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)

April 14, 2004
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NOTE ON DEBT SUSTAINABILITY

Attached for the April 25, 2004, Development Committee meeting is a "Note on Debt Sustainability," prepared by the staff of the World Bank and the International Monetary Fund. This item will be considered under Item II of the Provisional Agenda.

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DEVELOPMENT COMMITTEE MEETING—APRIL 25, 2004

Note on Debt Sustainability

Prepared by the Staffs of
The World Bank and International Monetary Fund

April 2004

1. **Financing the Millennium Development Goals (MDGs) will require a substantial increase in resource flows to developing countries**. Unless these resources are provided on appropriate terms, they could jeopardize debt sustainability in many low-income countries, particularly those where the external debt burden is already high and the economy is vulnerable to exogenous shocks. While a durable achievement of the MDGs depends on many factors, notably the pursuit of strong policies and reforms, maintaining debt sustainability is a prerequisite that requires an early, proactive strategy. This note focuses on two key elements of such a strategy: successful implementation of the HIPC Initiative; and a proposed framework for new concessional lending that tailors the terms of new lending to a country's risk of debt distress.[1] The third and final section in this note highlights directions for future work.

LOWERING DEBT BURDENS THROUGH THE HEAVILY INDEBTED POOR COUNTRIES (HIPC) INITIATIVE

2. **The HIPC Initiative is aimed at reducing the debt burdens of the most heavily indebted of the world's poorest countries**. Twenty seven HIPCs are already receiving debt relief expected to amount to US$51 billion in lower debt-service payments over time (equivalent to $34.7 billion in 2003 NPV terms). Of this amount, debt relief of $21 billion has been committed irrevocably to 10 countries that have reached the completion point. The total debt stock of the 27 HIPCs that have reached their decision points is projected to decline by about two thirds, from $77 billion to $26 billion (in 2003 NPV terms) after the application of traditional and HIPC debt relief, and additional bilateral relief beyond HIPC committed by several creditors.[2] Savings in lower debt service payments, which declined from 3.4 percent of GDP in 1999 to a projected 2.2 percent of GDP in 2004, have helped in increasing poverty-reducing expenditures from an estimated 6.4 percent of GDP in 1999 to 8.7 percent of GDP projected for 2004 for these 27 countries.

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[1] The note draws heavily on joint Bank-Fund papers on: "The Heavily Indebted Poor Countries Initiative—Statistical Update (March 2004, forthcoming); and "Debt Sustainability in Low-Income Countries—Proposal for an Operational Framework and Policy Implications", February 3, 2004, (SecM2004-0035), http://www.worldbank.org/hipc/; and February 3, 2004, (SM/04/27).

[2] The figure is based on the net present value of the assistance at the time of the decision point for each country. See "Heavily Indebted Poor Countries (HIPC) Initiative—Status of Implementation," September 12, 2003, (IDA/SecM2003-0477/1), http://www.worldbank.org/hipc/; and SM/03/294, August 18 2003 or IMFC/Doc/8/03/04, September 15, 2003, http://www.imf.org/external/np/hipc/2003/status/091203.htm.

3. **The total costs for 37 of the 38 countries deemed potentially eligible for assistance under the HIPC Initiative, including Liberia, Somalia, and Sudan, are estimated to be about $53 billion in 2003 NPV terms**—compared to $50 billion in 2002 NPV terms estimated in the September 2003 Status of Implementation Report.[3] Of this amount, the multilateral institutions are expected to contribute 46 percent, official bilateral creditors 49 percent, and commercial creditors 5 percent.

4. **The pace at which countries in the interim period are reaching their completion points has picked up,** with Guyana and Nicaragua reaching the completion point in December 2003 and January 2004, respectively. Several more countries are scheduled for completion point in 2004, with Niger, Ethiopia, and Senegal expected to be considered shortly.

5. **Of the 17 HIPCs in the interim period, 11 are largely on track with their macroeconomic programs.**[4] The other six are facing policy challenges in the areas of structural reform and public resource management.[5] Program discussions are continuing in these countries, with a view toward putting in place corrective measures so as to establish a track record that will allow resumption of their PRGF-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). Although other interim period countries still need to implement their Poverty Reduction Strategies satisfactorily for a year, this requirement will be unlikely to impede their progress toward reaching their completion points as scheduled, provided their macroeconomic performance remains on track.

7. **There are also 11 HIPCs that have not yet reached the Decision Point under the enhanced HIPC Initiative even though the HIPC sunset clause will take effect at the end of 2004.**[6] Many of these countries are affected by conflict and, in some instances, have substantial arrears outstanding to various creditors. A few of them, however, are moving toward establishing a track record of macroeconomic performance, which is a requirement for eligibility under the HIPC Initiative. The staff of the Bank and the Fund are currently evaluating alternative options for handling the sunset clause and will present the Boards of the two institutions with policy options prior to the Annual Meetings in September 2004.

8. **The HIPC framework establishes the possibility of providing additional relief ("topping up") at the completion point** if it is determined that exogenous factors have

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[3] Cost estimates are not available for Lao P.D.R., due to insufficient debt data.

[4] Cameroon, Democratic Republic of Congo, Ethiopia, Ghana, Honduras, Madagascar, Malawi, Niger, Rwanda, Senegal, and Sierra Leone.

[5] Chad, The Gambia, Guinea, Guinea-Bissau, São Tomé and Príncipe, and Zambia.

[6] Burundi, Central African Republic, Comoros, Republic of Congo, Côte d'Ivoire, Lao P.D.R., Liberia, Myanmar, Somalia, Sudan, and Togo.

caused a fundamental deterioration in a country's economic circumstances. The staffs of the Fund and the Bank have recommended topping up for the two countries that are expected to reach completion point in April: Niger and Ethiopia.

9. **Staff have recently updated estimates of topping-up costs**. The methodology used in preparing these estimates makes no assumption as to whether topping up would be justified: it only indicates the maximum envelope of costs were topping up to be provided in each case where the NPV of debt exceeds the HIPC thresholds. The new estimates reflect updated information on discount rates, exchange rates, new borrowing, exports and revenue, as well as a revision of the assumption for the completion point date for 13 of the 17 countries in the interim period.[7]

10. **The debt in excess of the HIPC thresholds is estimated at about $1.9 billion, compared to $1.3 billion in September 2003**. Four factors have contributed to this change: the depreciation of the US dollar against other major currencies accounted for almost $400 million of the increase; new estimates of completion point timing and associated borrowing in the interim period contributed another $400 million; declines in the US dollar discount rate and other discount rates applied to the debt stock accounted for under $100 million of the increase; and revised estimates of export performance since September *lowered* the debt in excess of the threshold by almost $300 million.

A PROPOSED FRAMEWORK FOR ACHIEVING DEBT SUSTAINABILITY IN LOW-INCOME COUNTRIES[8]

11. **The HIPC Initiative will reduce the stock of debt in qualifying HIPCs, but it cannot guarantee long-term debt sustainability in these countries.** Indeed, debt burden indicators are trending upward in some post-completion point HIPCs as well as in some other low-income countries. The challenge these countries face is how to ensure that debt remains sustainable while mobilizing the external resources needed to meet the MDGs.

12. **The concept of debt sustainability in low-income countries is somewhat different than in middle-income countries.** Low-income countries' tend to rely on official flows, so their ability to repay depends in large part on the willingness of official creditors and donors to maintain positive net transfers through new financing. Nevertheless, excessive debt in low-income countries poses serious problems. A debt overhang may undermine urgent progress on policy reform and discourage private investors. And to keep high debtors afloat, lenders may be forced to provide them scarce concessional resources, often at the expense of other deserving countries.

[7] The last assessment was in September 2003 at which time there were 19 interim period countries. Since then, two countries, Guyana and Nicaragua reached their completion point but neither qualified for topping up. See "Enhanced HIPC Initiative: Considerations Regarding the Calculation of Additional Debt Relief at the Completion Point", September 2, 2003 (IDA/SecM2003-0476); and August 18, 2003, (SM/03/295).

[8] See "Debt Sustainability in Low-Income Countries—Proposal for an Operational Framework and Policy Implications", op. cit..

13. **The need for external support notwithstanding, low-income countries themselves are primarily responsible for maintaining debt sustainability**. This applies equally to HIPCs, where debt burden indicators after debt relief compare favorably with the average for low-income countries. The improvement of domestic policies and institutions will continue to be essential for sustaining rapid growth and improving the prospects for debt sustainability by strengthening the ability to repay. In addition, low-income countries can take measures to increase their resilience to exogenous shocks by building reserves, using market instruments to hedge risks where possible, and over the long run, diversifying production and export bases.

14. **The Boards of the World Bank and Fund recently discussed a proposed new framework for assessing debt sustainability in low-income countries.** When fully operational, the proposed new framework will be expected to guide borrowing and lending decisions by providing a more systematic basis for analyzing debt sustainability prospects, including individual countries' current and prospective ability to service debt.

15. **The proposed new framework for assessing debt sustainability has two main elements:** first, an analysis and careful interpretation of actual and projected external and public debt-burden indicators under a baseline scenario and in the face of plausible shocks; and second, indicative country-specific debt-burden thresholds for public and publicly guaranteed external debt that depend on the quality of the country's policies and institutions. Countries in which the debt-burden indicators exceed the thresholds, or are likely to do so under plausible assumptions, would be deemed to have a significant risk of debt distress, signaling the need for a cautious approach to new borrowing. The appropriate strategy would also be influenced by other country-specific factors, including the level of domestic public debt and debt service. Where policies are sound and the need for funds to achieve the MDGs exceeds the level of new lending considered prudent under the circumstances, the global community would need to provide the additional resources on more concessional terms, including, in many cases, in the form of grants.

16. **The analysis underpinning the framework suggests three broad implications for all creditors and donors.** First, creditors would need to consider more carefully their current lending policies to ensure that they appropriately reflect countries' risk of debt distress. Second, the need of low-income countries for additional external resources from donors and creditors to meet the MDGs, and the desire to avoid future debt distress in these countries, will almost certainly require an increase in the concessionality of the aggregate financing package to low-income countries, including an increase in the volume of grants. And third, since a prudent approach to new borrowing may not be sufficient to preserve debt sustainability in the face of large, unforeseen, exogenous shocks, donors and creditors may also wish to develop instruments and mechanisms to ease the impact of such shocks *ex post* in a timely and coordinated manner.

17. **The proposed debt sustainability framework and the HIPC Initiative complement each other in the pursuit of a common objective.** The HIPC Initiative addresses the existing debt overhang in HIPCs and is built upon binding thresholds to achieve debt reduction which ensure equal treatment of qualifying countries. The proposed debt sustainability framework, on the other hand, serves the complementary purpose of informing

judgments on appropriate future borrowing policies in low-income countries to ensure that debt burdens do not again reach unsustainable levels.

18. **The modalities of implementing the proposed framework need to be clarified before it can become fully operational**. This includes developing detailed guidelines for Bank and Fund operations, consistent with the framework, and appropriate modalities for co-ordination with other creditors and donors around a common debt sustainability analysis at the country level. Once the modalities are clarified and operational guidelines are in place, Bank and Fund staff, in partnership with other stakeholders, will periodically review the experience with their implementation, introduce improvements as necessary, and more generally, continue to conduct research on the issues, in close consultation with partners and stakeholders.

DIRECTIONS FOR FURTHER WORK

19. **The above discussion points to directions for further work on a range of issues, the most important of which are:**

- **How should the global community address the debt overhang in HIPCs that will not be able to enter the HIPC Initiative by the end of 2004 when the sunset clause becomes effective?** Progress in establishing a track record of macroeconomic performance will be of great importance for the 11 HIPCs that have not yet reached the decision point. At the same time, a viable solution must be found for those countries that will not have done so by the end of the year. Staffs will be presenting options to their respective Boards in a joint note scheduled for June this year and make final proposals before the Annual Meetings.

- **How should the proposed new debt sustainability framework be made operational?** There are a number of issues that still need to be resolved before the proposed debt sustainability framework can become fully effective. In addition to making further refinements in the proposed methodology for debt sustainability assessments, it will be necessary to clarify the process for undertaking the assessments, the operational implications for the Bank and the Fund, and procedures for coordination with other multilateral and bilateral partners. In particular, the issue of how best to integrate the debt sustainability framework in the IDA-14 negotiations will need to be addressed; and how the global community should coordinate its actions to ensure low-income countries receive adequate levels of finance on appropriate terms to meet the MDGs while maintaining debt sustainability.

- **How can the global community, including the World Bank and the IMF, assist low-income countries in preserving debt sustainability in the face of exogenous shocks?** Even if a prudent borrowing strategy is effective in preventing normal volatility from undermining debt sustainability, low-income countries may still need assistance from the global community to mitigate the effects of occasional large shocks.