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Debt Relief and Sustainable Financing to Meet the MDGs
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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 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. This can have a positive effect on private sector investment, as investors face lower uncertainty over future tax increases that otherwise may have been required to service public debt. Third, 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.

Even after debt relief, recipient countries have not benefited from significant *fiscal space* to increase their primary deficits. The evidence suggests that the difference in net resource transfers to HIPC and non-HIPC countries has not changed in any marked degree as a result of the HIPC Initiative. Moreover, for post-completion point HIPCs, the size of resource transfers today is at about the same level as in the mid-1980s as a share of recipient country GDP. Thus, the hope that debt relief would translate into significantly more resources for poverty reduction appears not to have been realized. Debt relief has, however, coincided with the reversal of a declining trend in resource transfers to HIPCs.

Debt relief was one of several factors that have helped eliminate the *debt overhang*. Debt relief and better policies and institutions have led to an improvement in debt dynamics. But sustained growth, stronger exchange rates (as terms of trade improved) and reduced contingent liabilities have also had a significant positive effect. For some HIPCs, these other factors have been nearly as important as debt relief in the improvement in debt levels. And for interim countries, which still have large debt levels, the shocks to growth, exchange rates and contingent liabilities could continue to worsen debt dynamics even after full debt relief is afforded.

Improved debt sustainability - no doubt 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 sector. Still, several African countries have sold treasury bills in their own currency to foreign investors and two HIPCs managed to successfully place international bonds. A better policy environment and a boom in commodity prices have also made Sub-Saharan countries more attractive to non-traditional creditors. However, in the long run, the effect of the financing offered by these creditors on debt sustainability depends on the use to which the funds are put.

Policies and institutions have become stronger in countries that have adopted reform programs in the context of the HIPC process. However, non-HIPCs have also improved their policy performance during the last years at a similar rate, making it difficult to attribute the improvements solely to the HIPC Initiative. Similarly, the effect of the HIPC Initiative on growth is unclear, as there is not discernable difference in average growth rates between HIPCs and non-HIPC LICs.

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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 post-completion point countries may offer hope that resources will be put to better use than in the past.