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Debt Relief to Low-Income Countries – A Retrospective

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This paper provides a retrospective on the debt relief granted to Low Income Countries (LICs) since the establishment of the Bretton Woods Institutions in 1944. It traces the evolution of debt relief, from short-term debt restructuring to outright debt forgiveness, describes the range of debt relief measures adopted by creditors, and analyzes the extent to which debt relief has alleviated the debt burden of low income countries.

Born in the mid 1950s, the Paris Club is one of the earliest and most important debt relief fora for LICs. Until 1972 only three LICs (Ghana, Indonesia and Pakistan) requested debt relief from Paris Club creditors. The cases of Ghana and Indonesia provide the first instances in which debt sustainability was addressed in the restructuring process. Paris Club creditors first proposed terms similar to those already granted to middle income Latin American countries to help overcome liquidity crises. But, given the magnitude of the debt problem, they were forced in the end to extend highly concessional terms to both countries.

By the end of the 1970s, LICs' requests for debt relief from Paris Club creditors had grown exponentially. The accepted wisdom of the day was that LICs were confronting liquidity crises. Accordingly, Paris Club agreements in the 1970s and much of the 1980s were on non-concessional terms. The Ghana and Indonesia agreements were set aside as "exceptional" and the lesson of the importance of debt sustainability in the restructuring process was downplayed. As the successive decades were to show, this proved to be a very costly mistake for debtor countries and creditors alike.

The turning point in the modern history of debt relief was the launch of the Special Program for Assistance (SPA) for Africa in 1987. The first coordinated response to the debt and development crisis in Africa, the SPA was essentially a commitment by donors to provide support to eligible countries with credible and sustained economic reform programs in place. It encompassed six *dimensions* through which donor resources could be channeled. Four of them related to adjustment financing - IDA adjustment credits, the IMF's two Structural Adjustment Facilities (SAF and ESAF), other adjustment financing, and debt relief by bilateral donors. The remaining two *dimensions* were supplemental financing to offset debt service to the IBRD (the *Fifth Dimension)* and funding for commercial debt reduction through the Debt Reduction Facility (DRF) for IDA-only countries (the *Sixth Dimension*).

The first move by Paris Club creditors to include an element of forgiveness in non-concessional debt deals followed the 1988 G-7 summit in Toronto. G-7 leaders agreed that non-concessional debt of African IDA-only countries could be reduced by up to 33 percent in net present value (NPV). In 1990, these terms were extended to non-African countries. Although the Toronto terms had some beneficial effect, the international community realized before long that a deeper reduction was needed to achieve sustained improvement in the debt situation of LICs. Paris Club creditors accordingly increased the reduction to 50 percent in 1991 (London or Enhanced Toronto terms) and to 67 percent in 1994 (Naples terms). Among other fundamental changes to their approach, Paris Club creditors adopted a flexible two-step approach to debt restructuring combining the restructuring of debt service falling due during a limited consolidation period with the possibility of a later stock operation. In addition, Paris Club creditors allowed the possibility of rescheduling, under Naples Terms, debt previously rescheduled under Toronto or London terms.

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Some Paris Club creditors took important complementary measures, notably i) the forgiveness of Official Development Assistance (ODA) loans by members of the Development Assistance Committee (DAC) of the OECD, and ii) debt conversion arrangements under Paris Club auspices and through special initiatives such as the U.S. Enterprise for the Americas Initiative and the Swiss Debt Reduction Facility.

LICs have also benefited from debt relief from commercial creditors, the bulk of it provided through debt buybacks supported by the DRF (the SPA's Sixth Dimension). Since its inception in 1989, the DRF has provided grants allowing 21 LICs to buy back at deep discounts the debts owed to external, commercial creditors (and has also financed the services needed to implement this). In 2008, its policies and practices were modified to enhance the speed and effectiveness of its support for commercial debt reduction operations.

Nonetheless, several LICs continued to be affected by heavy debt burdens. By the mid 1990s, with an increasing share of debt owed to multilateral creditors, a new debt relief initiative was called for at the June 1996 G-7 summit in Lyon. In response, the World Bank and the International Monetary Fund launched the Heavily Indebted Poor Countries (HIPC) Initiative in September 1996. The Initiative aimed to reduce the debt burden of eligible countries to pre-determined levels, provided that they adopted and carried out programs of macroeconomic adjustment and structural reform. For the first time, debt relief was extended to loans from multilateral creditors.

In the fall of 1999, in line with the suggestions endorsed in the June 1999 G-7 summit in Cologne, the Initiative's framework was enhanced to allow provision of deeper, broader, and faster debt relief, and to strengthen the connection between debt relief and the recipient country's strategies for reducing poverty. Other revisions have been introduced since then in response to specific issues that emerged during implementation, most notably on the phasing of debt relief and the entry requirements.

The HIPC Initiative was followed by the Multilateral Debt Relief Initiative (MDRI) in 2005, instituted at the 2005 G-7 summit at Gleneagles to help accelerate progress toward the UN's Millennium Development Goals. The MDRI called for the cancellation of all eligible debts owed to IDA, the IMF, and the African Development Fund for countries reaching their HIPC "completion point". In 2007, the Inter-American Development Bank also decided to cancel eligible debts to HIPCs through an initiative similar to the MDRI.

The debt relief provided to LICs during the period covered by this note has significantly lowered their debt burden. Countries currently considered HIPCs are estimated to have received at least US$30 billion, in end-1997 NPV terms, in debt relief from Paris Club creditors through agreements signed between 1988 and 1998. Over the same period, most OECD countries cancelled their ODA loans and LICs were able to extinguish about US$5 billion of commercial external debt through DRF-supported operations. In addition, substantial progress has been made in the implementation of the HIPC Initiative and the MDRI – more than three quarters of HIPCs (33 out of 41) have passed the decision point and qualified for assistance (estimated at US$51 billion in end-2007 NPV terms); of these 23 have reached the completion point and qualified for irrevocable debt relief (US$23 billion in end-2007 NPV terms) under the HIPC Initiative and MDRI.

As a result of the debt relief provided under the HIPC Initiative, as well as relief under traditional mechanisms and additional relief from some creditors, the debt stock of the 33 post-decision-point HIPCs is expected to be reduced by about 90 percent. This reduction has been accompanied by an increase in poverty-reducing spending in HIPCs by about 2 percent of GDP since the late 1990s.

But long-term debt sustainability remains a concern even for the 23 post-completion-point HIPCs. Debt sustainability analyses performed using the joint World Bank/IMF Debt Sustainability Framework for LICs confirm that these HIPCs are in a better situation than other HIPCs and also other low income non-HIPC countries, but only about 40 percent of them have been assessed as having a low risk of debt distress. More importantly, reflecting structural weaknesses in their economies or weak macroeconomic management, four of these countries have been assessed as having a high risk of debt distress. In addition, the analyses show that the debt outlook in post-

completion-point countries is very sensitive to export shocks and the terms of new financing. These results highlight the need for implementing sound borrowing policies and strengthening the countries' capacity in public debt management.

Finally, a country's debt sustainability depends also on implementing growth-enhancing policies that would boost its repayment capacity. This is particularly relevant for post-completion-point countries given their increased attractiveness for private and nontraditional official creditors. In that regard, it is critical for LICs to reflect upon the middle income countries' experience regarding the links between debt sustainability and growth.