

"Debt relief and sustainable financing to meet the MDGs"¹

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Abstract

This paper looks into the impact of debt relief on development, using budget information from a large sample of Heavily Indebted Poor Countries (HIPCs) and non-HIPC low-income countries (LICs). We consider four main channels. First, by reducing interest and principal payments, debt relief can open up fiscal space for spending on development programs, including Millennium Development Goal (MDG) programs. The reduction in debt service payments can also allow recipient countries to run higher primary deficits than countries which still must service their debt fully. Second, debt relief eliminates the “debt overhang” from recipient countries’ balance sheets, having a positive effect on private sector investment. Third, debt relief can allow countries to borrow and spend more. Finally, the conditionality associated with debt relief can encourage reforms, which may—if appropriately designed—generate benefits for growth and poverty reduction. Combining evidence on these channels, the paper shows that despite overall access to more financing, post-completion point HIPCs have not made faster progress towards the MDGs than non HIPC LICs.

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I. Introduction

In its mid-term assessment of progress towards meeting the Millennium Development Goals (MDGs), the World Bank concludes that “at the country level, on current trends, most countries are off track to meet most MDGs”.² This assessment, mirroring the “development emergency” declared by world leaders at Davos in January 2008 when 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 with the least progress towards achieving the MDGs - costed out the requirements to meet the MDGs.³ The total estimated public external financing need from all sources was \$72 billion by 2010, of which some \$62 billion was requested from official development assistance. The remaining \$10 billion could come from non-DAC donors, 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 (SSA) was about \$40 billion. Of this amount, however, \$13 billion consisted of debt relief⁴, while \$15.5 billion was in the form of development projects and programs being implemented in the country. 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.

There are several channels through which debt relief can affect development. First, by reducing interest and principal payments, debt relief can free up domestic resources for spending on development programs. To the extent that this channel is important, we would expect to see countries with debt relief running significantly higher primary deficits on their budgets (smaller surpluses) than countries which still must service the debt. Evidence on this has been mixed. Depetris, Chauvin and Kraay (2005) did not find any significant effect of debt relief on expenditure on health and education. Similarly, Crespo Cuaresma and Vincelette (2008) find no effect of debt relief on educational expenditure.

Second, debt relief eliminates a significant “overhang” from countries’ balance sheets. Previous literature⁵, mostly associated with commercial borrowing in the 1970s, suggested that countries with high debt levels suffered from lower investment, as private businesses faced greater uncertainty over future tax increases that could be required to service public debt. In these circumstances, debt relief can have an indirect benefit on

² *Global Monitoring Report 2008*, World Bank, 2008. p. 22.

³ *Achieving the Millennium Development Goals in Africa: Recommendations of the MDG Africa Steering Group*, June 2008.

⁴ The Development Assistance Committee only counts debt relief on non-concessional debt as net ODA. Gross debt relief to SSA, including on concessional aid, totaled \$56 billion in 2006.

⁵ Cohen and Sachs (1985), Krugman (1988).

growth by inducing more private investment. Public investment can also be negatively affected if the returns largely go to repay foreign creditors.

Arslanalp and Blair Henry⁶ find that debt relief provided under the Heavily Indebted Poor Countries (HIPC) initiative had little impact on either investment or growth, contrary to countries benefiting from debt relief under the Brady Plan. They argue that the key constraint to investment in HIPC countries is not tax uncertainty but an absence of functional economic institutions that provide the foundation for a profitable private sector. But a recent paper by Claudio Raddatz (2008) provides evidence that the market values of firms operating in countries who benefited from debt relief under the Multilateral Debt Relief Initiative (MDRI) increased when this initiative was launched. And Cassimon and Van Compenhout (2006) found a positive effect of debt relief on overall investment spending in African HIPCs, using vector autoregressive techniques.

Third, debt relief can open the way for additional borrowing to generate resources for MDG programs. There is considerable controversy about this channel. On the one hand, the objective of debt relief is to make countries creditworthy, but this only has value if countries do actually borrow and spend more. On the other hand, if countries end up overborrowing⁷—and the fact that they got into debt problems in the first place suggests there is a proclivity to overborrowing or at least an absence of institutional checks to prevent it—then the benefits of debt relief can be quickly eroded. If those benefits come via the removal of the debt overhang, as suggested above, then new borrowing will quickly eliminate the confidence of investors in a stable future tax regime.

Fourth, debt relief has been provided in a structured way, focusing on countries that adopt a specific program 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 towards more liberal reform. The impact, therefore, depends on whether the reform program is appropriately designed and implemented. Debt relief could also be negative for reform if, for example, the softening of the budget constraint provided an opportunity to relax tax collection efforts. This does not seem to be a key part of the story, however. Several studies fail to find any tax reduction in HIPC countries in Africa.⁸

This paper reviews these four channels through which debt relief can have an impact on poverty reduction and growth. Specifically we ask (i) whether countries receiving debt relief have had larger flows of net ODA than countries without debt relief; (ii) whether investment and growth has risen in debt relief countries; (iii) whether debt dynamics

⁶ Arslanalp and Blair Henry, (2005, 2006).

⁷ Overborrowing is meant here as borrowing more than the optimal level given the availability of high return investment opportunities. Of course, the practical identification of overborrowing is fraught with difficulty.

⁸ See Gupta, Powell and Young (2006), Cassimon and Van Compenhout (2006), Kpodar and Unigovskaya (2008).

have improved significantly in these countries; (iv) whether debt relief affected HIPC's access to finance; and (v) whether reforms are being implemented more rapidly as a result of programs that are part of the debt relief package.

One innovation in the paper is the use of new data on the budgets of debt relief countries, which are published in annual debt sustainability analyses.⁹

II. Approach, Background and Data

A simple comparison of outcomes in countries receiving debt relief with outcomes in countries that did not get debt relief cannot be used to identify the impact of debt relief. Debt relief countries may be inherently different from countries that are not receiving debt relief, leading potentially to a significant selection bias.

There are two approaches to resolving this selectivity bias. First, we look at the performance of countries over time, thereby holding constant the country group. As most debt relief is provided at a very specific point in time (the “completion point”) we are able to compare outcomes before and after debt relief with the same country groups. Second, the sub-set of countries eligible for debt relief can be further divided into two groups. Countries in one group have already received full debt relief, while the countries in the other group are still in the midst of implementing their reform program, and have yet to receive full debt relief. This second group of countries is widely believed to have even worse initial conditions and ability or willingness to reform than completion point countries. The selection bias thus goes in the opposite direction from the selection bias apparent in the comparison between completion point countries and non-HIPC countries. The comparison against both groups thus allows some of the selection bias to be removed.

In summary, to address possible selection biases, we divide all low income countries into three groups, comprising: (i) those who have completed the HIPC process debt relief programs and obtained full debt relief referred to as “post-completion point countries”; (ii) those who are eligible for debt relief, have passed the first milestone (the so-called “decision point), but have not yet completed the process and received full relief; and (iii) those who have not been eligible for debt relief under the HIPC Initiative. We then compare the change of the variable of interest before and after the HIPC completion point of post-completion point HIPC's with the comparable change in the two comparator groups.

Providing funds through debt relief—comprehensive international agreements

After almost two decades of repeated debt reschedulings for low-income countries, the HIPC initiative was launched in 1996 to resolve debt problems in a comprehensive way.

⁹ For more information, see <http://web.worldbank.org/WBSITE/EXTERNAL/TOPICS/EXTDEBTDEPT/0,,contentMDK:20701723~menuPK:64166739~pagePK:64166689~piPK:64166646~theSitePK:469043,00.html>

The HIPC initiative differed from previous debt relief initiatives, providing deeper debt relief than traditional mechanisms¹⁰ and involving debt relief from multilateral financial institutions for the first time. As such it was the first (and to date remains the only) internationally agreed 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 HIPC Initiative is voluntary. While some creditors provide debt relief beyond what is required under the HIPC Initiative, participation of other 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 of debt relief to be provided increased. Moreover, debt relief to countries would only become irrevocable once they implemented a satisfactory policy reform program that would serve to demonstrate the ability of the country to use the resources freed up through debt relief to good use.¹¹

By 2005, it became clear that countries could not expand development programs fast enough to meet the Millennium Development Goals (MDGs). The Multilateral Debt Relief Initiative (MDRI) was introduced to reduce further the debts of HIPCs. Under the MDRI, three multilateral institutions – the International Development Association (IDA), the International Monetary Fund (IMF) and the African Development Fund (AfDF) – 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.

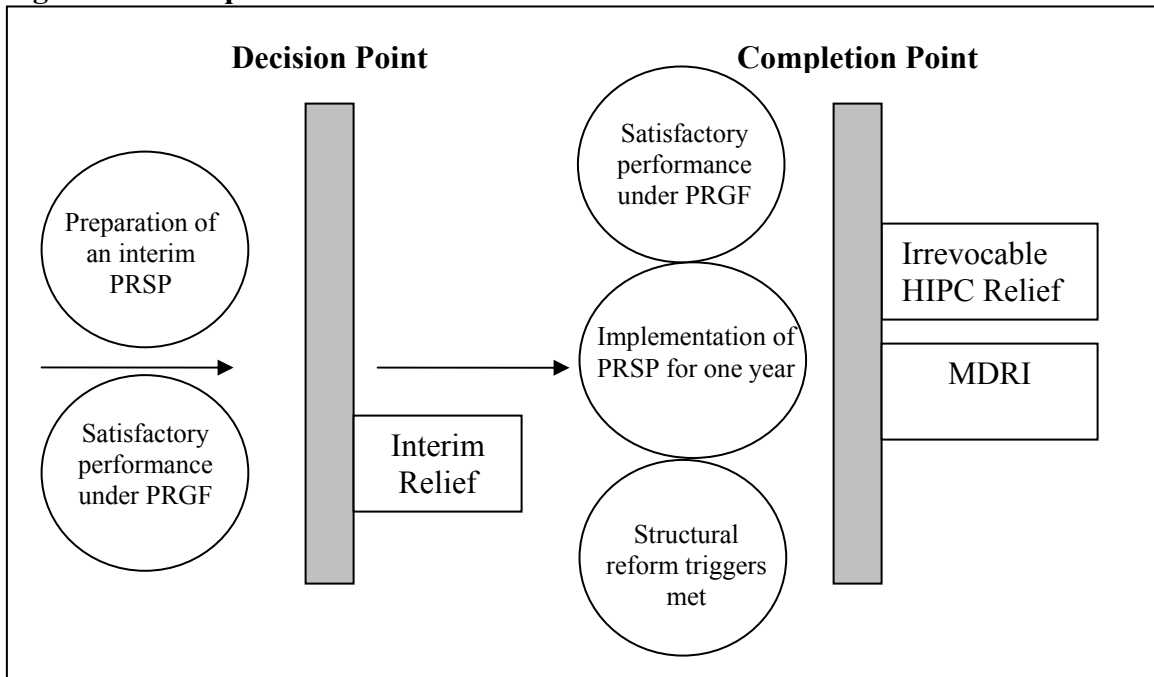
The debt relief process consists of several stages (Figure 1). Once a country satisfies the eligibility criteria, the Executive Boards of the IMF and IDA formally decide on its eligibility for debt relief. At this “decision point”, the international community commits to providing debt relief in amounts established under the enhanced HIPC program. Immediately after the decision point, the country starts receiving interim relief on its 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, it 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.

¹⁰ Traditional debt relief generally allowed for a debt reduction of up to 67 percent in net present value terms.

¹¹ To be eligible for debt relief under the HIPC initiative a country must satisfy the following criteria; (a) GDP per capita below USD965 and to be IDA-only and PRGF eligible; (b) an NPV of debt-to-exports ratio after traditional debt relief beyond 150 percent; (c) a track record of reform and sound policies through IMF- and IDA-supported programs.

After a slow start, the past twelve years have witnessed significant progress in the implementation of the HIPC initiative. Thirty-three of the 41 eligible countries have passed the decision point.¹² Of the 33, 23 have reached the completion point and qualified for irrevocable debt relief under the HIPC initiative and MDRI. The remaining 10 countries receive interim assistance on debt service falling due. The overall assistance expected to be provided to the 33 post-decision point countries amounts to US\$117 billion in nominal terms, including US\$49 billion under the MDRI. This represents on average about 50 percent of these countries' 2007 GDP. The debt burden of HIPC countries is expected to fall by about 90 percent after completion point is reached.

Figure 1: Description of the HIPC Process



Most HIPC debt relief has already been delivered (Figure 2). Total HIPC costs are estimated at \$71.2 billion in NPV terms, of which about half accrues to post-completion countries. Debt relief to pre-decision point countries is estimated to cost \$20 billion, most of which would be allocated to Sudan and Somalia. Many pre-decision point countries face tremendous challenges to satisfy the HIPC criteria. Almost half of pre-completion-point countries have been affected by war in recent years, and many remain at a high risk of conflict and/or political instability. With limited state capacity, these countries have particular difficulties in developing and implementing appropriate reform programs.

¹² For a list of HIPC countries see Annex Table 1.

III. Net ODA Flows to HIPC

When the HIPC Initiative was introduced in 1999, the IMF and 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.”¹³ This aspect of additionality was reiterated in 2002, when stakeholders met in Monterrey to agree on common goals for financing development. There the consensus was reached that the “enhanced (HIPC) Initiative... should be fully financed through additional resources...”¹⁴

The Multilateral Debt Relief Initiative was intended to go further than the HIPC Initiative by providing full debt relief so as to free up additional resources to help these countries reach the MDGs. But contrary to HIPC, MDRI debt relief does not change the net flows provided by some international financial institutions, reducing their annual allocation to a low income country by an amount corresponding to the debt service relief in that year provided upfront by the MDRI.

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 government or their export credit agencies (ECA) or through private loans which had been insured for payment by an ECA. Contrary to private creditors who typically reduce their exposure when a country enters into payment difficulties, these official creditors responded in the form of “flow reschedulings” in the Paris Club, new lending from multilateral agencies, as well as some additional creditors from the ECAs. Moreover, some bilateral creditors, in particular the then Soviet Union continued to provide substantial financing to countries with which they had close ties.

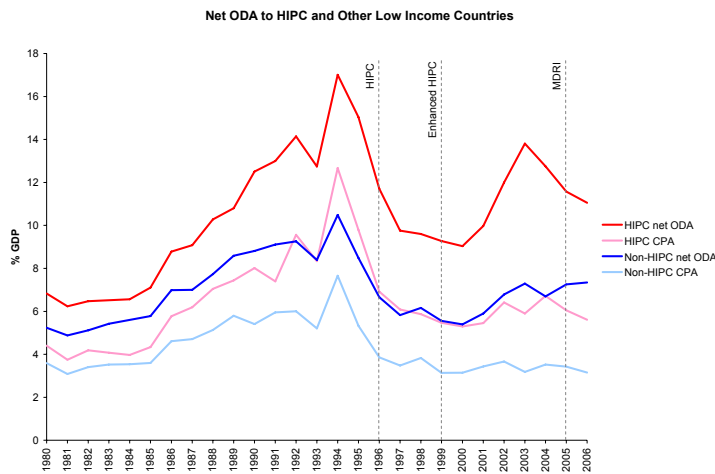
Although payment difficulties of many LICs started in the 1980s, aid flows to HIPC countries (net ODA) peaked in 1994 at a level of about 17 percent of GDP (Figure 3). Non-HIPC countries also saw an increase in aid over this period, but to a smaller degree. For them, aid plateaued at about 10 percent of GDP. Following that, aid started on a downturn, not to be reversed until after the Monterrey conference on financing development in 2002. Since then, aid has rebounded, but has still not reached the levels of the early 1990s.

Figure 3 is interesting because it shows a very similar pattern of movement between net ODA in HIPC and non-HIPC countries. Countries that later became eligible for HIPC were larger recipients of aid on average than non-HIPC countries, and have remained so throughout the last twenty-five years.

¹³ The World Bank and IMF, Modifications to the Heavily Indebted Poor Countries (HIPC) Initiative, IDA/SecM99-187/1, July 23, 1999.

¹⁴ Report of the International Conference on Financing for Development, Resolutions of Heads of State and Government, Monterrey, Mexico, March 18-22, 2002.

Figure 3:

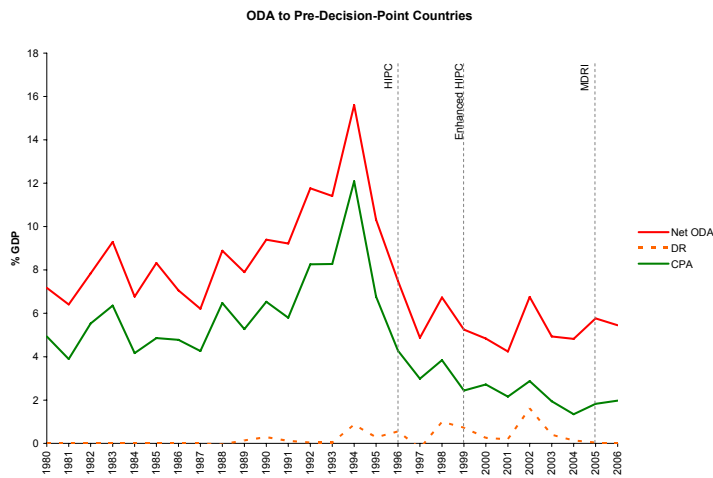
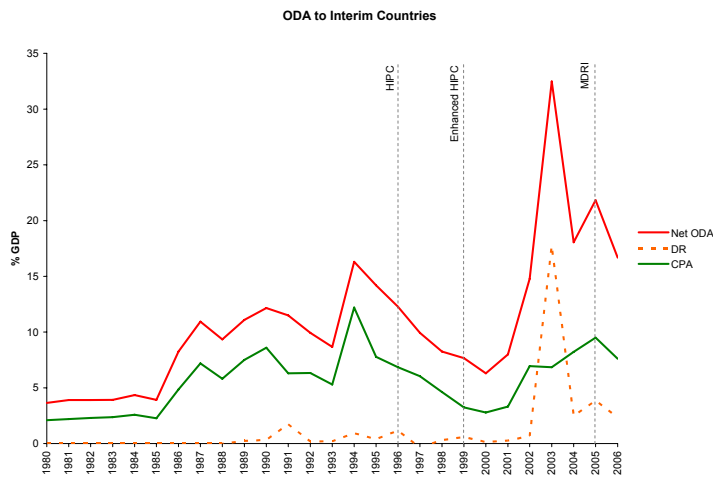
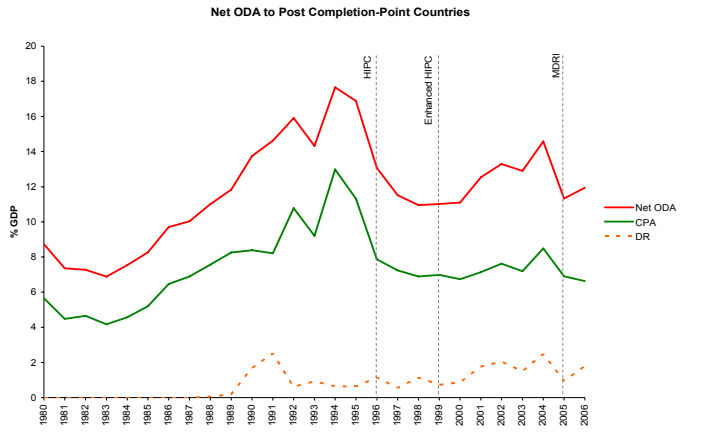


The finding that HIPC countries were larger aid recipients in earlier years is not surprising. After all, the reason they became eligible for the HIPC program is that they were heavily indebted. What is more surprising is that post-1996, participation in the HIPC, enhanced HIPC and MDRI programs has not resulted in a wide gap in the net aid received by countries receiving debt relief and those who did not. HIPC countries receive on average about 4 percentage points of GDP more aid than non-HIPC countries. This is about the same as the gap in the five years prior to HIPC, but considerably more than the gap between these two groups in the early 1980s.

Before trying to infer whether the HIPC program has resulted in a greater aid transfer to eligible countries, it is useful to look at an alternative concept of aid in comparing between HIPC and non-HIPC countries. Country Programmable Aid (CPA) is a measure which is closer than net ODA to the cash flow available for development projects and programs in the recipient country. CPA is defined as total net ODA less debt relief, technical assistance, humanitarian and food aid and interest payments made to creditors. As with net ODA, CPA for HIPC countries has systematically exceeded CPA for non-HIPC countries. 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 3 to support the notion that the HIPC program has resulted in a larger transfer of resources to participating countries.

It may still be the case that the HIPC program prevented a decline in resource transfers that may have occurred in its absence. There is some evidence to support this. In Figure 4, the group of HIPC countries is broken down into three sub-groups: post-completion point countries, interim countries and pre-decision point countries. The results are quite clear. Both interim countries and post-completion countries have continued to receive significant amounts of aid, both net ODA and CPA, since the start of the HIPC Initiative. While participating in HIPC did not halt the aid decline that all low-income countries suffered from after 1994, post-completion point countries and interim countries still received more than 6 percent of GDP in aid, comparable to levels they had gotten in the mid-1980s.

Figure 4: Net ODA Flows



There is a sharp contrast with pre-decision point eligible HIPCs. There, 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.

One reason why aid flows have moved away from pre-decision point countries is that allocation formulae in major multilateral institutions consider now debt sustainability as a factor for their grant allocation since 2005. For IDA countries, for example, allocations are cut by 20 percent for countries that do not meet the debt sustainability test. Countries receive the reduced amounts in the form of grants, but total available resources falls.

In summary, participation in HIPC programs has not caused a shift of donor resources towards HIPC countries and away from non-HIPC countries. But some heavily indebted countries did face the prospect of a rapid decline in aid flows due to debt service obligations. Thanks to the HIPC program donors were able to flexibly respond to country needs through debt relief and maintain resource flows at historical levels.

Behind the Debt Relief numbers

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

Aid is registered whenever a cash flow with a concessional element greater than 25 percent is received by a low income country. Some aid is in the form of grants, but much aid has been in the form of low-interest credits. In aid accounting, there is no difference 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 credit is repaid. Then, the concept of net ODA subtracts the repayment on prior credits from disbursements of new 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 would be doubling counting: a country would be said to receive “aid” of \$100 on receipt of the initial credit and again receive \$100 when the repayment is forgiven. But of course, the country only actually receives \$100 once, when the credit is first extended. To prevent double counting, therefore, an offset is recorded for concessional aid forgiveness.

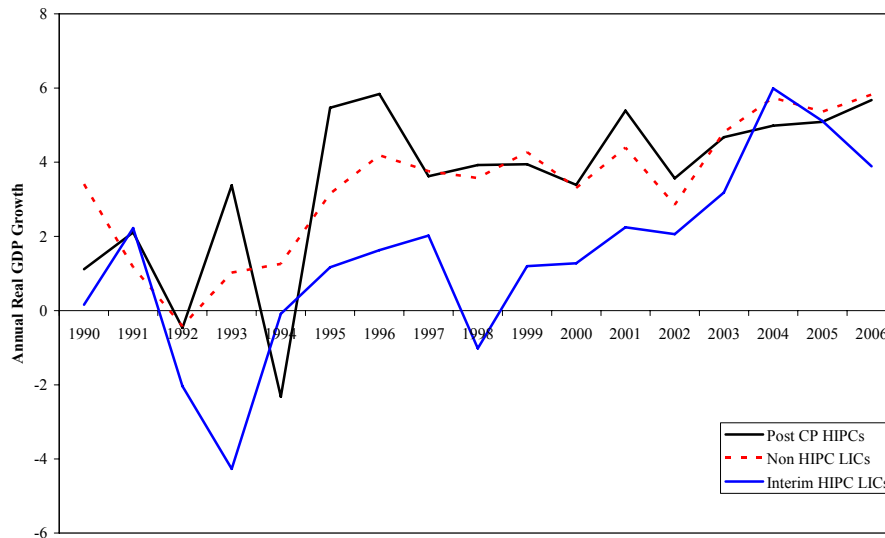
The implication of this offset is that high levels of debt forgiveness may not translate into high levels of net ODA. In fact, MDRI does not affect ODA at the time of its implementation at all since all the debt being forgiven was already counted as aid. However, future net ODA flows will be higher *ceteris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

The Impact of Debt Relief

Growth

Did debt relief boost growth by eliminating the debt overhang? Answering this question is complicated by the fact that growth is affected by many factors. The period 2002-07 is also a period of very rapid global growth and of extraordinary movements in the terms of trade. Thus, looking at growth over time of those countries receiving debt relief does not give an accurate portrayal. Figure 6 shows average growth rates from a sample of twenty-one post-completion rate countries, nine interim countries and eleven non-HIPC countries.¹⁵ Growth in all three groups has risen recently. Average growth in non-HIPCs, however, has accelerated most rapidly. There appears to be little difference between growth in interim countries and post-completion countries in recent years.

Figure 6: Annual Real GDP Growth



Several studies looked at the effect debt relief on growth. Depetris Chauvin and Kraay (2005) did not find any significant effect of debt relief on public spending, investment or economic growth. Cordella, Ricci and Ruiz-Aranz (2006) find that there is a negative marginal relationship between debt and growth for countries with an intermediate level of indebtedness, but 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.

¹⁵ The sample consists of forty-one countries. It is the same as the sample of countries covered under the debt dynamics section below. It covers countries where there is adequate fiscal data to undertake a debt decomposition (see below).

Debt dynamics

The enhanced HIPC initiative and even more 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 over time of the real exchange rate, 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 played by debt relief to improving debt dynamics, we look at the detailed budget data for each HIPC country. The fundamental drivers of debt can be given as follows:

$$(1) \quad \dot{D} = rD - PS + C - S$$

The change in net debt is given by new borrowings that are needed to fund interest payments on debt (rD), less the primary surplus¹⁶ (PS) plus any contingent liabilities that the government may take on, less seignorage (S) or interest-free high-powered money creation. Contingent liabilities are typically off-budget items. In some cases they represent bail-outs of the financial system, when governments step in to protect bank deposits. In other instances they are payments made by governments to bail out companies which are too big to fail or where the government has previously guaranteed some level of activity that fails to come about. Private toll-roads and utilities are examples where 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, even more so when expressed as a percent of GDP. But for developing countries, especially those with weak budget institutions, contingent liabilities can be very large.

It is convenient to express equation (1) in terms of the change in the debt/GDP ratio, and to recognize the fact that debt for most low income countries is denominated in foreign currency, while GDP is in local currency. Thus, when the real exchange rate depreciates, the debt/GDP ratio tends to rise.

$$(2) \quad (\dot{d}) = d(r + e - g) - ps + c - s$$

Where lower case letters represent the variable expressed as a percent of GDP, g is the growth rate of the economy and e is the rate of change of the real exchange rate.

Equation (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

¹⁶ In debt accounting, the primary surplus is calculated including grants as revenues.

growth rate of the economy. Thus, debt relief is particularly useful for slow growing countries, for countries which have faced high interest rates, and for countries which have faced major pressures on their exchange rates, because of difficulties in expanding exports and attracting private capital flows.

Equation (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, that is they will increase the effective interest rate they pay on debt. As is clear, any increase in interest rates would worsen debt dynamics. In order to understand the quantitative dimensions of the variables expressed in equation (2), we look at the change in the debt to GDP ratio for forty-one low income countries.

Figure 7 below shows that debt relief has indeed had a sizeable impact on the debt/GDP ratio of both post-completion and interim countries. The first panel shows post-completion point countries. The debt/GDP ratio has fallen by very substantial amounts, but what is interesting is that the overall decline in the debt ratio is much higher than the decline attributable to debt cancellation. In other words, these countries would have shown a marked reduction in their debt ratios even in the absence of debt relief.

The main additional factors behind the fall in debt in post-completion point countries have been higher growth and a real appreciation of their currencies due in part to strong commodity prices in recent years. These factors have reduced debt/GDP by about ten percentage points each year for the last five years.

Interim countries show the same pattern. There too debt ratios have declined dramatically, but, despite this, debt levels remain high, with countries like Haiti and Guinea having debt/GDP ratios exceeding 350 percent¹⁷. The sharp reduction in debt in 2007 is attributable to the clearing of arrears for Liberia. But apart from debt relief, growth and the real exchange rate have also contributed very significantly to a decline in the debt burden.

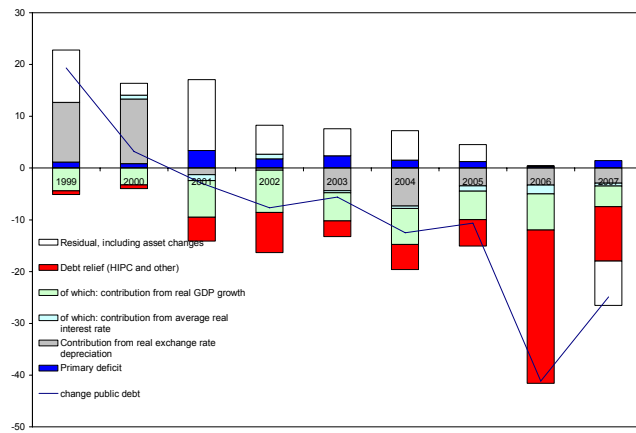
Interim countries show large contingent liabilities as major drivers of debt build-up in the past. These countries often have weak public management systems, so it is not surprising to see them faced with obligations which need to be paid that do not pass through the budget. The implication however is that debt relief by itself cannot halt such claims. Improved institutional structures are needed.

Non-HIPC countries have also experienced declines in their debt ratios during this period. Their average debt/GDP ratio has fallen to under 50 percent, thanks to growth and real exchange rate appreciation.

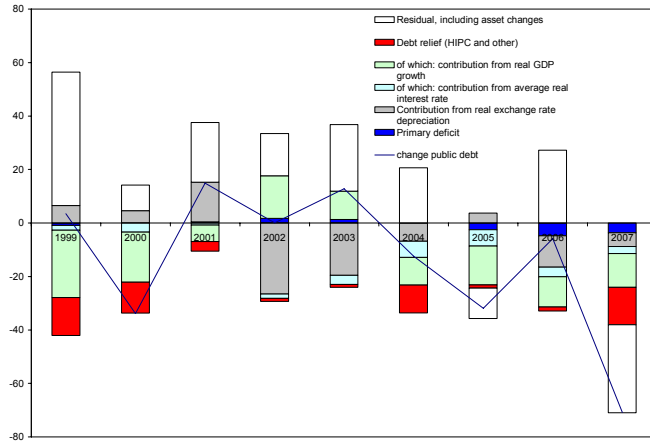
¹⁷ The implication of such numbers is that these countries have debt levels equal to the approximate total value of their capital stock!

Figure 7: Debt decomposition

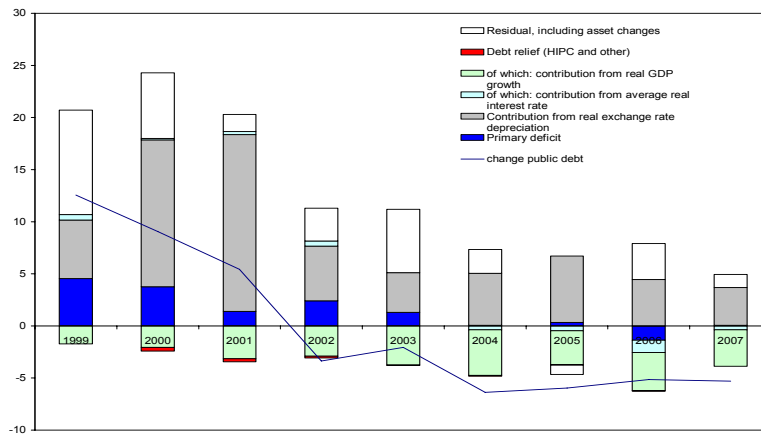
(a) Post Completion countries



(b) Interim Countries



(c) Non-HIPC countries



Investment and new financing options

According to the debt overhang argument, debt relief should lead to increased private investment. Some authors, such as Arslanalp and Blair Henry (2005), argue, however, that debt relief provided to HIPCs had little impact on either investment or growth, since the key constraint to investment in these countries is not tax uncertainty but an absence of functional economic institutions. As discussed above, there is evidence that generous official assistance helped HIPCs service their external debt. Still, markets may perceive debt relief positively. A recent study by Claudio Raddatz (2008) concludes that the MDRI had a positive impact on the financial assessment of firms operating in countries benefiting from debt relief, but this could be due to exchange rate effects as well as to improved growth prospects for the firms.

Improved macro-economic performance of some Sub-Saharan countries combined with debt relief have led to increased interest of foreign investors in Sub-Saharan Africa. Private capital flows have risen sharply since 2002 from very low levels of around \$7 billion to \$53 billion in 2007. These private capital flows are still mainly equity foreign direct investment targeted to the mineral sector. But there is an increased tendency of inflows to other sectors, such as banking and telecoms.

The improvement in policies and institutions in HIPC countries reinforces the improvement in creditworthiness brought about by debt relief. Some studies show a direct link between strong policies and a higher capacity to carry debt¹⁸. In the formal debt sustainability framework 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—has led some countries to explore new forms of borrowing, including on commercial terms.

Four Sub-Saharan African countries, of which two are HIPCs, have successfully tapped into international capital markets. Ghana issued a \$750 million bond in September 2007. The Republic of Congo, an interim HIPC, issued a \$478 million bond in December 2007 to replace defaulted London Club debt. Gabon, although 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. According to Fitch Ratings, Kenya is considering a \$300 million bond to fund infrastructure and Nigeria may issue an international bond of \$1 billion in 2009.

A better policy environment and a boom in commodity prices, have also made Sub-Saharan countries more attractive to non-traditional creditors. While these creditors offer funds that allow countries to address large investment needs, the terms they offer are often non-concessional. This has caused some concern that countries might simply return to situations of debt distress.

¹⁸ Cite Nehru and Kraay (2004)

There is some hope that this time around the new borrowing will be more beneficial to development than before. There is already talk that Africa represents a new frontier for financial markets.¹⁹ In a comparison between eight African “emerging markets” today and ASEAN countries in 1980²⁰, just prior to an acceleration of their growth and mobilization of external resources, Nellor (2008) finds that the African economies compare favorably with ASEAN on six of eight categories important to investors, including inflation, financial depth, foreign exchange reserves, debt, FDI inflows and portfolio inflows.²¹ 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 bear no currency risk for the borrower, improve the flexibility of financing, can be a means of developing local financial markets and help to sterilize aid flows. In Sierra Leone and Ethiopia, domestic debt was above 30 percent of GDP 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 were also attracted by attractive yield-earning opportunities and 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 over \$400 million, at end of June 2007. This share is reportedly even higher in Zambia, and foreigners seem also to hold a significant share of domestic currency government debt in Tanzania and Uganda. All four countries are HIPC post-completion point countries.

Overborrowing

Evidence from recent debt sustainability assessments confirms that debt sustainability is a concern in all pre-completion point HIPCs and in over one-third of non-HIPC LICs²² Despite the significant decline of debt burdens thanks to debt relief, less than half of the post-completion-point HIPCs have a low risk of debt distress according to the most recent DSAs. To prevent low-income countries from overborrowing, major creditors now provide an increased level of grants to countries with an elevated risk of debt distress under the Debt Sustainability Framework (DSF) 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

¹⁹ David Nellor, “The Rise of Africa’s Frontier Markets”, Finance and Development, September 2008

²⁰ The eight countries are: Botswana, Ghana, Kenya, Mozambique, Nigeria, Tanzania, Uganda and Zambia. They represent 40 percent of the GDP of sub-Saharan Africa, excluding South Africa.

²¹ Of course, a comparison with ASEAN does not imply that debt distress will be avoided. Several ASEAN countries suffered from a major debt problem in 1997/98.

²² For more information, see World Bank and IMF (2008) “Debt Sustainability in Low-Income Countries – Recent Experiences and Challenges Ahead”.

the distribution of ratings with the number of countries with a high risk rating increasing from two to four between 2007 and 2008

Policy and Institutional Improvements

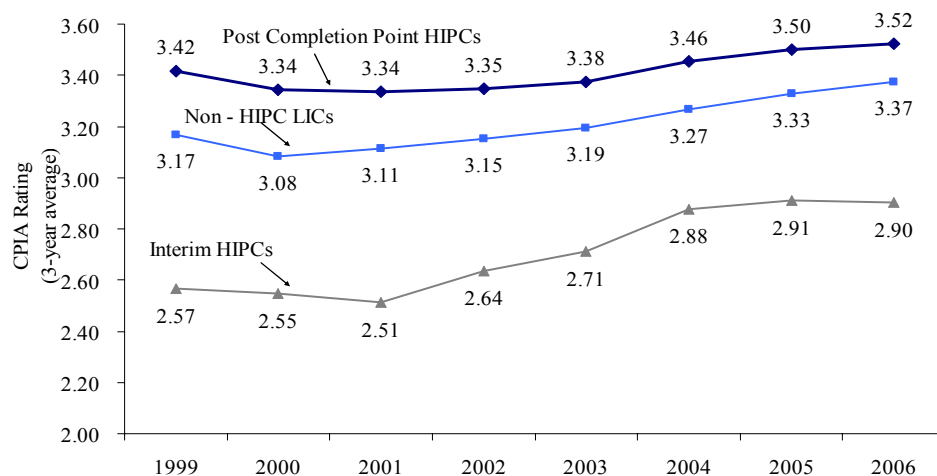
Countries only receive debt relief after developing a track record of a satisfactory reform program. If debt relief is the “sweetener” to encourage significant reform, then the benefits from debt relief may be felt in longer term institutional development and growth.

Figure 8 compares an index of policy and institutional change for post-completion point, interim and non-HIPC countries. Post-completion point countries have the best policies of the three groups and have seen significant improvements in their policy performance over the past few years.²³ That progress is consistent with the requirement that they implement a satisfactory program of reform.

Interim countries also seem to have improved policies, but in a less smooth fashion. A period of poor policy performance until 2001 gave way to a spate of reforms, but the last three years again appears to have seen a stagnation in policies.

Non-HIPC countries also show sustained policy improvement during this period. In fact, the gap between these countries and post-completion point HIPC countries has narrowed in recent years. The rate of improvement of non-HIPC countries seems to have been faster.

Figure 8: Evolution of CPIA



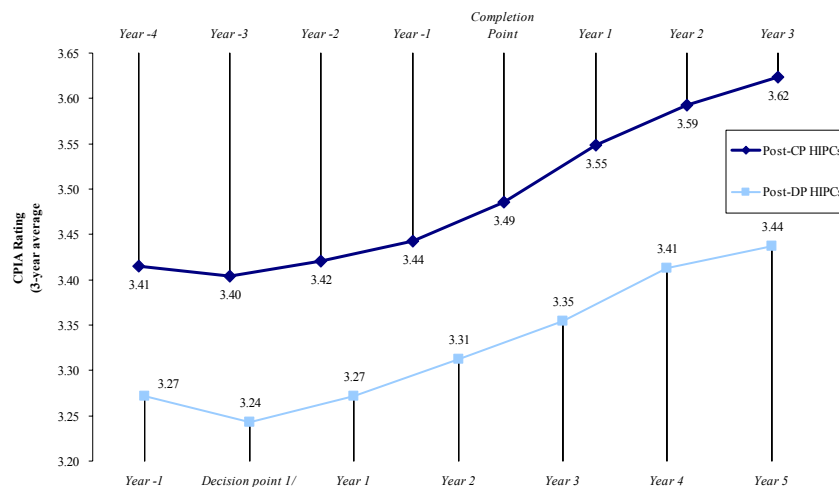
The link between policy improvement and debt relief is more clearly seen when policies are compared pre- and post-completion point and decision point. Figure 9 below

²³ There is a minor bias in these figures as debt sustainability is itself a component of the policy and institutional index, and debt sustainability automatically improves once debt relief has been granted. However, this effect is quite small and does not materially affect the trends reported above.

summarizes these changes (excluding the debt sustainability component). Strong gains in policy performance are evident in the three years prior to completion point, and the momentum of these reforms seems to carry through to the years after 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 which had some of the worst initial conditions of all HIPC, they have already reached almost the same level of average policy performance as other HIPCs at their completion point.

Figure 9: Evolution of the CPIA without Debt Policy Component in HIPCs

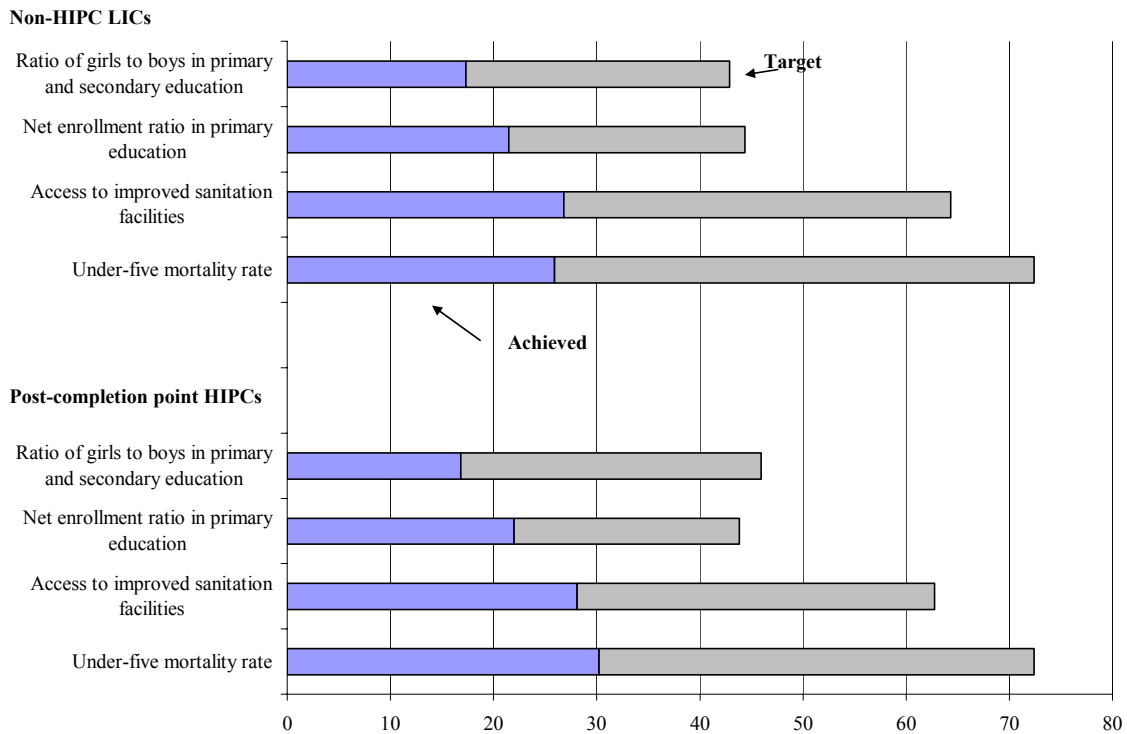


Meeting the MDGs

Some acceleration of resource flows is undoubtedly required to help HIPC countries meet the MDGs. As Figure 10 shows, both HIPC and non-HIPC countries have a significant distance to go to meet their MDGs. Although post-completion HIPC countries have a demonstrated track record of better policy performance, this has yet to show up in terms of better outcomes on MDG related targets.

In education, health and sanitation, HIPC and non-HIPC countries alike have achieved less than half the progress necessary to be on-track towards meeting their targets. It will take much more than finance to achieve these targets, but finance is probably a necessary, if not sufficient, condition for success. Using the new-found space created by debt relief offers the best hope for rapidly increasing expenditures on MDG programs.

Figure 10: Meeting the MDGs



V. Concluding remarks

The HIPC and MDRI initiatives have provided very significant debt relief to a set of developing countries. This paper comments on the effects of such relief.

One surprise is that even after getting debt relief, countries have not been able to use the fiscal space afforded to increase their primary deficits. The evidence suggests that net resource transfers to HIPC and non-HIPC countries do not differ in any marked degree. Moreover, the size of resource transfers today is at about the same level as in the mid-1980s as a share of recipient country GDP, in post-completion point HIPC countries. The hope that debt relief would translate into significantly more resource for poverty reduction appears not to have been realized.

Debt relief has had more success in avoiding a collapse of resource transfers to low income countries. Those heavily indebted countries which 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. Post-completion HIPC countries are in much stronger positions but still have average debt levels over 40 percent of GDP. However, debt dynamics were

also improving due to 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. Also, subsidies to dampen the effect of the food and fuel price shocks can put additional strain on fiscal management.

An improved debt sustainability outlook – accompanied by an enhanced security situation, better macro-economic performance and high commodity prices - has led to increased interest of foreign investors in Sub-Saharan Africa. Private capital flows have risen sharply since 2002. These private capital flows are mainly equity foreign direct investment targeted to the mineral sectors. Still, several African countries have sold treasury bills in their own currency to foreign investors and two HIPCs managed successfully to place international bonds. A better policy environment and the boom in commodity prices have also made Sub-Saharan countries more attractive to non-traditional creditors. However, in the long run, the financing offered by these creditors might actually worsen debt sustainability, as funding terms are often non-concessional. 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 decision point and completion point and after completion point. However, non-HIPC countries have also improved policy performance, making it difficult to attribute the improvements to the HIPC program. There is no discernible difference in the rate of improvement.

Despite debt relief, strengthening of institutions and a relatively benign external environment during the past years, post completion point HIPCs are still far away from reaching the MDGs. Fiscal space seems not to have increased as a result of debt relief, but 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. However, the improvement in the policy and institutional environment in these countries offers hope that resources will be used better than in the past.

Annex

Table 1. List of Heavily Indebted Poor Countries (as of end-July 2008)

23 Post-Completion-Point Countries ^{1/}		
Benin	Honduras	Rwanda
Bolivia	Madagascar	São Tomé and Príncipe
Burkina Faso	Malawi	Senegal
Cameroon	Mali	Sierra Leone
Ethiopia	Mauritania	Tanzania
Ghana	Mozambique	Uganda
Guyana	Nicaragua	Zambia
Gambia, The	Niger	
10 Interim Countries ^{2/}		
Afghanistan	Congo, Dem. Rep. of the	Haiti
Burundi	Congo, Rep. of	Liberia
Central African Republic	Guinea	
Chad	Guinea-Bissau	
8 Pre-Decision-Point Countries ^{3/}		
Côte d'Ivoire	Kyrgyz Republic ^{4/}	Sudan
Comoros	Nepal	Togo
Eritrea	Somalia	

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