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Debt Relief for the Poorest

An Evaluation Update of the HIPC Initiative

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Foreword

In the past decade, debt relief has become an increasingly significant vehicle for delivering development aid. This update builds on the findings of the 2003 evaluation of the Heavily Indebted Poor Countries (HIPC) Initiative, *Debt Relief for the Poorest: An OED Review of the HIPC Initiative*. It finds that many of the original conclusions remain relevant for the HIPC Initiative and are potentially instructive for future debt relief initiatives.

Debt Reduction Is Not Sufficient for Debt Sustainability

The Enhanced HIPC Initiative has reduced $19 billion of debt[1] in 18 countries, thereby halving their debt ratios. But in 11 of 13 post-completion-point countries for which data are available, the key indicator of external debt sustainability has deteriorated since completion point. In eight of these countries, the ratios once again exceed HIPC thresholds.

New analyses present a more optimistic outlook for debt sustainability. Six of eight post-completion-point countries have only a moderate risk of debt distress. But all remain vulnerable to export shocks and still require highly concessional financing and sound debt management.

Debt reduction alone is not a sufficient instrument to affect the multiple drivers of debt sustainability. Sustained improvements in export diversification, fiscal management, the terms of new financing, and public debt management are also needed, measures that fall outside the ambit of the HIPC Initiative.

Debt Relief Has Become a Significant Vehicle of Resource Transfer for HIPCs

HIPC debt relief has been significantly additional to other net resource transfers, both in the aggregate, and for 21 of 28 countries. Net transfers to HIPC countries doubled from $8.8 billion in 1999 to $17.5 billion in 2004, while transfers to other developing countries grew by only a third.

In 2005, eight more non-HIPC low-income countries have become potentially eligible for HIPC. The repeated extension of the deadline for eligibility has significantly expanded the reach of the initiative. The emergence of proposals for future rounds of debt relief suggests that debt relief is becoming an ongoing mechanism for resource transfer.

Maintaining Policy Performance Is Essential to Reaping the Benefits of Debt Reduction

Post-completion-point countries started out with higher scores on key policy ratings than other low-income countries and they still score higher. HIPC countries not yet at completion point—both decision-point and pre-decision-point countries—have, on average, the lowest ratings of all low-income countries. They face serious challenges in managing their economies, which will affect their prospects for reaping the potential benefits of debt reduction. Even though the initiative has granted poorer performing countries more time to begin a reform program supported by the World Bank and the International Monetary Fund (IMF), they are held to the same performance requirements as countries that became eligible earlier. Fiscal and debt management are areas of particular weakness in many HIPC countries. Efforts arising from the HIPC Initiative to upgrade countries' public expenditure management systems have resulted in only modest improvements.

Most Creditors Have Committed Their Share of Relief

The HIPC Initiative was innovative in its attempt to seek a comprehensive approach among all creditors to debt reduction. The Bank, IMF, and Paris Club creditors have committed most of their shares of debt relief. But the initiative's structure as a voluntary agreement has hindered efforts to achieve the full participation of all creditors. The sluggish participation of commercial creditors and those not in the Paris Club—who were not involved in shaping the design—has generated a shortfall of 8 percent of total HIPC assistance, which affects some countries particularly.

Five Implications for Future Debt Relief Efforts

The experience under HIPC suggests five lessons for future debt relief efforts:

- Debt reduction is not sufficient for debt sustainability. Future debt relief initiatives need to stress that debt sustainability requires other policy actions by governments and external partners to improve repayment capacity.
- Does debt relief add to or substitute for other aid flows? To demonstrate that future debt relief initiatives are additional, donors will need to establish what their net transfers would be in the absence of debt relief.
- The initiative is delivering an increasing share of concessional resources to HIPC countries. Since non-HIPC countries do not have access to these resources, donors will need to ensure that the resulting pattern of resource allocation rewards better performers overall.
- Debtors cannot oblige creditors to participate in debt relief under voluntary initiatives. Involving both creditors and debtors at the design stage of proposals for debt relief can be an important step for securing the cooperation of all creditors.
- Future debt relief initiatives may also be expected to continually revisit and extend deadlines for eligibility. Extensions of the deadline keep open the opportunity for countries to receive debt relief, while holding all countries to the same standards. On the other hand, they could provide incentives to countries to increase their borrowings in order to avail themselves of debt relief.

Ajay Chhibber
Acting Director-General
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Main Messages

- HIPC has channeled additional resources to qualifying countries.
- HIPC has reduced debt ratios to half their levels before debt relief. But debt ratios have increased since completion point, and in eight countries, once again, exceed HIPC thresholds.
- Six of eight post-completion-point countries with a new debt sustainability analysis have only a moderate risk of debt distress. But all eight remain vulnerable to export shocks and still require highly concessional financing and prudent debt management.
- Debt sustainability requires policy actions by governments and external partners to improve repayment capacity.
- Countries that are not yet at completion point face serious challenges in managing their economies that will affect their prospects for reaping the potential benefits of debt reduction.
- In future debt relief efforts, donors will have to ensure that the resulting allocation of concessional resources rewards better-performing countries overall.

Executive Summary

In the past decade, debt relief has become an increasingly significant vehicle for delivering development aid, with emerging debt reduction proposals now aiming to provide 100 percent debt cancellation. This review updates the March 2003 evaluation of the Heavily Indebted Poor Countries Initiative (HIPC), *Debt Relief for the Poorest: An OED Review of the HIPC Initiative*,[1] the findings of which are summarized below.

Since the 2003 evaluation, 12 countries have progressed to receiving irrevocable debt relief and two more countries have qualified for relief. About $50 billion has been committed in nominal debt service relief under the Enhanced HIPC Initiative[2] to decision-point countries, of which $15.4 billion has been committed since the previous evaluation. This update builds on the 2003 evaluation and finds that many of its conclusions remain relevant for the HIPC Initiative and are potentially instructive for future debt relief initiatives.

Findings from the 2003 IEG Evaluation of HIPC

The 2003 evaluation found the HIPC Initiative highly relevant in addressing a key obstacle facing many poor countries, and noted that the initiative would substantially achieve its goal of reducing the excessive debt burden of the qualifying countries, if the anticipated debt relief was delivered in full. But achieving the expanded objectives of the initiative—a "permanent" exit from debt rescheduling, promoting growth, and releasing resources for social expenditures targeted at poverty reduction—would require actions by donors and HIPC governments beyond the scope and means of the initiative. HIPC governments would need to have sound policy frameworks and balanced development strategies, and the international community would need to assist the countries with enhancing their exports and building needed institutional capacities, while ensuring that HIPC debt relief is truly additional to other aid flows.

Source: OED 2003.

Debt Sustainability. The Enhanced HIPC Initiative has reduced $19 billion of debt in 18 countries, thereby halving their debt ratios.[3] But in 11 of 13 post-completion-point countries for which data are available, the key indicator of external debt sustainability has deteriorated since completion point. In eight of these countries, the ratios once again exceed HIPC thresholds. Changes in discount and exchange rates have worked to increase debt ratios. The effect of improved exports and revenue mobilization on debt ratios has been offset by new borrowing. Six of eight post-completion-point countries with new debt sustainability analyses are considered to have only a moderate risk of debt distress, but all remain vulnerable to export shocks and still require highly concessional financing and sound debt management. Debt reduction alone is not a sufficient instrument to affect the multiple drivers of debt sustainability. Sustained improvements in export diversification, fiscal management, the terms of new financing, and public debt management are also needed, measures that are outside the ambit of the HIPC Initiative.

Policy Performance. Countries past the completion point started out with higher scores on key policy ratings than other low-income countries and they still score higher. Countries not yet at completion point—both decision-point and pre-decision-point countries—have, on average, the lowest ratings of all low-income countries and face serious challenges in managing their economies that will affect their prospects for reaping the potential benefits of debt reduction. Even though the initiative has granted poorer performing countries more time to begin a reform program supported by the World Bank and the IMF, they are held to the same track record requirements as countries that became eligible earlier. Fiscal and debt management are areas of particular weakness in many HIPC countries.

Poverty Reduction. Debt relief was intended to contribute to poverty reduction. The requirement to develop and implement a country-owned poverty reduction strategy has been an important and beneficial outcome of the initiative. These strategies have tended to emphasize social sector spending rather than a more balanced approach to growth and poverty reduction. By continuing to track public expenditures deemed "poverty reducing," the initiative's approach to poverty reduction has leaned toward channeling additional resources to social expenditures. The emphasis on expenditures has prompted the Bank and the IMF to do more to upgrade public expenditure management systems in HIPC countries. These efforts have resulted in only modest improvements.

Creditor Participation. The HIPC Initiative was innovative in its attempt to seek a comprehensive approach among all creditors to debt reduction. The multilaterals and Paris Club creditors have committed most of their share of debt relief. But the initiative's structure as a voluntary agreement has hindered efforts to achieve full participation of all creditors. The sluggish participation of non–Paris Club and commercial creditors, who were not involved in shaping the initiative's design, has generated a shortfall of 8 percent of total expected HIPC assistance.

Additionality of Resources. HIPC has channeled additional development resources to its qualifying countries. Net transfers to HIPC countries doubled from $8.8 billion in 1999 to $17.5 billion in 2004, while transfers to other developing countries grew by only a third.

Debt relief has become a significant vehicle of resource transfer to HIPC countries. In the past year, eight additional non-HIPC low-income countries have become potentially eligible for HIPC. The repeated extension of the deadline for eligibility has significantly expanded the reach of the initiative. The emergence of proposals for future rounds of debt relief suggests that debt relief is becoming an ongoing mechanism for resource transfer.

Implications for Future Debt Relief Efforts. The experience under HIPC suggests five lessons for future debt relief efforts.

- Debt reduction is not sufficient for debt sustainability. Future initiatives need to be clear about the objectives of debt relief and how their outcomes will be measured. In addition, to ensure debt sustainability they need to stress the importance of other policy actions by governments and external partners to improve repayment capacity.
- Does debt relief add to or substitute for other aid flows? To demonstrate that future debt relief initiatives are additional, donors will need to establish what net transfers—both multilateral and bilateral—would be in the absence of debt relief.
- The initiative is delivering an increasing share of concessional resources to HIPC countries. Since non-HIPC countries do not have access to these resources, donors will need to en-

sure that the resulting pattern of resource allocation rewards better performers overall.

- Debtors cannot oblige creditors to participate in debt relief under voluntary initiatives. Involving both creditors and debtors at the design stage of proposals for debt relief can be an important step in disseminating information about the workings of the initiative and securing the cooperation of all creditors.
- Future debt relief initiatives may also be expected to continually revisit and extend deadlines for eligibility. Extensions of the deadline keep open the opportunity for countries to receive debt relief, while holding all countries to the same standards. On the other hand, they could provide incentives to countries to increase their borrowing in order to avail themselves of debt relief.

ACRONYMS AND ABBREVIATIONS

CP	Completion point
CPIA	Country Policy and Institutional Assessment
DAC	Development Assistance Committee
DP	Decision point
DRF	Debt Reduction Facility
DSA	Debt Sustainability Analysis
E-HIPC	Enhanced Heavily Indebted Poor Countries (Initiative)
HIPC	Heavily Indebted Poor Countries (Initiative)
IDA	International Development Association
IEG	Independent Evaluation Group (formerly OED)
IMF	International Monetary Fund
I-PRSP	Interim Poverty Reduction Strategy Paper
KKM	Kaufmann, Kraay, and Mastruzzi
LIC	Low-income countries
MDG	Millennium Development Goal
NPV	Net present value
ODA	Official development assistance
OECD	Organisation for Economic Co-operation and Development
OED	Operations Evaluation Department (changed to IEG)
PRGF	Poverty Reduction and Growth Facility
PRSP	Poverty Reduction Strategy Paper
UN	United Nations
UNCTAD	United Nations Conference on Trade and Development

Chapter 1: Evaluation Essentials

- This review updates the 2003 independent evaluation of the HIPC Initiative.
- HIPC objectives remain largely unchanged.
- Debt relief is becoming an ongoing mechanism for resource transfer.