



DEVELOPMENT COMMITTEE
(Joint Ministerial Committee
of the
Boards of Governors of the Bank and the Fund
On the
Transfer of Real Resources to Developing Countries)



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**NOTE ON THE STATUS OF IMPLEMENTATION OF THE HIPC INITIATIVE AND
FURTHER CONSIDERATIONS ON AN OPERATIONAL FRAMEWORK FOR DEBT
SUSTAINABILITY IN LOW-INCOME COUNTRIES**

Attached for the October 2, 2004, Development Committee Meeting is a note entitled "Note on the Status of Implementation of the HIPC Initiative and Further Considerations on an Operational Framework for Debt Sustainability in Low-Income Countries," prepared by the staff of the IMF and the World Bank, and to be considered under Item IV of the Provisional Agenda.

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DEVELOPMENT COMMITTEE MEETING OCTOBER 1, 2004

Note on the Status of Implementation of the HIPC Initiative and Further Considerations on an Operational Framework for Debt Sustainability in Low-Income Countries

1. **At the Development Committee meeting on April 25, 2004, Ministers discussed issues related to the progress of the HIPC Initiative and debt sustainability in low-income countries.** This note updates Ministers on progress in implementing the HIPC Initiative, reports on the extension of the sunset clause, and briefly describes recent work on the modalities and operational implications of the proposed framework for debt sustainability in low-income countries.

HIPC INITIATIVE: STATUS OF IMPLEMENTATION

2. **Since the last annual meetings in September 2003, six countries (Guyana, Nicaragua, Niger, Ethiopia, Senegal, and Ghana) have reached their completion points,** increasing the number of post-completion point HIPCs from eight to 14 as of end-July 2004. Madagascar is expected to reach completion point in the near future.

3. **The total debt stock of the 27 HIPCs that have reached the decision point is projected to decline by about two-thirds, from about US\$80 billion to US\$26 billion (in 2003 NPV terms) after the delivery of traditional debt relief by bilateral creditors, assistance under the HIPC Initiative, and additional bilateral relief.**¹ The debt stock of the 14 countries that have reached their completion points has declined from US\$37 billion to US\$12 billion, or by about 67 percent in NPV terms.² This reduction in the debt stocks translates into substantial savings in terms of debt-service payments for HIPCs. Compared with the 1998-99 averages, debt-service payments relative to exports and fiscal revenue in the 27 countries that have reached their decision or completion points have declined from an average of about 16 percent and 24 percent to 10 percent and 15 percent in 2003, respectively. Debt relief under the HIPC Initiative has helped countries to increase poverty-reducing expenditures, which on average have risen from 6.4 percent of GDP in 1999 to 7.9 percent of GDP in 2003, a level about three times that spent on debt service.

4. **The cost of providing debt relief under the Initiative to 37 countries including Liberia, Somalia, and Sudan is estimated at US\$54.5 billion in 2003 NPV terms,** slightly higher than earlier estimates.³ The revision in total costs reflects mainly

¹See "Heavily Indebted Poor Countries (HIPC) Initiative – Status of Implementation," September 9, 2004, (IDA/SecM2004-0599), <http://www.worldbank.org/hipc>.

² These calculations are based on the assumption of full creditor participation. Financing assurances already obtained for these countries average approximately 90 percent of total required HIPC relief.

³ These estimates do not include Angola, Kenya, Vietnam, or Yemen, which are estimated to have debt ratios below the HIPC thresholds. Lao P.D.R. is not included due to uncertainty on debt data.

topping-up assistance to Niger and Ethiopia approved at their completion points. Nearly two-thirds of this amount has already been committed to countries that have reached the decision or completion point. The cost of assistance is roughly equally divided between multilateral (46 percent) and bilateral creditors (49 percent), while commercial creditors account for about 5 percent of the total costs.

5. **For countries that are in the interim period between their decision and completion points, maintaining macroeconomic stability remains the foremost challenge.** Of the 13 HIPC in the interim period, six are on track with their macroeconomic programs,⁴ but the remaining seven face policy challenges, mainly in the area of fiscal policy.⁵ Staffs of the Fund and IDA continue to assist these countries in the implementation of reforms supported by Fund Staff Monitored Programs (SMPs) and IDA-supported programs.

6. **Only three countries in the interim period have yet to complete their Poverty Reduction Strategy Papers** (The Democratic Republic of Congo, Guinea-Bissau and Sierra Leone). Completion of PRSPs, followed by implementation in the subsequent year, is not expected to impede progress in reaching the completion point, provided that performance under Fund- and IDA-supported programs remains satisfactory.

7. **There are 11 potentially eligible HIPC that have not yet reached their decision points.** Nearly all these countries have been affected by conflict and several have large arrears to various creditors.⁶ These problems have complicated the design and implementation of viable policy adjustment and reform programs. Notwithstanding these difficulties, some are making progress in establishing a track record of macroeconomic performance.

⁴ The six countries are: The Democratic Republic of Congo, Honduras, Madagascar, Rwanda, Sierra Leone and Zambia.

⁵ The seven countries are: Cameroon, Chad, The Gambia, Guinea, Guinea-Bissau Malawi, and Sao Tome and Principe.

⁶ For an in-depth analysis of the challenges facing post-conflict countries, see "Assistance to Post-Conflict Countries and the HIPC Initiative," IMFC/Doc/3/01/7 and DC2001-0014, April 20, 2001, <http://www.imf.org/external/np/hipc> and <http://www.worldbank.org/hipc/progress-to-date/progress-to-date.html>.

THE SUNSET CLAUSE

8. **A sunset clause was included in the HIPC Initiative to prevent the Initiative from becoming a permanent facility, minimize moral hazard, and encourage the early adoption of programs of reform.**⁷ In July 2004, the IMF and World Bank Boards discussed four options to address the end-2004 expiration of the sunset clause. The options were: (i) letting the sunset clause take effect at end-2004 (Option 1); (ii) extending the sunset clause by another two years (Option 2); (iii) extending the HIPC Initiative for five years solely for countries meeting predefined criteria to reach the decision point (Option 3); and (iv) limiting debt subject to debt relief under the HIPC Initiative using a cutoff date of end-2004 (Option 4).

9. **Based on guidance and feedback from Directors, staffs submitted a revised set of options for the Boards to consider.**⁸ Based on these options, the Fund and IDA Boards agreed to extend the existing sunset clause by two years to end-2006 to provide an opportunity for the remaining countries to meet the eligibility requirements for the HIPC Initiative. Directors also agreed to modify the extension by limiting eligibility to a set of countries that have not yet benefited from HIPC debt relief and that meet the HIPC Initiative's income criteria (IDA-only/PRGF-eligible countries) and indebtedness criteria (external public debt in excess of the enhanced HIPC Initiative thresholds after full application of traditional debt relief mechanisms) based on end-2004 data.

10. In all cases, countries would (as now) receive debt relief under the Initiative based on their level of debt upon reaching the decision point.

⁷ The 1996 HIPC Initiative Program of Action stated that "the Initiative would be open to all HIPCs that pursue or adopt programs of adjustment and reform supported by the IMF and IDA in the next two years, after which the Initiative would be reviewed and a decision made whether it should be continued." See "A Program for Action to Resolve the Debt Problem for HIPCs—Draft Report of the Managing Director of the IMF and the President of the World Bank to the Interim and Development Committees" (EBS/96/152, 9/17/96) and SecM96-975. Under the sunset clause, IDA-only and PRGF-eligible countries need to have adopted a program of adjustment and reform supported by the Fund and IDA by end-2004 to be eligible for assistance under the Initiative; there is no deadline for eligible countries which, after the application of traditional debt relief mechanisms, qualify for assistance under the Initiative to reach the decision point.

⁸ "Heavily Indebted Poor Countries Initiative (HIPC): Status of Implementation", August 25, 2004, pp. 20-22, (IDA/SecM2004-599).

**OPERATIONAL IMPLICATIONS OF THE PROPOSED FRAMEWORK FOR DEBT
SUSTAINABILITY IN LOW-INCOME COUNTRIES**

11. **In February 2004, Bank and Fund staffs proposed a framework for assessing debt sustainability in low-income countries that is expected to guide borrowing and lending decisions by matching the need for financing by low-income countries with their current and prospective debt sustainability.** At the Spring Meetings in April 2004, Ministers broadly endorsed this framework.⁹

12. **The framework proposes that debt sustainability analyses (DSAs) evaluate a country's debt burden with reference to indicative external debt-burden thresholds that are informed by the quality of policies and institutions.** Countries would be considered at high risk of debt distress if debt-burden indicators are expected to exceed thresholds for significant periods. In these countries, creditors would need to be prudent in providing new loans and increasing the burden of debt. Where policies and institutions are strong, however, and resources beyond a country's capacity to carry debt may be employed productively to generate growth and achieve the MDGs, these additional resources should be provided in the form of grants rather than loans.

13. **In a follow-up paper discussed by the Fund and Bank Boards on September 24th and 28th respectively, staffs have further examined issues related to the operationalization of the framework,** including the robustness of the indicative debt burden thresholds, the modalities for implementing debt sustainability analyses; and the operational implications for the Bank, Fund, and other official creditors.

The paper notes that:

- a) **The proposed framework serves a different purpose from the ongoing HIPC Initiative, but the two approaches are not incompatible.** The purpose of the HIPC Initiative is to address an existing debt overhang through fully coordinated action by creditors, while the new framework is intended to provide forward-looking guidance on new borrowing and lending decisions, that allows adequate room for judgment.
- b) **Indicative thresholds for debt burden indicators should be informed by the quality of policies and institutions.** Notwithstanding their limitations, empirical thresholds can help inform decisions on debt sustainability, and consequently, the financing mix for low-income countries. Such thresholds, however, must be treated as indicative guideposts rather than rigid ceilings, and allow room for judgment based on specific country circumstances. Whether the specific threshold levels are appropriate is ultimately a policy decision about the tolerable risk of debt distress.

⁹ This framework was described in the Note on Debt sustainability presented to the Development Committee on April 25, 2004 (SecM2004-0133).

- c) **The framework emphasizes that the analysis of debt sustainability should include an assessment of domestic debt, given its growing importance in low-income countries.** The framework provides the opportunity to incorporate domestic debt in the analysis of public sector debt dynamics. Employing indicative domestic debt thresholds, however, would be problematic given the different role and characteristics of domestic debt across low-income countries and the difficulties in collecting reliable and consistent data. The staffs propose to adopt an approach to domestic debt that is closely tailored to country-specific circumstances.
- d) **Regarding the modalities for preparing debt sustainability analyses, the proposal is for Bank and Fund staffs to collaborate closely in the preparation of DSAs with the objective of a common assessment, and each institution will report to its respective Board.** Close collaboration is essential because: (i) the DSA has implications for aggregate financing and donor coordination in low-income countries; a consistent Bank-Fund assessment of a country's debt sustainability will be critical in facilitating dialogue on these matters with country authorities, donors and creditors; and (ii) the Bank and Fund staffs will focus on their areas of comparative advantage, which together would strengthen the analysis.

14. **The framework is expected to form the basis for operational changes in IDA and PRGF operations.** IDA Deputies recently indicated broad support for allocating grants to countries with a high risk of debt distress, and Bank staff are finalizing a rules-based allocation framework that currently uses the indicative thresholds in the new framework, but would gradually incorporate results of DSAs as they become available. For the Fund, the framework would form the basis for incorporating debt sustainability considerations more explicitly in Fund conditionality.

15. **In the discussion at the Boards of the Bank and Fund, Directors welcomed the paper's clarification of the modalities and operational implications of the proposed DSA framework for low-income countries.** Most Directors agreed with the distinction made between the proposed debt sustainability framework and the HIPC Initiative. They regarded the basic analytic foundations of the framework as sound, and considered the use of stock as well as flow indicators for the debt burden as appropriate. Given the role of the CPIA in the framework as the primary indicator of policy and institutional performance, Directors welcomed its prospective move toward disclosure. Directors, however, asked that the set of debt burden thresholds be revised to reflect a lower tolerance for the risk of debt distress and asked the staffs to prepare a joint note on alternative threshold options together with their financing implications. They further recommended that these thresholds be reviewed periodically in light of experience and new information, and revised if necessary.

16. **Directors also asked that the staffs review the modalities for preparing debt sustainability analyses in the Bank and Fund in the light of Directors' comments.** Directors endorsed a collaborative process between the Bank and the Fund in

the preparation of debt sustainability analyses. Many Directors supported the objective of the IMF and the World Bank agreeing on a common DSA. Such an assessment should be developed jointly by both staffs, based on a clear division of labor, and in line with the mandates of the two institutions, with the Fund focusing on aggregate aspects of macroeconomic policy and the Bank focusing on medium-term real GDP and export growth as well as available financing. Some Directors in the Fund were of the opinion that the IMF should take the lead in preparing the DSAs given its mandate for macroeconomic surveillance.