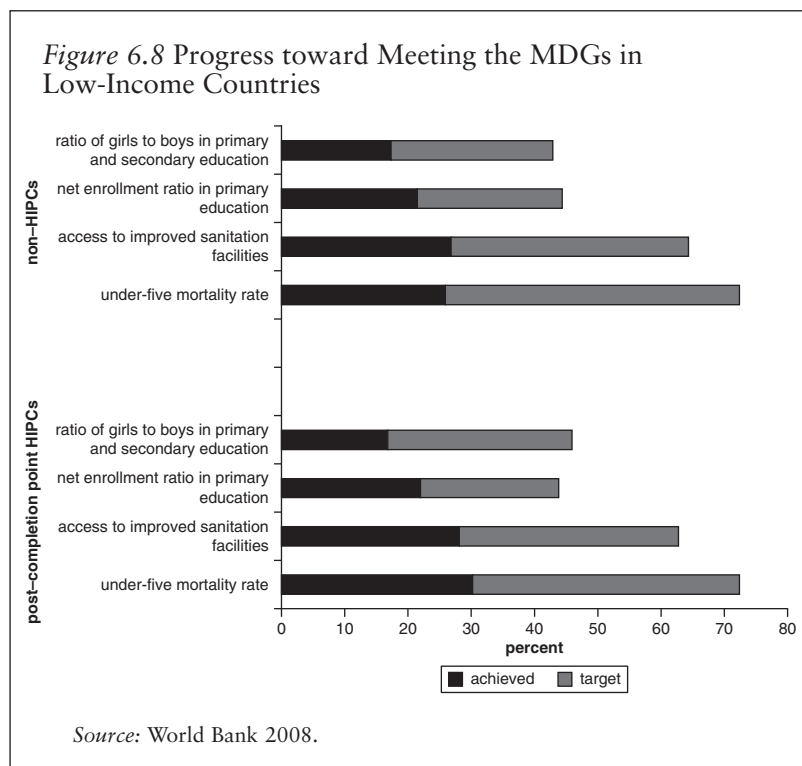


are those that had some of the worst initial conditions of all HIPCs, they have already reached almost the same level of average policy performance as other HIPCs at their completion point.

Achieving the MDGs

Accelerated resource flows are required to help HIPCs meet the MDGs: both HIPCs and non-HIPCs have a significant distance to go to meet these goals (figure 6.8). Although post-completion point HIPCs have a demonstrated track record of better policy performance, this has yet to show up in better outcomes on MDG-related targets.

In education, health, and sanitation, HIPCs and non-HIPCs alike have achieved less than half the progress necessary to be on track to meeting their targets. It will take much more than finance to achieve these targets, but finance is probably a necessary condition for success. Using the new-found space created by debt relief offers the best hope for rapidly increasing expenditures on MDG-related programs.



Concluding Remarks

Despite very significant debt relief provided to a set of developing countries through the HIPC Initiative and the MDRI, beneficiary countries have not been able to use the fiscal space afforded to increase their primary deficits. The evidence suggests that net resource transfers to HIPCs and non-HIPCs do not differ markedly. Moreover, as a share of GDP, the size of resource transfers today is at about the same level as in post-completion point HIPCs in the mid-1980s. The hope that debt relief would translate into significantly more resources appears not to have been realized.

Debt relief has had more success in avoiding a collapse of resource transfers to low-income countries. HIPCs that have completed or even initiated reform programs under the debt-relief initiatives have managed to reverse the declining trend in resource transfers.

Debt dynamics have been improved thanks to debt relief and the accompanying improvement in policies. HIPCs are in much stronger positions after passing the completion point, but they still have average debt levels of more than 40 percent of GDP. Moreover, debt dynamics have been improving as a result of other factors, including an environment of better growth, stronger exchange rates (as terms of trade improved), and reduced contingent liabilities in recent years. For interim countries, which still have large debt levels, the shocks to growth, exchange rates, and contingent liabilities could continue to drive debt dynamics even after full debt relief is afforded.

An improved debt sustainability outlook—accompanied by an enhanced security situation, better macroeconomic performance, and high commodity prices—has led to increased interest in Sub-Saharan Africa by foreign investors. Private capital flows have risen sharply since 2002. Although most of these private capital flows are equity FDI in the mineral sectors, several African countries have sold treasury bills in their own currency to foreign investors, and two HIPCs successfully placed international bonds. A better policy environment and the boom in commodity prices have also made Sub-Saharan African countries more attractive to nontraditional creditors. However, in the long run, the financing offered by these creditors might exacerbate debt sustainability, because funding terms are often nonconcessional. Private flows may also be volatile in today's tight credit markets.

Policies and institutions have become stronger in countries that have adopted reform programs—before the decision point, between the decision point and the completion point, and after the completion point. However, non-HIPCs have also improved policy performance, and there is no discernible difference in the rate of improvement in HIPCs and non-HIPCs, making it difficult to attribute the improvements to the HIPC Initiative.

Despite debt relief, the strengthening of institutions, and a relatively benign external environment during the past several years, post-completion point HIPC countries are still far away from reaching the MDGs. Fiscal space seems not to have increased as a result of debt relief, although improvements in the debt sustainability outlook have contributed to increased interest by foreign investors, opening up new financing opportunities. Still, the debt sustainability outlook is highly sensitive to the terms of new financing, and the number of post-completion point countries with a high risk of debt distress is increasing. Improvement in the policy and institutional environment in these countries offers hope that resources will be used more effectively in the future than they have been in the past.

Notes

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1. DAC counts only debt relief on nonconcessional debt as net ODA. Gross debt relief to Sub-Saharan Africa, including concessional aid, totaled \$56 billion in 2006 (OECD 2008).

2. This does not necessarily apply to countries that are in arrears before debt relief, because their debt service may actually increase as arrears are rescheduled in the context of debt relief. Still, arrears clearance is generally an important step for accessing new finance that can lead to an increase in net transfers for a given country.

3. Several studies fail to find any tax reduction in HIPC countries in Africa (see Cassimon and Van Compenhout 2006; Gupta, Powell, and Yang 2006; Kpodar and Unigovskaya 2008), although in at least one case, debt relief has been used to reduce domestic debt.

4. Because HIPC debt relief is linked to poverty-reducing expenditures, it would simply replace one form of expenditure (debt service) with another (poverty-reducing expenditures), leaving the overall budget deficit unchanged (see Burnside and Fanizza 2005).

5. *Overborrowing* is used here to mean borrowing more than the optimal level given the availability of high-return investment opportunities. The practical identification of overborrowing is fraught with difficulty.

6. See <http://web.worldbank.org/WBSITE/EXTERNAL/TOPICS/EXTDEBT/DEPT/0,,contentMDK:20701723~menuPK:64166739~pagePK:64166689~piPK:64166646~theSitePK:469043,00.html>.

7. Traditional debt relief generally allowed for a debt reduction of up to 67 percent in net present value terms.

8. To be eligible for debt relief under the HIPC Initiative, a country must satisfy the following criteria: (a) GDP per capita below \$965 and to be IDA-only and PRGF eligible, (b) a net present value of debt-to-exports ratio after traditional debt relief beyond 150 percent, and (c) a track record of reform and sound policies through IMF- and IDA-supported programs.

9. The sample consists of 41 countries: 21 post-completion point countries, 9 interim countries, and 11 non-HIPCs. It covers countries for which there are adequate fiscal data on which to decompose debt.

10. In debt accounting, the primary surplus includes grants as revenues.

11. The implication of such numbers is that these countries have debt levels equal to the approximate total value of their capital stock.

12. The eight countries—Botswana, Ghana, Kenya, Mozambique, Nigeria, Tanzania, Uganda, and Zambia—account for 40 percent of the GDP of Sub-Saharan Africa excluding South Africa.

13. Of course, a comparison with ASEAN does not imply that debt distress will be avoided: several ASEAN countries suffered from major debt problems in 1997–98.

14. There is a minor bias in these figures, because debt sustainability is itself a component of the policy and institutional index, and debt sustainability automatically improves once debt relief has been granted. This effect is small, however, and does not materially affect the trends reported.

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