Third World Debt

CIVIL SOCIETY/
DEMOCRACY BUILDING

The World Bank
Washington, D.C. 20433
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November 11, 1997

Ms. Melanne Verveer
Chief of Staff to the First Lady
The White House
Washington, DC 20502

RE: Brief on the World Bank/IMF Debt Initiative for Heavily Indebted Poor Countries (HIPC)

Dear Ms. Verveer,

Mr. Wolfensohn had offered to convey to Mrs. Clinton information on the Debt Initiative for Heavily Indebted Poor Countries (HIPC) sponsored by the World Bank and the International Monetary Fund.

Attached please find a summary describing the main principles and stages of the HIPC initiative, its costs, its financing, and its progress to date.

Should you have any questions on this brief, please do not hesitate to contact me at (202) 473-7583.

Yours sincerely,

Marisela Montoliu

Marisela Montoliu Munoz

Attachment.

The Debt Initiative
for Heavily Indebted Poor Countries
(HIPCs)

Introduction/Summary

High levels of debt, owed mostly to official agencies in developed countries, have been increasingly recognized as an important brake on the ability of poor countries to pursue sustainable development and reduce poverty. The actions of the international community to resolve the debt crisis of the 1980s --through massive commercial debt restructuring within the framework of reform programs of structural reform programs supported by the IMF and the World Bank-- were successful in resolving the debt problems of middle-income developing countries. Capital flows to them have increased fivefold since 1990, reaching $244 billion in 1996. However, the poorest countries benefited to a far lesser extent from these efforts, and the debts of a large number of them have remained unsustainable despite progressively more concessional terms of relief that have been made available under the auspices of the Paris Club of bilateral official creditors. The World Bank has classified some 40 uncreditworthy poor countries as Heavily Indebted Poor Countries (HIPCs), based on their high levels of debt. These countries together owe some $175 billion in external public debt (in 1996 dollars). While this amount is but a small fraction of the total debt of developing countries of more than $2 trillion, the debts of HIPCs are, on average, about four times their annual export earnings, and well exceed their annual GNPs. These are about twice the levels considered to be sustainable, though there are significant variations of debt levels among these countries. By comparison, the total public debt of the US is equivalent to about 50% GNP.

While the debt issue has been a long-standing major concern of officials and NGOs in African and other poor countries and in international fora, in recent years there has also been a growing concern amongst the public in developed countries, particularly among NGOs, churches and religious groups concerned with poverty. This concern has helped pave the way for greater international action to address the debt problem.

The HIPC Debt Initiative is the best instrument available to provide poor countries a way out of the debt trap. Proposed by Jim Wolfensohn and Michel Camdessus, the Initiative was launched with broad international support, including the very strong support of the United States, in September 1996. The HIPC Debt Initiative aims at ensuring that debts will be reduced to sustainable levels for poor countries that are prepared to seriously pursue reform programs covering economic policy and social development, specifically in cases where traditional debt relief mechanisms will not be adequate.

The remainder of this note elaborates on the framework of the HIPC Debt Initiative, its estimated cost and financing, the progress made in its first year of implementation, including the debt relief packages agreed for Uganda, Bolivia, and Burkina Faso, and the challenges faced. The HIPC Debt Initiative will require continued support to succeed, and it should be the focus of efforts to address the debt problems of poor countries.

A New Framework for Debt Relief for Poor Countries

The approval of the HIPC Debt Initiative in 1996 was a breakthrough in two key respects:

- for the first time, bringing the debt to sustainable levels was accepted as the explicit objective of debt relief to low income countries; and

- all creditors, including most notably multilateral creditors for the first time, are participating.

The design of the Initiative reflects several objectives:

- It focuses only on the poorest ("IDA-only") countries

- It aims at helping countries willing to take steps to stand more on their own feet, by implementing sound economic and social policies; debt relief under the Initiative is only made available after a track record of good policy performance has been established, to ensure that debt relief does not encourage repeated episodes of over-borrowing and weak economic management.

- debt relief is targeted to countries for which other mechanisms are not adequate to attain debt sustainability; relief builds on and is additional to relief under these other mechanisms.

- each creditor provides relief under the Initiative in proportion to its claims (after full application of traditional debt-relief mechanisms, in particular, from the Paris Club). This avoids passing the buck to the multilateral development institutions, and so helps preserve their financial integrity.

A three-staged process is used to provide relief.

- After establishing a three-year record of performance, a potentially-qualifying country reaches the "decision-point". At that time, a joint *debt sustainability analysis* is done by the staff of the World Bank, IMF, and the country concerned to determine whether traditional debt-relief mechanisms will be adequate to attain debt sustainability. If not, agreement will be reached among creditors on the amount of relief needed to achieve sustainability at the "completion point", three years later. A key target for debt sustainability is the present value of debt to exports ratio, which is normally expected to be set in the lower half of the range of 200-250 percent. Other factors, such as the ratio of debt service to exports, the vulnerability of the economy to export shocks, and the fiscal burden debt are taken into account in setting the debt targets.

- During the "interim period" (between the decision point and the completion point), the country undertakes a program of reforms, including social development reforms in such areas as primary education, health, and rural development. The Debt Initiative raises the stakes for countries in implementing these programs.

- At the completion point, creditors deliver the debt relief promised at the decision point, with no further conditions, provided the country successfully implements the second three-year performance program. If the country's debt situation is worse than anticipated at the decision point, additional relief would be provided so as to ensure that the debt sustainability targets are met.

Flexibility is provided for in implementing the Initiative. Credit for past performance is given for countries to reach the decision point. The interim period can be shortened for countries that have already sustained a record of strong performance. The interim period has been shortened in each of the three countries for which decisions have already been taken: Bolivia, Burkina Faso, and Uganda.

Costs and Financing

About 20 of the 40 HIPCs are estimated to have debt burdens that would qualify them for relief under the Initiative. The additional relief provided by the Initiative is estimated to total about $7.4 billion (in 1996 dollars). In most cases, the relief under the Initiative is expected to be about 15-20 percent of the debt outstanding (in present value terms), on top of the relief provided through traditional mechanisms. The burdensharing approach that has been agreed at the Boards of the World Bank and IMF is for each creditor to provide relief under the Initiative in proportion to its claims in the HIPC base.

Costs for the World Bank are estimated to be about $1.6 billion. The Bank is committed to meet its full share of the costs out of its own resources. It has already transferred $750 million out of its net income to a HIPC Trust Fund that it has established to deliver debt relief. At the completion point for each country, the Trust Fund will purchase the necessary amount of debt from IDA and then cancel it or pay the debt service as it comes due.

Costs for the IMF are estimated to be about $0.8 billion. The IMF has agreed to allocate the equivalent of $240 million to an "ESAF/HIPC Trust" to finance its early participation in the Initiative, and is committed to meet its costs of participation.

Costs for other multilateral institutions are estimated at $1.8 billion. Some of these institutions, most notably the African Development Bank, do not have the necessary resources to meet their own costs. Consequently, government contributions have been needed to help meet these costs.

Donor contributions. To date, about $120 million has been pledged or contributed to the HIPC Trust Fund. Only one G-7 country --the United Kingdom-- has indicated a contribution so far, while a number of non-G-7 countries (Belgium, Denmark, Greece, Indonesia, Luxembourg, Netherlands, Norway, Portugal, Sweden, Switzerland) have decided to contribute. Some countries have indicated that they would be prepared to contribute or contribute more if the United States or other G-7 countries were to make a contribution.

Progress to Date

In the year that has passed since the Initiative was launched, the debt situation of seven countries reaching the decision point has been reviewed by the Boards of the World Bank and IMF.

- HIPC relief totaling an estimated $3 billion in net present value (NPV) terms will be provided to these countries, equivalent to about $5 billion in debt service relief over time.

- Three countries, Bolivia, Burkina Faso, and Uganda, have qualified for relief totaling $900 million in NPV terms ($1.5 billion in debt service relief over time).

- Progress on HIPC debt reduction deals is well advanced for three more countries --Côte d'Ivoire, Guyana, and Mozambique will account for a further $2 billion in NPV terms (about $3.5 billion debt-service relief over time).

- One country (Benin) has been determined not to require further debt relief.

Next Steps

The momentum of progress in implementing the Initiative is continuing. Over the coming months, the debt reduction deals for Côte d'Ivoire, Guyana, Mozambique, are due to be completed, following consultations with other creditors. (With respect to Mozambique, the response of bilateral creditors through the Paris Club will be key, as they will need to go beyond previous practice in order to provide their share of the debt relief needed to bring that country's debt to a sustainable level). World Bank /IMF missions have gone to the field to participate in the preparation of debt sustainability analyses for a number of additional countries, including Guinea-Bissau, Mali and Mauritania, which are approaching their decision points.

The HIPC Debt Initiative offers poor countries a clear way out of the debt trap--the overhang of unsustainable debt--and to focus their resources on sustainable development and reducing poverty. Bringing debt down to an affordable level, as part of a broader set of economic an social reforms, can make a real difference in achieving these goals. The Debt Initiative has had an excellent start. The pace of further debt relief will depend on the performance of countries in seriously pursuing reform programs, as well as the continued willingness of the creditor and donor community to provide the necessary resources.

HIPC Debt Initiative Group
November 6, 1997
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