

# Debt relief, the new policy conditionality and poverty reduction strategies

## Chapter

# 5

### A. Introduction

In spite of extensive policy reforms, rates of external indebtedness increased in many LDCs during the 1990s, and according to World Bank calculations, 28 LDCs - including two-thirds of LDCs that are not island economies – are entering the new millennium with levels of external indebtedness that are unsustainable even after the full deployment of traditional (pre-HIPC) debt relief mechanisms. One of the arguments of the last chapter was that the effectiveness of reforms in LDCs depended on the severity of their debt problems. This chapter assesses from the point of view of LDCs the effectiveness of the HIPC Initiative, which was introduced in 1996 as a new mechanism to deal with the debt problems of low-income countries. It addresses five questions:

1. How have the mechanisms, modalities and conditionalities of debt relief changed for LDCs with the introduction of the HIPC Initiative? (sections B and C);
2. What is the reach of the HIPC Initiative, and what are the financial costs for creditors and the financial benefits for LDCs? (section D);
3. Does the HIPC Initiative offer LDCs debt sustainability in the medium and long term? (section E);
4. To what extent can the Initiative contribute to poverty reduction in LDCs? (sections F and G);
5. What are the policy implications of the analysis in this chapter? (section H)

Particular attention is paid to the transformation of the IMF's ESAF into the Poverty Reduction and Growth Facility (PRGF), the introduction of the Poverty Reduction Strategy Papers (PRSPs), and associated changes in policy conditionality (sections C and G). It is the HIPCs, including HIPC LDCs, that are setting the pace in the implementation of these new policy mechanisms. But the PRGF and PRSP have much wider significance than for HIPC LDCs alone. The PRGF now will act as the gatekeeper mechanism for access to concessional finance, as well as debt relief, in all low-income countries, and the PRSP is intended as the framework for better aid coordination. As the OECD (OECD, 2000: 21) has insightfully and succinctly put it, "The decision to place the implementation of the enhanced HIPC into the larger context of the new development partnership paradigm has in effect leveraged political support for debt relief into a reform of the whole concessional financing system".

It must be stressed at the outset that the HIPC Initiative is targeted at poor countries, rather than LDCs as such. But it is a vital component of the international enabling environment for future growth and poverty reduction prospects for those 30 LDCs that are HIPCs. Moreover, the manner of the financing of the HIPC Initiative, if it reduces resources available for aid, particularly through IDA, could have important implications for LDCs that are not HIPCs. Finally, it is important to note that almost three quarters of all HIPCs (30 out of 41) are currently LDCs, and that the HIPC problem is rapidly becoming an exclusively LDC problem. After the end of 2000, if the schedule of

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implementation set by the international community stays on track, all except two of the HIPCs that have not reached their decision point will be LDCs.

## B. Traditional debt relief mechanisms and the HIPC Initiative

Since the mid-1970s, the international community (including Paris Club creditors, non-Paris Club bilateral and commercial creditors, and multilateral institutions) has introduced and implemented a variety of instruments to deal with the debt problems of developing countries. In middle-income countries, where most of the debt was owed to commercial creditors, a resolution of the debt problem of the 1980s was achieved following the financial innovation of the Brady Plan (conversion of debt into bonds, with a discount). The debt relief process in these cases was informed by market valuations of the probability of debt repayment, together with hard-headed calculations of the returns which had already been realized on outstanding debts.<sup>1</sup>

In contrast, the debt relief process in low-income countries, where most of the outstanding debt was lent or guaranteed by Governments and owed by Governments, has been founded upon a complex intergovernmental process. Creditors, hedged in by the different degrees of freedom which diverse national legal and public accounting practices give them, have sought to recoup as much of their original loans as possible and to ensure that the burden of debt relief is fairly shared among themselves.

### 1. TRADITIONAL DEBT RELIEF MECHANISMS

The major traditional (pre-HIPC) mechanisms of debt relief for LDCs have been: (i) rescheduling of principal and interest payments with Paris Club creditors on either concessional or non-concessional terms, most generally without extinguishing any of the debt stock; (ii) the pursuit of comparable terms from non-Paris Club creditors; (iii) forgiveness of bilateral ODA debt by converting concessional loans into grants; (iv) reduction of commercial debt through the IDA Debt Reduction Facility; and (v) special programmes supported by bilateral donors to enable debtor countries to meet multilateral debt service obligations, notably the "fifth dimension" programme of the World Bank, which was introduced in 1988 to enable IDA-only countries to repay interest on past IBRD loans, and the Rights Accumulation Programme of the IMF, introduced in 1991 to enable countries to clear arrears to the IMF.<sup>2</sup> In addition, as indicated in chapter 4, debt relief has also taken the form of new concessional financing.

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Most LDCs have taken advantage of these opportunities to alleviate their debt burden. Many have been granted debt forgiveness on at least part of their ODA debt. Between 1978 and 1986, 33 LDCs benefited from retroactive terms adjustment measures provided by 15 DAC countries, for an overall nominal value of \$4.1 billion, of which \$3 billion was in the form of debt cancellation (UNCTAD, 1986: 128-134). Between 1988 and 1998 almost all LDCs benefited, and total debt forgiveness according to statistics on grant commitments has a face value of \$ 7.2 billion (table 30). The number of Paris Club reschedulings in the 1990s (51) was somewhat lower than during the period 1980-1989, which was 70, but the amount of debt consolidated was, at \$14.1 billion, higher than in the former period (table 31). Twenty-two LDCs undertook Paris Club reschedulings in the 1990s, and most of these countries

TABLE 30: OFFICIAL BILATERAL DEBT FORGIVENESS GRANTS TO LDCs, 1988–1998  
(\$ millions)

	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	Total (1988–98)
Afghanistan	-	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.7
Angola	-	-	4.3	-	2.4	-	-	63.7	13.9	13.7	11.4	109.2
Bangladesh	-	1.5	2.4	298.2	6.5	3.7	16.4	3.8	6.0	151.6	189.0	679.0
Benin	-	2.9	5.0	20.8	51.5	3.9	5.3	6.4	6.1	15.5	10.6	127.9
Burkina Faso	-	8.1	8.5	14.3	12.1	12.7	19.2	14.0	22.9	6.2	19.7	137.8
Burundi	-	2.4	10.2	6.5	7.0	7.4	7.9	8.6	9.6	0.6	8.7	68.9
Cambodia	-	0.0	-	-	-	-	11.1	-	-	-	-	11.1
Cape Verde	-	0.0	0.4	0.6	0.7	0.6	0.7	0.7	0.7	-	0.7	5.2
Central African Republic	-	2.1	3.0	4.6	6.7	8.0	18.4	17.4	19.4	0.1	14.2	94.0
Chad	-	0.5	2.1	2.9	3.8	3.3	4.0	8.8	6.5	0.4	8.5	40.7
Comoros	-	0.2	0.9	1.1	1.1	1.2	1.7	1.7	1.9	0.0	2.7	12.5
Dem. Rep. of the Congo	-	3.7	32.8	274.0	7.7	8.5	18.3	20.8	17.0	5.5	12.8	401.0
Djibouti	-	0.7	2.6	2.6	2.8	2.6	2.7	3.0	3.0	-	2.5	22.3
Equatorial Guinea	-	-	-	-	-	-	-	0.6	0.6	-	2.4	3.5
Eritrea	-	-	-	-	-	-	0.0	-	-	-	-	0.0
Ethiopia	0.1	0.3	0.4	0.3	68.1	0.2	42.2	13.7	1.4	10.8	34.6	172.1
Gambia	3.0	1.0	2.5	2.4	2.3	2.1	2.3	2.6	2.4	0.2	2.0	19.9
Guinea	-	40.6	6.9	11.0	13.9	17.2	15.8	26.0	22.8	4.0	50.0	208.2
Guinea-Bissau	-	0.3	0.1	0.1	0.1	0.1	1.6	12.6	7.0	4.7	5.3	31.8
Haiti	-	-	-	99.0	-	-	16.3	46.6	8.8	-	4.5	175.3
Lao People's Dem. Rep.	-	-	-	-	-	-	0.3	-	35.1	2.5	3.7	41.7
Lesotho	-	0.0	0.0	0.0	-	-	0.1	0.1	0.2	-	0.3	0.6
Liberia	-	0.7	0.8	0.8	0.9	0.8	0.6	0.6	0.5	-	0.5	6.1
Madagascar	0.0	3.9	152.4	74.2	23.6	26.4	40.8	45.7	44.1	135.1	220.6	766.8
Malawi	-	2.9	2.0	19.0	2.7	2.2	2.2	6.3	11.2	13.4	15.0	76.8
Mali	0.1	0.1	4.6	7.1	7.7	8.4	24.6	12.3	30.0	1.3	18.3	114.4
Mauritania	-3.3	56.1	3.0	4.5	4.7	6.3	7.9	9.5	8.3	3.2	7.6	111.1
Mozambique	20.5	19.7	44.1	153.7	168.0	33.5	39.9	255.6	55.0	81.3	208.6	1 059.4
Myanmar	-	-	-	-	-	-	1.5	-	1.9	49.6	49.7	102.7
Nepal	-	0.2	0.2	0.2	0.2	0.2	0.2	-	0.9	9.1	19.9	31.1
Niger	-	1.9	10.1	12.0	9.0	8.0	29.2	17.6	21.1	1.4	33.0	143.3
Rwanda	-	0.9	3.3	3.1	3.6	4.8	6.6	7.3	10.9	4.1	22.5	67.2
Samoa	-	0.0	0.0	0.0	0.0	0.0	0.0	0.0	-	-	-	0.1
Sao Tome and Principe	-	-	-	-	-	-	-	1.0	1.8	3.7	2.5	9.0
Sierra Leone	-	8.3	1.3	1.2	1.1	96.4	6.4	8.2	3.3	4.1	0.2	130.6
Somalia	-	7.3	1.7	1.8	2.0	2.3	2.8	3.1	3.3	-	4.1	28.3
Sudan	0.3	24.2	1.7	1.8	0.8	0.6	3.4	3.8	3.8	0.6	5.3	45.9
Togo	-13.5	9.1	5.0	12.4	5.3	5.5	16.8	40.2	24.3	3.5	24.9	146.8
Uganda	-10.0	0.9	13.1	17.4	3.0	0.8	1.5	35.1	30.2	21.0	16.6	139.6
United Rep. of Tanzania	27.5	20.0	61.4	112.8	0.8	256.1	7.5	35.9	11.4	25.3	190.2	721.4
Vanuatu	-	-	-	-	-	-	0.6	-	0.7	-	0.6	1.9
Yemen	2.4	-	-	0.2	0.2	0.2	7.4	4.0	14.6	26.1	29.2	81.9
Zambia	3.2	-	355.6	79.5	78.8	139.6	35.1	60.3	74.0	87.4	111.3	1 021.5
<b>Total LDCs</b>	<b>30.2</b>	<b>220.8</b>	<b>742.31</b>	<b>240.3</b>	<b>499.2</b>	<b>663.5</b>	<b>418.9</b>	<b>797.5</b>	<b>536.4</b>	<b>686.0</b>	<b>1 364.2</b>	<b>7 169.0</b>

Source: UNCTAD secretariat estimates, based on OECD/DAC database.

TABLE 31: PARIS CLUB DEBT RESCHEDULINGS WITH OFFICIAL CREDITORS, 1980–1998: LDCs

Country																				Amount consolidated (\$ million)			Total number debt reschedulings		
	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	80-89	90-98	80-98	80-89	90-98	80-98
Angola										365										365	-	365	1	-	1
Benin										199		116		37			20			199	173	372	1	3	4
Burkina Faso												53		36			64			-	153	153	-	3	3
Cambodia																258				-	258	258	-	1	1
Central African Rep.		28		15		17			39		11				30				99	64	163	4	3	7	
Chad										33						24	n.a		33	24	57	1	2	3	
Dem. Rep. of the Congo		276		1417		385	425	740		1602									4845	-	4845	6	-	6	
Equatorial Guinea						44				12			32		51				56	83	139	2	2	4	
Ethiopia													371						-	555	555	-	2	2	
Gambia							19												19	-	19	1	-	1	
Guinea							232			161			169			163		123	393	455	848	2	3	5	
Guinea-Bissau								24		40						150			64	150	214	2	1	3	
Haiti																117			-	117	117	-	1	1	
Liberia	21	24		18	13														76	-	76	4	-	4	
Madagascar		172	107		389	141	181		236		111								1226	1 358	2 584	6	2	8	
Malawi			26	15					43										84	-	84	3	-	3	
Mali									48	33			107				33		81	140	221	2	2	4	
Mauritania						40	36	39		66				211		72			181	283	464	4	2	6	
Mozambique					317			429			739			343			664		746	1 746	2 492	2	3	5	
Niger				37	44	48	34		34+57		151				194		128		254	473	727	6	3	9	
Rwanda																			-	54	54	-	1	1	
Sierra Leone	39				88		65						276		47		39		192	362	554	3	3	6	
Somalia						126		95											221	-	221	2	-	2	
Sudan			211	546	231														988	-	988	3	-	3	
Togo		120		125	67	25			118	82	101		50			246			537	397	934	6	3	9	
Uganda		63	16					102		86			172			110			267	430	697	4	3	7	
Utd. Rep. of Tanzania							676		236		245		779						912	2 632	3 544	2	3	5	
Yemen																	113	1 444	-	1 557	1 557	-	2	2	
Zambia				302	263		355			1 174		874					566		920	2 614	3 534	3	3	6	
Amount in \$ millions	60	683	360	2 475	1 412	826	2 023	1 429	811	2 679	2 532	169	2 830	627	322	1 140	1 627	4 606	225	12 758	14 078	26 836			
Total number of LDCs	2	6	4	8	8	8	9	6	7	11	7	2	9	4	4	8	9	5	3						

Source: World Bank, *Global Development Finance 2000*; Official debt restructuring (Paris Club Agreed Minutes).

were returning to reschedule their debts again. By 1998, 12 LDCs had gone to the Paris Club five or more times to restructure their debts, and 21 out of the 29 LDCs which had ever undertaken such rescheduling had, by the end of the 1990s, done so three or more times. Ten LDCs benefited from commercial debt reduction through the IDA Debt Reduction Facility. The total commercial debt extinguished in debt buy-back operations in LDCs through that Facility was equivalent to \$0.62 billion. The debt was bought back for 8 - 13 cents for every nominal dollar in LDCs (table 32).

Although these “traditional” debt relief mechanisms have alleviated the debt burden of many LDCs, their deployment proved unable to engineer a durable exit from their debt problems. In deciding on the scale of debt relief which they provide, the question for creditors has been “What is the minimum amount of relief that must be granted to debtors such that the remaining debt-service burden can be paid without recourse to further relief?” (Killick and Stevens, 1997: 154). There has been a persistent tendency to underestimate what has been needed, which has in itself contributed to the build-up of the debt. The Paris and London Club reschedulings for most of the 1980s were on non-concessional “standard terms” with relatively short grace periods (five years) and maturity (ten years), and market-related interest rates. This inevitably led to repeated reschedulings and growth of the stock of debt.<sup>3</sup> The international community introduced the principle of concessional rescheduling in October 1988 with the “Toronto terms”, and then progressively increased the percentage reduction in future debt service obligations on eligible debt with the introduction of “London terms” in December 1991, “Naples terms” in January 1995 and “Lyons terms” in 1998.

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TABLE 32: IDA DEBT REDUCTION FACILITY: SUMMARY OF COMPLETED OPERATIONS IN THE LDCs  
(\$ millions)

Date completed	Country	Principal extinguished (\$ millions)	Price (Cents per dollar) <sup>a</sup>	Interest extinguished (estimates) (\$ millions)	Total debt (incl. interest) extinguished/GDP (%)
March 1991	Niger	107	18	100	9
December 1991	Mozambique	124	10	74	14
February 1993	Uganda	153	12	24	5
August 1994	Sao Tome	10	10	..	20
September 1994	Zambia	200	11	208	13
September 1995	Sierra Leone	235	13	51	30
January 1996	Ethiopia	226	8	58	5
August 1996	Mauritania	53	10	36	8
December 1997	Togo	46	13	29	5
<b>Total</b>		<b>1 154</b>	<b>12<sup>b</sup></b>	<b>580</b>	<b>9<sup>c</sup></b>

Source: World Bank, [www.worldbank.org/hipc/progress-to-date/progress-to-date.html](http://www.worldbank.org/hipc/progress-to-date/progress-to-date.html).

Notes: Up to end of December 1998.

a Of original face value of principal.

b Weighted by principal extinguished.

c Weighted by GDP.

## 2. THE INNOVATIONS OF THE HIPC INITIATIVE

The HIPC Initiative is a further extension of this process, which innovates in three important ways. First, it widens the coverage of the types of debts which are eligible for relief to include multilateral debt. This is the critical shift, since it recognizes the need for a formal mechanism of multilateral debt relief. Before the HIPC Initiative, the only way in which the World Bank and the IMF could respond to the growing debt-servicing difficulties of some of their clients was through provision of new financing, i.e. maintaining a sufficient flow of new lending to debtor countries to ensure they could continue to service past credits. Multilateral debt has become increasingly important to LDCs, constituting over 60 per cent of long-term debt (including use of IMF credit) in 1998 in half of the LDCs for which information is available. (see chapter 2, table 17)

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Secondly, the Initiative sets an explicit target for debt sustainability, and provides a commitment to the HIPCs that if traditional debt relief mechanisms cannot bring their debts down to a level at which they are sustainable, additional action will be taken by the international community to do so. A country can be considered to have achieved external debt sustainability "if it is expected to be able to meet current and future external debt-service obligations in full without recourse to debt relief, re-scheduling of debts, or accumulation of arrears, and without unduly compromising growth" (Boote et al., 1997: 126). But a central question is the criteria which are used to decide the target for debt sustainability. The lower the target, the greater the likelihood that there will be a durable exit for the indebted country, but the greater the costs will be for the creditors.

Within the HIPC Initiative, the target for debt sustainability is set as a threshold ratio of the present value (PV) of debt to exports or to government revenue.<sup>4</sup> The present value is a measure of the value of a country's future debt service obligations which is calculated within the HIPC Initiative by discounting the future debt service flows at the commercial interest reference rate (CIRR). This is calculated for each country at a particular moment in time, and then an estimate is made of by how much a country's future debt service obligations have to be reduced in order for the debt to be sustainable. The maximum ratio of PV debt to exports considered sustainable was initially set at 200 – 250 per cent, but with enhancements of the Initiative announced at the G-8 Cologne Summit in June 1999, these were lowered to a fixed level of 150 per cent. The maximum sustainable level for the ratio of the PV debt to fiscal revenue was also lowered – from 280 to 250 per cent – and the thresholds required to qualify for HIPC assistance under this criterion were lowered from 40 to 30 per cent in the case of the export-to-GDP ratio, and from 20 to 15 per cent in the case of the revenue-to-GDP ratio. Creditors are expected to share the reduction in the future debt service obligations required to bring the PV debt-to-exports and debt-to-revenue ratios down to sustainable levels according to their share of the present value of the debt at the decision point. But they can choose how to provide their share of the reduction in future debt service obligations. Debt relief is distributed on future maturities of the loans, and it may take up to 20 years or more before the relief has finally been delivered.

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Thirdly and finally, an important innovation of the HIPC Initiative is that new sources and mechanisms for financing debt relief were introduced. These include IMF gold sales, enabling the World Bank and other multilateral institutions to use some of their own resources, and the setting up of the HIPC Trust Fund to which bilateral donors may contribute to help the multilateral institutions provide debt relief.



## C. The new policy conditionality

### 1. THE NATURE AND SCOPE OF POLICY CONDITIONALITY

The HIPC Initiative was introduced in 1996, but as indicated above, enhanced in 1999. This continued the pattern of the 1980s and early 1990s whereby creditors progressively realized the inadequacy of past debt relief mechanisms. Details of the enhancement are set out in *The Least Developed Countries 1999 Report* (pp.30-34), but in brief it entailed setting lower debt sustainability targets (see above), fixing the magnitude of debt relief which creditors will deliver in the future at the time of the decision point, providing interim assistance between the decision point and completion point (at which latter point debt relief would be irrevocably committed), and increasing the flexibility in the timing of the completion point. Also, the Paris Club agreed to increase the concessionality of its relief on eligible debt (“Cologne terms”).<sup>5</sup>

With the enhancement of the HIPC Initiative, there is more debt relief on offer. But equally, there has been a significant change in the nature and extent of conditionality attached to debt relief. In HIPC I, a country had to establish a three-year track record of good performance under an ESAF programme before it reached decision point, and was expected to follow with a further three years of ESAF-based economic reforms before it reached completion point, after which point debt relief was provided unconditionally and irrevocably. In HIPC II, a country still has to establish a three-year track record of good performance under IMF- and World Bank-supported adjustment programmes before the decision point (chart 43). But the completion point is “floating” in the sense that it can be reached in less than three years if a country can implement reforms which would normally be expected to take three years in less time, and conversely later, if they take longer. Moreover, the achievement of the completion point is conditional on a track record, which encompasses, firstly, appropriate macroeconomic policies in place, and “a macroeconomic position conducive to sustainable growth and poverty reduction”, indicated by low inflation, a fiscal policy consistent with a low and sustainable level of bank financing and an adequate reserve cushion; secondly, the implementation, as in ESAFs, of agreed and monitorable structural reforms; and thirdly, the implementation of agreed and monitorable social development policies.<sup>6</sup>

With the introduction of the floating completion point it is possible for exceptionally good performers to shorten the amount of time which elapses before which they receive unconditional and irrevocable relief. But equally, the completion point may float into a distant future if countries cannot stay on track. However, more significant than the change in the period of time during which performance is monitored is the change in the content and extent of policy conditionality and in the procedures for setting it.

The key change in the content of policy conditionality is that the goal of poverty reduction has been added to existing policy conditionalities. Policy reforms are now much more geared towards the achievement of poverty reduction objectives, and should seek to ensure the complementarity between macroeconomic, structural and social policies. Not only does this involve a change of emphasis, but it also represents a significant extension of policy conditionality. As no policy conditionalities have been subtracted, there is a net addition to the extent of conditionality faced by Governments that want to take advantage of HIPC assistance (Killick, 2000: 3).

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CHART 43: ENHANCED HIPC INITIATIVE: FLOW CHART OF THE DELIVERY OF DEBT RELIEF

### First stage

Country establishes a three-year track record of good performance and develops together with civil society a Poverty Reduction Strategy Paper (PRSP); in early cases, an interim PRSP may be sufficient to reach the decision point.

- Paris Club provides flow rescheduling as per current Naples terms, i.e. rescheduling of debt service on eligible debt falling due during the three-year consolidation period (up to 67 per cent reduction on eligible maturities on a net present value basis).
- Other bilateral and commercial creditors provide at least comparable treatment.
- Multilateral institutions continue to provide support within the framework of a comprehensive poverty reduction strategy designed by Governments, with broad participation of civil society and donor community.

**EITHER**

**OR**

Paris Club stock-of-debt operation under Naples terms and comparable treatment by other bilateral and commercial creditors  
**is adequate**  
for the country to reach sustainability by the decision point.

→ **Exit**

(Country is not eligible for HIPC-assistance.)

Paris Club stock-of-debt operation under Naples terms and comparable treatment by other bilateral and commercial creditors  
**is not sufficient**  
for the country to reach sustainability by the decision point.

→ **Decision Point**

(World Bank and IMF Boards determine eligibility.)

All creditors (multilateral, bilateral, and commercial) commit debt relief to be delivered at the floating completion point. The amount of assistance depends on the need to bring the debt to a sustainable level at the decision point. This is calculated based on latest available data at the decision point.

### Second stage

Country establishes a second track record by implementing the policies determined at the decision point (which are triggers to reaching the floating completion point) and linked to the (interim) PRSP.

- World Bank and IMF provide interim assistance.
- Other multilateral and bilateral creditors and donors provide interim debt relief at their discretion.
- All creditors continue to provide support within the framework of a comprehensive poverty reduction strategy designed by Governments, with broad participation of civil society and donor community.

### "Floating" completion point

- Timing of completion point is tied to the implementation of policies determined at the decision point.
- All creditors provide the assistance determined at the decision point; interim debt relief provided between decision and completion points counts towards this assistance:
  - ▶ Paris Club goes beyond Naples terms to provide more concessional debt reduction of up to 90 per cent in NPV terms (and, if needed, even higher) on eligible debt so as to achieve an exit from unsustainable debt.
  - ▶ Other bilateral and commercial creditors provide at least comparable treatment on stock of debt.
  - ▶ Multilateral institutions take additional measures, as may be needed, for the country's debt to be reduced to a sustainable level, each choosing from a menu of options, and ensuring broad and equitable participation by all creditors involved.



The new orientation towards poverty reduction is most dramatically indicated in the replacement of ESAF by the Poverty Reduction and Growth Facility (PRGF), which became effective in November 1999. The purpose of the new Facility is “to support programs to strengthen substantially and in a sustainable manner [qualifying low-income members’] balance of payments position and to foster durable growth, leading to higher living standards and a reduction in poverty”. These programmes will stem from and be consistent with Poverty Reduction Strategy Papers (PRSPs), which will replace the Policy Framework Papers (PFP) which underpinned ESAFs.<sup>7</sup>

The PRSPs would normally be prepared every three years, with annual progress reports prepared by authorities updating the strategy as appropriate in the intervening years. They are meant to be context-specific and should vary between countries. However, their likely elements should include: a description of the nature and locus of poverty; an analysis of macroeconomic, structural, social and institutional obstacles to faster growth and poverty reduction; long-term goals for key poverty reduction targets together with annual (or six-monthly) targets covering a three-year horizon for related intermediate and proxy indicators; an action plan focusing on priorities for increasing sustainable growth and reducing poverty, which takes into account what is known of the linkages between different policies, their appropriate sequencing and the expected contribution of policy actions to the attainment of intermediate indicators; and a macroeconomic framework which incorporates the priorities for increasing sustainable growth and reducing poverty set out in the action plan. PRSPs are expected to be clearly linked to international development goals for poverty reduction, education, health and gender equality.

Conditionality in PRGF arrangements will seek to evaluate implementation of the PRSP with a view to ensuring its objectives. The PRSP would contain a quantified medium-term macroeconomic framework, and specific quarterly performance benchmarks deriving from the framework would be elaborated in the PRGF-supported programme. It is expected that macroeconomic monitoring would be based on established practice, setting intermediate targets in fiscal, monetary and external sectors. Structural reform conditions in PRGF-supported programmes would be drawn from or elaborate on the universe of structural measures contained in the PRSP. A timetable of key policy actions over a three-year period could be included in a policy matrix, which, if set out in sufficient detail, would provide the basis for the monitoring of lending operations and lessen the need for lengthy negotiations to specify the conditions of both PRGF and IDA operations. The focus and efficiency of conditionality may also be tightened by reducing overlapping Fund and Bank conditionality through identifying, for each measure which is to be monitored, whether the Bank or the Fund would take primary responsibility for supporting the Government’s policy formulation and for monitoring.

The change in the content of policy conditionality is complemented by a change in the procedures through which conditions are agreed. The PRSP is intended to be a country-owned document prepared through a participatory process which elicits the involvement of civil society, other national stakeholders and elected institutions. “Ownership” in this context refers to the Government’s taking the lead in the preparation of the PRSP, including the animation of the participatory process (which is expected to increase public accountability) and the drafting of the action plan. As comparison of the documentation requirements of ESAFs and PRGFs shows, the critical shift is in the leadership in the preparation of the PFP and PRSP (table 33), although the authorities may draw on outside expertise as required, including from the Bank and the Fund.

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*The PRSP is intended to be a country-owned document prepared through a participatory process which elicits the involvement of civil society, other national stakeholders and elected institutions.*

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TABLE 33: CHANGES IN DOCUMENTATION REQUIREMENTS WITH THE TRANSFORMATION OF ESAF INTO PRGF

Document	Periodicity	Ownership	Audience
<b>A. Documents needed for ESAF arrangement</b>			
Policy Framework Paper	Annual	Prepared jointly by Fund and Bank; country's document	Fund and Bank Boards; most countries now publish
Letter of Intent (may include Memorandum of Economic Policies)	With every request for arrangement or review	Country prepares jointly with Fund; country's document	Fund Board; most countries now publish
Staff Report	With every request for arrangement or review	Fund staff prepares	Fund Board
<b>B. Proposed documentation for PRGF arrangements</b>			
Poverty Reduction Strategy Paper (PRSP)	PRSP every 3 years; with annual progress report in intervening years	Country prepares and owns, in consultation with civil society and donors, with assistance from Funds and Bank	Public document; Fund and Bank endorsement needed to underpin their operations; donors may use to organize support
Staff Assessment of PRSP	With every PRSP progress report, and interim PRSP	Fund and Bank staff prepare jointly	Fund and Bank Boards; to be published
Letter of Intent (may include Memorandum of Economic Policies)	With every request for arrangement or review	Country prepares jointly with Fund; country's document	Fund Board; most countries now publish
Staff Report	With every request for arrangement or review	Fund staff prepares	Fund Board

Source: IMF, [www.imf.org/external/np/pdr/prsp/poverty2.htm](http://www.imf.org/external/np/pdr/prsp/poverty2.htm).

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*Access to debt relief under the HIPC Initiative and access to concessional lending by the Fund and the Bank are now linked to the preparation of poverty reduction strategies.*

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Once it is finalized, the PRSP will be presented to the Boards of the Fund and the Bank for endorsement. The latter would be a condition for Fund approval of a PRGF arrangement, or for completion of a review thereunder. A short assessment, prepared by Fund and Bank staff, would be circulated to both Boards alongside the PRSP and would recommend endorsement (or rejection) of the strategy as a basis for Bank and Fund concessional lending to the country concerned. It would include a description of the participatory process followed in the preparation of the strategy, but the joint assessment would not recommend rejection or acceptance on the basis of the participatory process.

Access to debt relief under the HIPC Initiative and access to concessional lending by the Fund and the Bank are now linked to the preparation of poverty reduction strategies. On a transitional basis, to reduce the tension between the desire to deliver debt relief faster and the pace at which effective country-owned and participatory poverty strategies can be prepared, an interim PRSP, which sets out the Government's commitment to, and plans, for developing a PRSP, will be sufficient for a country to reach decision point within the HIPC Initiative. Special provisions are also being made for retroactive cases which reached their decision point under HIPC I. But in general, PRSPs, interim PRSPs or annual PRSP progress reports, supported by Joint Staff Assessments and broadly endorsed by the Boards of both the Bank and the Fund within the previous 12 months, will now be a necessary condition for approval of new PRGF arrangements or reviews of existing arrangements and for HIPCs to reach a decision or completion point under the HIPC Initiative. They will also be

necessary for all IDA borrowers, at a date to be determined no later than 1 January, 2001, in the light of experience during the first year, for a high case lending scenario and adjustment lending, except in special circumstances such as emergency or crisis situations. As table 34 shows, 27 LDCs have been engaged in the process of producing PRSPs in 2000.

## 2. SOME DANGERS OF POLICY CONDITIONALITY

For creditors, policy conditionality and performance monitoring are a vital mechanism to ensure that bad policies are not rewarded, problems of moral hazard on the part of debtor countries are minimized, and the right policy framework is put in place to maximize the chances that the benefits of debt relief will be used to promote economic growth and poverty reduction. Whilst debtor countries generally accept the principle of conditionality, its precise content and manner of implementation can be costly, both for creditors and debtors, and the international administrative guidance of a process of poverty reduction potentially counter-productive.<sup>8</sup>

TABLE 34: LDCs: EXPECTED PROGRESS IN PRSP PROCESS, PRGF ARRANGEMENTS AND REVIEWS, AND HIPC INITIATIVE DURING 2000

	I	P	F	R	D	C	S
Benin	x		x		x		x
Burkina Faso		x		x	x	x	x
Cambodia	x			x			x
Central African Rep.	x			x			
Chad	x	x		x	x		x
Djibouti	x			x			
Ethiopia	x		x				
Gambia	x			x			
Guinea	x			x	x		
Guinea-Bissau	x		x	x	x		
Haiti	x		x				
Lao PDR	x		x				
Lesotho	x		x				
Madagascar	x			x			
Malawi	x		x	x	x		x
Mali	x			x	x	x	x
Mauritania		x		x	x		
Mozambique	x			x	x		x
Nepal	x		x				
Niger	x		x	x			
Rwanda	x			x	x		
Sao Tome & Principe	x		x	x			
Sierra Leone	x		x				
Uganda		x		x	x	x	x
U.R. of Tanzania	x	x	x	x	x		
Yemen	x			x			
Zambia	x			x	x		

Source: IMF, [www.imf.org/external/np/hipc/doc.htm#1999](http://www.imf.org/external/np/hipc/doc.htm#1999).

Notes: I- Interim PRSP; P- PRSP; F- new PRGF 3-year arrangement; R- review of PRGF arrangement, or new annual arrangement; D- HIPC decision point under enhanced Initiative; C- HIPC completion point, enhanced or original Initiative; S- Country Assistance Strategy.

The greatest costs arise if the conditions which a country is obliged to meet as part of its policy reform programme diverge from those which are actually necessary to promote capital accumulation, increase economic efficiency and underpin sustained development and beneficial integration into the world economy. The new approach to PRSPs considerably reduces the probability that off-the-shelf strategies which are inappropriate to the particular situation of a country will guide policy conditionality, particularly if countries are actually given sufficient space to develop their own innovative approaches. But certain other dangers remain.

First, even with home-grown, fully owned policy conditionality, countries will be on a "short-leash" for between four and six (or more) years before debt relief is irrevocably and unconditionally committed. Within this period, policies and performance are monitored frequently. The critical problem with this short-leash approach is that it increases uncertainty and unpredictability. Linking debt relief to poverty performance creates the risk that the volume and timing of aid will be interrupted if performance falls below target, and the consequent squeeze in funding puts the whole reform process off track (Deusy-Fournier, 1999). Rather than a once-and-for-all debt reduction, short-leash conditionality leads to an approach to relief delivery which is not conducive to boosting economic growth by providing a strong private sector expectations shock.

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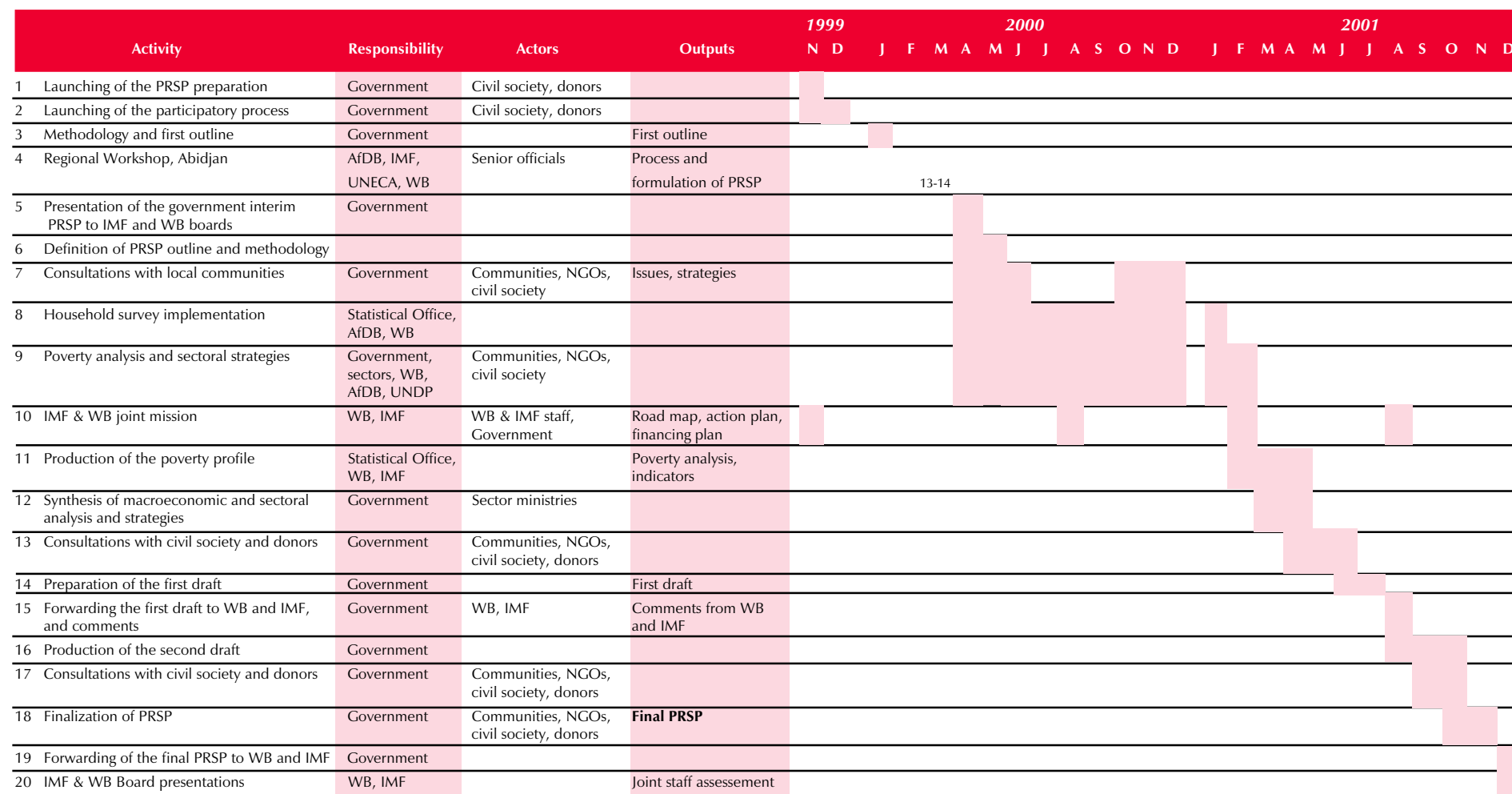
*There are high transaction costs associated with fulfilling conditions with policy reforms and debt relief.*

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Secondly, as indicated in chapter 4, there are high transaction costs associated with fulfilling conditions with policy reforms and debt relief. To the extent that the conditions are the right ones, these transaction costs will be an important investment for a country. But as the international community has switched the development agenda towards poverty reduction, a new process of learning has to be put in place within LDCs. The requirements for producing a PRSP are incredibly demanding (see chart 44), and "to reach a decision point, countries will have to undertake extremely complex and lengthy discussion processes, both internal (with civil societies) and externally (with the Bretton Woods Institutions, regional banks and donors) to build a consensus on priorities, best policies and instruments to reduce poverty, and the selection of appropriate indicators and targets to measure government efforts" (Debt Relief International, 2000a: 5). The World Bank and the IMF estimate that a full poverty reduction strategy can be produced in two years. But Uganda, which is in the forefront of this approach (see box 7), has been working on a strategy for five years. Even then, World Bank and IMF staff consider that Uganda needs to provide additional estimates of the cost of poverty reduction programmes and strengthen the links between expenditures on poverty reduction and indicators of poverty (GAO, 2000: 57).

Thirdly, a curious feature of the form of conditionality which is associated with the HIPC Initiative is that the more effective policy reforms are in promoting exports during the first three years before the decision point, the less the debt relief for which the country becomes eligible. This situation arises because countries have to establish a track record of performance for three years under IMF- and World Bank-supported programmes, and the level of debt relief is calculated in terms of the PV debt-to-exports ratio, based on exports over those years. The higher the exports, the less the relief. Moreover, if the export performance is so good that it brings the PV debt-to-exports ratio down to a level where the debt is sustainable after the full use of traditional debt relief mechanisms, the country, by its good performance, renders itself ineligible for HIPC assistance. In HIPC I this occurred in the case of Benin.<sup>9</sup>

CHART 44: SAO TOMÉ AND PRINCIPE: ROADMAP FOR THE PREPARATION OF A FULL PRSP



Source: Sao Tome and Principe authorities (2000); table 5.

### BOX 7: THE DEVELOPMENT OF ANTI-POVERTY POLICY IN UGANDA

Uganda's Poverty Eradication Action Plan (PEAP) is often cited as a good example of a poverty reduction strategy and held up as a model. Since its inception in 1997, it has guided the formulation of government policy. While providing national priorities for poverty reduction and guiding sector policies, the PEAP is established on four major pillars: (i) creating a framework for economic growth and transformation; (ii) ensuring good governance and security; (iii) directly increasing the ability of the poor to raise their income; and (iv) directly increasing the quality of life of the poor.

The PEAP involves wide consultation with individuals inside and outside government. The consultation process has been extended directly to the poor communities via the Uganda Participatory Poverty Assessment Programme (UPPAP) to assess the people's needs, priorities, and perceptions of the quality of service delivery and of government policies. The UPPAP aims to institutionalize a participatory approach to poverty planning and monitoring that extends to the district level.

In 1998/99, the Government adopted a Medium-Term Budget Framework (MTBF), under which budget priorities are formulated consistent with the PEAP and medium-term financial stability. Also, local government officials prepared medium-term expenditure plans to better reflect district poverty priorities, and civil society is involved in the dialogue on priorities and spending commitments. This process feeds into the budget framework paper and annual budgets.

Poverty monitoring involves a large number of institutions, including the Poverty-Monitoring Unit in the Ministry of Finance, Planning and Development (MFPED), the Uganda Bureau of Statistics and the UPPAP. The Poverty-Monitoring Unit integrates annual household surveys with other data sources (e.g. participatory analysis, sector surveys and line ministry data sources) to ensure that policy is continually influenced by poverty data and by perceptions of the poor.

The PEAP is monitored through the Poverty Status Report (PSR), which was first prepared in 1999 and is expected to be repeated every two years. The PSR synthesizes information on recent poverty trends and makes recommendations on the poverty eradication strategy, to be incorporated in future PEAP revisions.

The 1997 PEAP drew particular attention to the need for increased expenditure on the delivery of those services directly benefiting the poor. As a key element of the management process, the Government of Uganda established the Poverty Action Fund (PAF), designed to direct funds made available as a result of HIPC Initiative debt relief, and donor resources more broadly, towards the implementation of programmes focused on poverty. The PAF is fully integrated into the budget and includes the high-priority public expenditures from the poverty-eradication perspective as expressed by the poor communities (rural roads, agricultural extension, primary health, primary education, water supply, equalization grants across districts to reduce marginalization). Under the 2000/2001 PAF budget, the priority attached to water supply was increased and adult literacy was introduced as a priority. To ensure and enhance transparency, all releases of PAF resources are published and discussed at quarterly donor meetings, whose participants include relevant government officials, as well as NGO representatives and the media. The priorities contained in the PAF are to evolve in line with PEAP implementation and with the country's economic and social development.

The PEAP is currently being revised. So that it remains relevant, it is envisaged that its revision will be a regular process carried out every two years.

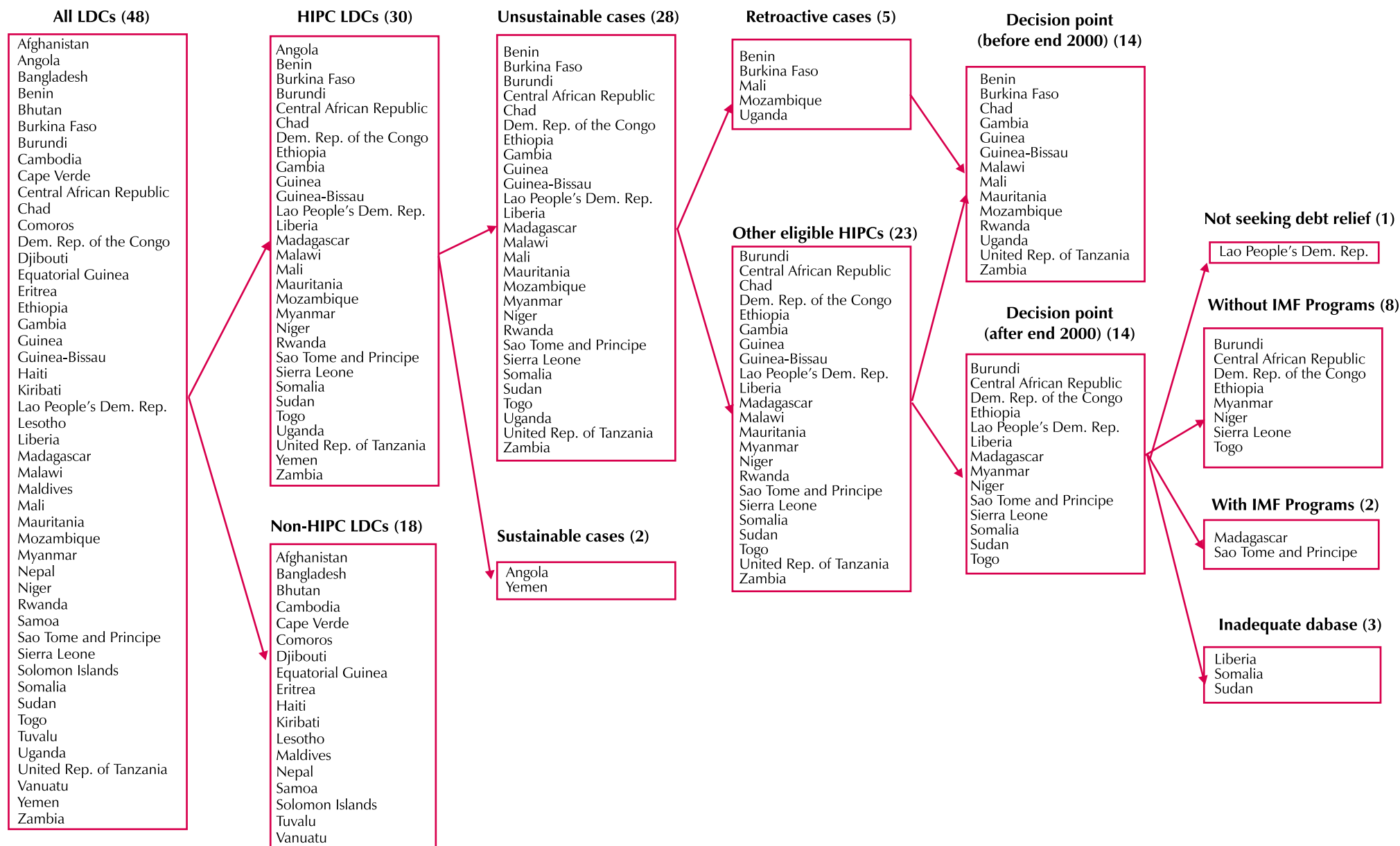
## D. The costs and benefits of HIPC debt relief

### 1. THE REACH OF RELIEF

Chart 45 indicates the current status of LDCs' eligibility in relation to the HIPC and also the likely timing of decision point. Eighteen LDCs are currently excluded from the Initiative, although the justification for doing so, if their debt situation warrants, is doubtful. One of the underlying principles in establishing the HIPC Initiative was that debt relief should be targeted at the poorest member countries for which excessive debt can be a particularly formidable obstacle to development. Application of this principle should logically take account of the special problems of the least developed countries, and as argued in *The Least Developed Countries 1999 Report*, debt sustainability analysis should be undertaken for all LDCs with a view to determining their debt relief needs. Malawi, which was originally categorized as a severely indebted non-HIPC, has already been moved from this group to join the HIPCs, and the



CHART 45: ELIGIBILITY OF LDCs FOR HIPC ASSISTANCE



Source: UNCTAD secretariat, based on [www.imf.org/external/np/prsp/pdf/diagram.pdf](http://www.imf.org/external/np/prsp/pdf/diagram.pdf)

Gambia has also recently been reclassified as the latest HIPC. Cambodia and the Comoros have PV debt-to-exports ratios which are above the HIPC threshold of sustainability. Moreover, if workers' remittances as well as re-exports are not included in the calculation of the PV debt-to-exports ratio, it is possible that a number of other LDCs might also be above HIPC thresholds of sustainability.

For the LDCs that are HIPCs, the time it is taking to reach the decision point is, for most of them, a problem. Of the 28 unsustainable countries, only four countries – Mauritania, Mozambique, Uganda and the United Republic of Tanzania – had reached decision point by July 2000, and only one of these (Uganda) had reached completion point. The other three are now eligible for interim assistance, but Mozambique and the United Republic of Tanzania are expected to reach the floating completion point in 2001 and Mauritania in 2002. Three other LDCs – Benin, Burkina Faso and Mali – are retroactive cases which reached their decision point under HIPC I, and they can be confidently expected to reach the new decision point in the second half of 2000. Bank and Fund staff are also committed to do everything possible to bring a further 10 HIPCs, including seven LDCs, to their decision point by the end of 2000.

There are 14 LDCs whose external debt is considered unsustainable after traditional debt relief but which will not reach decision point before the end of 2000. Of the 13 in this group that are seeking relief under the HIPC Initiative, only two were identified as meeting eligibility requirements in June 2000. Eight countries are judged not to meet the requirement of having IMF- and World Bank-supported programmes currently in place (even though they have undertaken ESAFs in the past). In principle, these countries will become ineligible for relief if they do not initiate such programmes before the end of 2000, although it is possible that this "sunset clause" may be extended as it was in 1998. Finally, three countries – Liberia, Somalia and Sudan - are classified apart owing to difficulties regarding how the large arrears of these countries will be dealt with and an inadequate database.

## 2. THE FINANCIAL COSTS OF DEBT RELIEF: CREDITORS' PERSPECTIVE

From the creditors' perspective, the financial costs of debt relief are estimated by the World Bank and the IMF as the difference between future debt-service payments (principal and interest) which are due prior to HIPC assistance and those which are due after implementation of HIPC assistance. A recent estimate of the costs of HIPC assistance for 36 of the 40 HIPCs is \$28.2 billion in 1999 PV terms.<sup>10</sup> This excludes Ghana, which has decided to keep its options open regarding whether to pursue HIPC relief, and three LDCs – Liberia, Somalia, and Sudan. If these three are included, a further \$6.3 billion would be added to the total costs. The estimates are indicative in that they depend heavily on assumptions regarding the timing of decision points and projections of exports, revenue and debt to those points, and they also calculate the additionality of HIPC relief. Alongside HIPC relief, countries would be expected to receive a stock-of-debt operation under Naples terms from Paris Club creditors and comparable treatment from other creditors, which together with the HIPC relief would result in a total reduction in future service obligations equivalent to about \$45 billion in PV terms (i.e an additional \$17 billion).<sup>11</sup>

It is impossible to make a precise estimate, from published sources, of the share of LDC HIPCs in total costs for all HIPCs. But of the non-LDC HIPCs, two are regarded as sustainable and the total costs that the assistance levels provided to the six non-LDC HIPCs which have reached decision point is \$5 billion. Thus

the financial costs of HIPC assistance to LDCs, including estimates for Liberia, Somalia and Sudan, may be put at \$29.5 billion, less the costs of relief for the three remaining non-LDC HIPCs which have not yet reached decision point – Cameroon, Congo and Senegal.

To put these numbers in perspective, it is worth recalling that it has been estimated that private banks forgave the equivalent of more than \$60 billion in nominal terms in the debt workout associated with Brady Plan operations (Cline, 1997: 143). The affordability of HIPC debt relief also needs to be placed in the context of the extent to which the debt is deemed collectable (Cohen, 2000). In some countries, the value of the debt has been discounted, or reduced, in recognition of the risk that the loans may not be repaid. For example, according to United States Treasury officials, the budgetary cost to the United States is about \$346 million (in present value terms) to forgive about \$3.8 billion in debt (in nominal terms) owed by 22 countries under the enhanced Initiative (GAO, 2000: 19).

### 3. THE FINANCIAL BENEFITS OF DEBT RELIEF: DEBTORS' PERSPECTIVE

From the debtors' perspective, what matters is whether the scale of debt relief is sufficient to remove the debt overhang on investment activity and ease the crowding-out effects of debt service payments on foreign exchange earnings and government expenditure. Also critical are the degree of front-loading of debt relief, and the latter's delivery in a form that can positively affect private sector expectations, and have an immediate impact on debt service payments, easing the liquidity constraint on the government budget which is reducing investment in both productive capacity and poverty reduction.

Table 35 provides estimates of the total debt relief in PV and nominal terms and the average annual reduction in debt service payments from 2000 to 2005 for the four LDCs which reached their decision point within the enhanced HIPC framework by July 2000. Mozambique has the highest debt relief. Total debt relief of \$1.97 billion in PV terms and \$4.3 billion in nominal terms translates into expected average annual debt service relief over the period 2000–2005 of \$116 million per annum. Uganda, which has reached completion point, is expected to receive annual debt service relief over the same period of \$102 million as a result of total assistance of \$1 billion in PV terms, whilst the United Republic of Tanzania, which is expected to reach completion point in 2001, should receive \$94 million as a result of total assistance of \$2 billion in PV terms. Finally, Mauritania, which is expected to reach completion point in 2002, should receive debt service relief of \$25 million per year from 2000 to 2002 and \$49 million from 2003 to 2005 on the basis of total assistance of \$622 million in PV terms.

These figures on annual debt service relief in the period 2000–2005 are estimates which depend on assumptions about the timing of completion points and the way in which creditors deliver their share of the reduction in the PV value of the debt.<sup>12</sup> Following the convention of the World Bank and IMF estimation of the costs of the HIPC Initiative to creditors, the estimates exclude debt relief through traditional relief mechanisms (stock-of-debt operation on Naples terms) which would also be undertaken together with the additional HIPC assistance to bring future debt service obligations down to sustainable levels. Such traditional relief would certainly increase total assistance and the financial benefits. However, as an estimate of the debt relief accruing through the HIPC Initiative per se, these figures are more likely to be overestimates than underestimates.

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*From the debtors' perspective, what matters is whether the scale of debt relief is sufficient to remove the debt overhang on investment activity and ease the crowding-out effects of debt service payments on foreign exchange earnings and government expenditure.*

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TABLE 35: ESTIMATED FINANCIAL COSTS AND CASH-FLOW BENEFITS<sup>a</sup> OF HIPC INITIATIVE

LDCs for which Decision Point reached under Enhanced Framework	Completion Point <sup>b</sup> under Enhanced Framework	Estimated total <sup>b</sup> assistance level (in \$ million, present value)	Estimated total <sup>b</sup> nominal debt relief (in \$ million)	Annual average debt service relief (in \$ million)	
				2000-2002	2003-2005
Mauritania	Floating	622	1 100	25.1 <sup>c</sup>	49.1 <sup>c</sup>
Mozambique	Floating	1 970	4 300	117 <sup>d</sup>	115 <sup>d</sup>
United Rep. of Tanzania	Floating	2 026	3 000	94.5 <sup>e</sup>	93.8 <sup>e</sup>
Uganda	May 2000	1 003	1 950	111.0 <sup>f</sup>	92.3

Notes: a Financial costs and benefits are estimated after the full use of traditional debt relief mechanism.

b IMF/World Bank (2000); Assistance levels at countries' respective decision or completion points, as applicable.

c From IDA/IMF (2000a), box 4, tables 9 and 13. Assumes a hypothetical stock of debt operation on Naples terms at end 1998 and at least comparable treatment from other official bilateral creditors. Completion point under HIPC in July 2002.

d From IMF/IDA (2000a), tables 9 and 10. Assumes a hypothetical stock-of-debt operation on Naples terms at end 1998, and full delivery of assistance under the original Initiative of July 1999.

e From IDA/IMF (2000b), tables 11 and 12. Assumes a hypothetical stock-of-debt operation on Naples terms at end 1999 and at least comparable treatment from other official bilateral creditors. Data are for fiscal years; completion point is assumed to be in 2001/02.

f From IMF/IDA (2000a), tables 9 and 10. Incorporates effects of the Paris Club stock-of-debt operation before first decision point in 1997. Data are for fiscal years.

The simple reason for this is that they assume that the Initiative is going to be adequately financed and that the debt relief which is hypothetically due according to the terms of the Initiative will actually be delivered. There are two problems in this regard. First, the enhancement of the HIPC Initiative can be achieved only if full financing will come available for multilateral debt relief which the international financial institutions (IFIs) cannot finance themselves. Under the present timetable, 85 per cent of the irrevocable commitments for HIPC relief are needed before the year 2000, but the IFIs can only make these irrevocable commitments if financing is secured. But "many creditors, especially the multilateral and smaller bilateral creditors, report that they are having difficulty identifying their share of the necessary financing from their own resources due to budgetary and other constraints" (GAO, 2000: 18).

Second, the delivery of HIPC assistance depends on non-Paris Club creditors providing comparable treatment to Paris Club creditors. By June 2000, none of the cases which had reached decision point within the enhanced Initiative had received assurances that they would receive the relief. For the front-runner, Uganda, "non-OECD creditors have steadfastly refused to offer terms comparable to those granted by the Paris Club" (Tumusiime-Mutebile, 1999:7). The implications, as summarized by a principal architect of Uganda's economic reform strategy, are that:

1. The Enhanced HIPC Debt Initiative will not be seen as a first step towards a comprehensive debt relief/poverty reduction strategy, leading to increased criticisms from pressure groups.
2. HIPC countries will not receive the full amount of relief which is deemed necessary at the completion point. This will preclude the attainment of a sustainable debt and will undermine efforts to finance poverty reduction programmes, thus defeating the dual objectives of the Initiative.
3. The non-OECD debt stock will remain on a country's books creating a debt overhang. This may threaten prospects for the increased private sector investment which is a crucial element of our poverty reduction programme (Tumusiime-Mutebile, 1999: 8).

Recent information on the status of country cases suggests that LDC HIPC cases which have reached decision point now have received satisfactory assurances from non-Paris Club creditors. But ensuring full burden-sharing amongst all creditors may still be a problem for new cases.

All the foregoing estimates of debt relief under the HIPC Initiative calculate the magnitude of financial costs and benefits as the difference between what countries would have had to pay after the implementation of traditional debt relief measures and what they would have to pay after implementation of HIPC measures. As we have seen in earlier chapters, however, many of the countries concerned have been unable to meet all their contractual payment obligations and, with arrears building up, actual payments are below contractual payments. This implies that in some cases it is possible that even with debt service relief under the HIPC Initiative, the debt service payments due after debt relief may be larger than those actually paid before relief.

Table 36 compares estimates of debt service due after the application of traditional relief mechanisms and provision of HIPC assistance, with debt service paid before the establishment of the Initiative, for four LDCs on the basis of IMF/IDA estimates. Within HIPC I, debt service due after completion point is actually more than debt service paid in 1993–1998 for two out of the four cases. Within the enhanced framework, in three out of four cases, debt service payments due are lower than debt service paid, and by over 40 per cent if debt relief from the World Bank and the IMF is front-loaded in the first five years. But for Mali, debt service payments due after completion point under the enhanced HIPC Initiative are estimated to be 20 per cent higher than those actually paid in the period 1993–1998 without front-loading of multilateral debt relief and still 7 per cent higher with front-loading.

Although Mali is just one case, it is relevant as a number of LDC HIPC cases had arrears accumulating during the period 1994–1998. For such cases, the putative gains from the HIPC Initiative, estimated by the difference between contractual payments obligations under different relief schemes, may be virtual gains rather

TABLE 36: DIFFERENCE BETWEEN AVERAGE ANNUAL DEBT SERVICE DUE POST-HIPC AND AVERAGE ANNUAL DEBT SERVICE PAID PRE-HIPC<sup>a</sup>  
(\$ millions)

	Original Framework	Enhanced Framework <sup>b</sup>		Memo: Net ODA in 1997 <sup>e</sup>
		without frontloading of multilateral debt relief <sup>c</sup>	with frontloading of multilateral debt relief <sup>d</sup>	
Burkina Faso	6	-11	-27	370
Mali	32	15	5	455
Mozambique	-41	-50	-64	963
Uganda	-13	-52	-69	840

Source: IMF/IDA (1999a: table 6), and OECD, 2000 (tables 1-2).

- a Difference between average debt service paid 1993–1998 and estimated debt service due between completion point and 2005.
- b Figures are highly illustrative.
- c Based on assumption of 70 per cent of total IMF assistance, and 25 per cent of total assistance from the World Bank and other multilateral development banks, being delivered over years 1–5.
- d Based on assumption of 100 per cent of total IMF assistance, and 45 per cent of total assistance from the World Bank and other multilateral development banks being delivered over years 1–5.
- e OECD 2000 (tables 1 and 2).



than actual gains. If the countries meet their obligations under the Initiative, no extra resources will be released for building productive capacities and for poverty reduction. On the contrary, they will be paying more than they were before.

Even for countries in which debt service payments due after receipt of HIPC relief are lower than debt service payments actually made before, the actual resources released through the Initiative are small in comparison with aid flows. As table 36 shows, the average reduction in annual debt service through 2005 under HIPC II compared with debt service actually paid during 1993–1998 for Burkina Faso, Mozambique and Uganda is equivalent to just 6–8 per cent of net ODA in 1997 (see also OECD, 2000: table 1-2). Recent estimates for all HIPC countries taken together similarly show that the annual savings on debt servicing from HIPC II levels of relief are equivalent to only about a tenth of total net resource flows to those countries (Martin, 2000: table 1).

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*The actual resources released through the Initiative are small in comparison with aid flows.*

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## E. The medium-term outlook for debt sustainability

Under the HIPC Initiative, the debt relief which is believed to be sufficient to achieve debt sustainability is decided at one point in time, the decision point. The PV debt-to-exports and debt-to-revenue ratios are useful rule-of-thumb numbers for making judgements about present creditworthiness, i.e. the risk in the short term that default will be provoked by a liquidity crisis.<sup>13</sup> But reducing the debt-to-exports or debt-to-revenue ratios at a single point in time provides no automatic guarantee of debt sustainability in the medium and long term, particularly in the face of external shocks. Within HIPC II there is the possibility of reviewing debt relief needs at the completion point if the situation has changed. But even with this provision, a critical issue for both creditors and debtors is the medium-term outlook for debt sustainability.

### 1. IMPACT OF EXTERNAL SHOCKS: LESSONS FROM HIPC I

The experience of countries qualifying for debt relief under the initial version of the HIPC Initiative (including non-LDCs) provides instructive lessons in this regard. Under HIPC I, the amount of assistance committed was calculated at the decision point but was based on projected data for the completion point three years later. For all four front runners, including two LDCs (Mozambique and Uganda), the total debt relief committed at decision point proved, either at the completion point or during the next year, to be insufficient to achieve the debt sustainability threshold targets, as predicted through the balance-of-payments forecasts. In each case the projections on which the debt sustainability analysis was based proved to be wrong, and in each case they were overoptimistic.

For Mozambique, although economic performance remained strong, exports of goods and non-factor services were significantly lower in 1998 than had been projected at the decision point owing, *inter alia*, to a marked fall in commodity prices. For Uganda, the assistance committed was sufficient to bring the PV debt-to-export ratio down to below the thresholds of sustainability at the completion point, but the ratio increased to above the threshold levels in the following year owing to: reduced exports of good and services due to lower commodity prices (principally coffee) and adverse weather conditions associated with El Niño; an increase in new borrowing, mainly from multilaterals, to avoid a



financing gap in the balance of payments; a global fall in interest rates, which increased the PV stock of debt despite the Government's prudent adherence to its debt strategy; and the refusal of non-OECD creditors to grant relief on terms comparable to those offered by the Paris Club.

## 2. FORECASTS OF THE DEBT OVERHANG AND DEBT SERVICE RATIOS IN HIPC II

The enhancements of the Initiative through provision of lower PV debt-to-exports and debt-to-revenue thresholds are designed to provide an appropriate cushion against exogenous shocks of the type which rendered debt relief under HIPC I insufficient to ensure debt sustainability. But whether they actually provide such a cushion, and how external debt will develop in the medium term, depend on rates of growth of the economy, exports, imports and government revenue, and the terms of external finance to fill any financing gaps.

For countries which have reached their decision point, future scenarios have been constructed to show how external indebtedness indicators are expected to change in the medium and long term. Built into these scenarios is a profile for the delivery of total debt relief which, whilst taking account of creditors' constraints and also "any absorption capacity and implementation constraints in the country concerned in executing additional social expenditures", "should aim *ex ante* at a steady declining trend of the PV of debt-to-exports and -revenue ratios, and of debt service-to-exports and -revenue ratios, in order to provide a reasonable assurance that debt sustainability has been achieved and that debt problems will not re-emerge at a later stage" (IMF/IDA, 1999a: 14).

Analysis of the medium-term scenarios within the decision point documents for LDC HIPCs indeed shows the smooth, steadily declining trends in key indebtedness indicators. The debt relief provided under HIPC II, together with traditional relief mechanisms, is expected to reduce debt service ratios significantly, according to the desired profile. However, in two of the four cases – Mauritania and the United Republic of Tanzania - the application of the reduction factor to existing debt which has been decided as necessary to bring the PV debt-to-exports and -revenue ratios down to the threshold of sustainability will not remove the debt overhang or provide an effective cushion against shocks.

The basic reason for this is that there is an accumulation of new debt to finance substantial investment in physical and social infrastructure. In the United Republic of Tanzania, for example, without new borrowing, the PV debt-to-exports ratio is expected to fall 125.5 per cent by 2001/02, but with new borrowing the PV of total debt to exports is expected to be 177.9 in that year, which is assumed to be the completion point. The new borrowing (mainly new multilateral disbursements assumed to be obtained on IDA terms) is projected for physical and social infrastructure. If there was a write-off of eligible Paris Club ODA debt at the assumed completion point, the PV of debt-to-exports after enhanced HIPC assistance would decline by a further 17.6 percentage points to about 160 per cent at the end of 2001–2002. Without such assistance, the PV debt-to-exports ratio is projected to reach the 150 per cent threshold in 2007–2008 (chart 46).

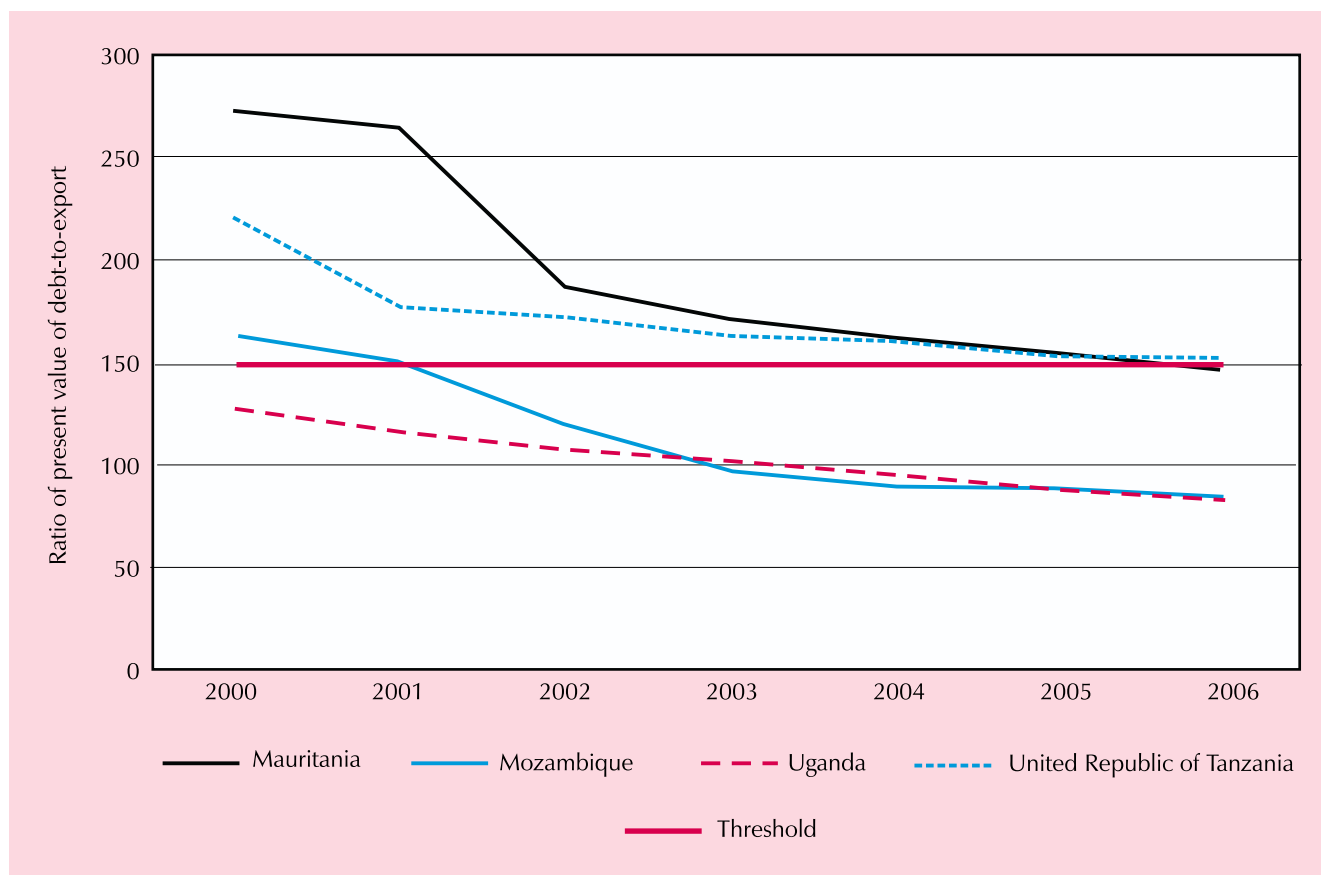
Sensitivity analysis shows that the persistence of the debt overhang is likely to be further aggravated by small deviations from forecast assumptions. In Mauritania, a 5 per cent drop in the volume of fish exports would raise the

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*For countries which have reached their decision point, future scenarios have been constructed to show how external indebtedness indicators are expected to change in the medium and long term.*

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CHART 46: RATIO OF THE PRESENT VALUE OF DEBT-TO-EXPORTS AFTER ENHANCED HIPC ASSISTANCE, 2000–2006:  
LDCs WHICH HAVE REACHED DECISION POINT BY MID 2000



Source: Same as table 37.

average PV debt-to-exports ratio by 29 percentage points over the baseline to an average of 195 during the projection period (1998–2017) and to more than 251 during the period 1998–2007. In the United Republic of Tanzania, with lower growth of traditional exports, the ratio would not reach the 150 per cent threshold until 2013/14, and with a less favourable outlook for gold production the average ratio for each year during the period from 1999/2000 to 2017/18 would remain above the threshold. The PV debt-to-exports ratio would remain at 184 during the period from 1999/2000 to 2008/09.

### 3. THE REALISM OF THE FORECASTING ASSUMPTIONS

The medium-term scenarios of debt sustainability are founded on both macroeconomic and balance-of-payments forecasts. Key variables, whose future behaviour has to be projected, include: real GDP growth; the income elasticity of imports; growth in the volume and prices of traditional and non-traditional exports, including both goods and services; future flows of grants and FDI, and future debt-creating flows; and the conditions attached to loans. Medium-term debt sustainability requires that the current account deficit be covered by non-debt-creating capital inflows, or debt-creating flows which are sufficiently concessional that the external debt stock does not build up once again. Small changes in projections of individual elements of the balance of payments (such as exports, grants and FDI) can over time have quite large effects on the external financing gap, i.e. the residual in the balance of payments after estimation of the extent to which the current account balance is covered by net capital flows (see box 8). If an external financing gap starts to open up, this is not necessarily a problem for a country if it can be covered by non-debt-creating flows over and

**BOX 8: FORECASTING THE EXTERNAL FINANCING GAP AFTER HIPC ASSISTANCE:  
A SENSITIVITY ANALYSIS FOR THE UNITED REPUBLIC OF TANZANIA**

Whether HIPC debt relief is sufficient to enable debt sustainability in the medium term is appropriately assessed through sensitivity analysis of the baseline forecast of the future balance-of-payments trends after debt relief. Such an exercise was undertaken to test the effects of small changes in some of the key assumptions of the balance-of-payments forecast produced by Tanzanian authorities and IMF staff.

The baseline forecast assumes that in current price terms: (i) exports of goods and non-factor services will increase by 9.9 per cent per annum from 2000 to 2018; (ii) grants will grow at an average of 2.1 per cent from 2000 to 2018, with rates of 2.4 per cent per annum during 2002–2004 and 2.5 per cent during 2005–2018; and (iii) net FDI inflows will grow at 8.3 per cent per annum from 2000 to 2018. The sensitivity analysis examined what would happen if: (i) the growth rate of exports and non-factor services was 10 per cent lower (a change which would mean that, other things being equal, the export-to-GDP ratio would increase to 16.3 per cent rather than 18.1 per cent by 2010 as predicted in the baseline); (ii) official grants remained the same from the year 2000 onwards at the level assumed for that year in the IMF and Tanzanian authorities' forecast; and (iii) there was a reduction of 20 per cent in the growth rates in foreign direct investment.

Each of these changes is likely to have repercussions elsewhere in the economy. However, the sensitivity analysis focused simply on what the changes implied for the residual financial gap (that is, the financing gap which remains after expected net capital flows are subtracted from the forecast current account deficit and reserve changes). Scenarios were created using DSM+ version 2.0.0, a programme developed by the World Bank for debt sustainability analysis. Estimates were made of how the size of the financing gap would change relative to the baseline scenario with the assumed changes. The size of the financing gap depends on the precise format used to present the balance-of-payments statistics, and in the present simulation private-sector interest payments and changes in reserves are included in the calculation of the baseline gap.

The results indicate that the greatest impact results from the slower than forecast export growth rate. By 2005, the financial gap will be 120 per cent higher than the baseline forecast of \$107.30 million if exports grow by 10 per cent less than predicted, 27 per cent higher if grants stay constant, and 66 per cent higher if FDI grows at 20 per cent less than predicted.

These results are, of course, quite predictable. But the intention is simply to underline the implications of small deviations from the baseline forecast. In the end such gaps will not build up because imports can be cut. But this will jeopardize the high growth rates which are expected in the next 20 years, and therefore also, rates of poverty reduction. This can be avoided if the larger financing gaps are covered by higher levels of grants or deeper debt relief. But if, to be covered, they depend on new loans there is the possibility that a debt problem will snowball out of control again. Policies to accelerate export growth remain essential.

Source: Olortegui, 2000.

above those assumed in the baseline scenario (such as extra grants). However, if these are not available, the country will face the prospect of a new snowballing external debt unless: (i) the financial gap is closed through a reduction in imports, which will inevitably reduce the rate of growth; or (ii) there is a return to the pattern of build-up of arrears coupled with further debt rescheduling.

A critical issue, therefore, is whether the economic forecasts underlying the medium-term scenarios of debt sustainability are characterized by optimism or caution. Experience is not encouraging in this regard. It had become normal practice for the IMF to project zero balance-of-payments financing gaps after whatever relief terms the Paris Club was prepared to provide. With the introduction of the HIPC Initiative such practices changed. In the case of Uganda, for example, the balance-of-payments projections were recast in 1996 for the debt sustainability analysis, because they were no longer obliged to show that Paris Club relief made the debt and balance of payments sustainable, and as a result they changed fundamentally, with lower exports, higher imports and considerable financing gaps (Tran-Nguyen, Addison and Martin, 1996: 35). However, forecasts in HIPC I, including the sensitivity analysis, have still erred

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*A critical issue is whether the economic forecasts underlying the medium-term scenarios of debt sustainability are characterized by optimism or caution.*

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on the side of optimism.<sup>14</sup> Moreover, recent analysis of HIPC II indicates a similar bias:

Most recipient countries that GAO has analyzed are projected by World Bank and Fund staffs to have robust growth in export earnings, with projected growth for four of these countries – Honduras, Nicaragua, Tanzania and Uganda – expected to average at least 9.1 per cent a year over 20 years. The staffs also assume strong growth in gross domestic product and government revenue for most of the recipient countries that GAO analyzed. The average annual growth (in nominal dollars) of these two factors was assumed to be greater than 6 per cent in all cases and to exceed 9 per cent for Honduras, Mozambique, Tanzania and Uganda in one or both of these factors (GAO, 2000: 14).

*The medium-term outlook for the HIPC Initiative hangs precariously on international and national actions which will ensure that the optimistic forecasts, on which future trends in debt sustainability are predicated, come true.*

Table 37 summarizes some of the key assumptions underlying the balance-of-payments forecasts up to 2005 in the medium-term scenarios of debt sustainability for LDCs under HIPC II. It is difficult to obtain comparable data to compare these figures with those of the recent past. However, export growth rates appear to be high, given trends in demand for the traditional exports in the main markets, and the high export growth rates often depend on future positive events such as mines coming on stream or rapid development of non-traditional exports such as tourism. The income elasticity of imports is assumed to be around or just over 1, but in two out of four cases in which macroeconomic assumptions are clearly set out, the imports-to-GDP ratio is expected to decline over the period by 5–6 percentage points. In effect, it is assumed that extra growth and exports will be achieved without increasing import intensity of growth. The medium-term outlook for the HIPC Initiative, even in its enhanced form, thus hangs precariously on international and national actions which will ensure that the optimistic forecasts, on which future trends in debt sustainability are predicated, come true.

## F. Linkage between debt relief and poverty reduction

A central goal of the enhanced HIPC Initiative is to strengthen the link between debt relief and poverty reduction. Two broad approaches can be taken to achieve this goal. The first, “direct” route is to use welfare criteria as a basis for deciding the depth, breadth and speed of debt relief. The second, “indirect”

TABLE 37: SOME ASSUMPTIONS OF THE MEDIUM-TERM PROJECTIONS OF THE DEBT SUSTAINABILITY ANALYSIS OF HIPC-LDCs

	Real	Real	Export		Import		Official transfers		Private capital	
	GDP growth	Export growth	% GDP		% GDP		% GDP		Inflows % GDP	
	2000–05	2000–05	2000	2005	2000	2005	2000	2005	2000	2005
Burkina Faso	5.7	8.4	..	..	Rising very slowly		6.6	4.5	0.8	1.0
Guinea	5.8	5.9	26.6	27.0	27.5	27.1	2.6	1.8	0.7	0.8
Mali	5.0	..	..	..	Unchanged		5.5	4.2	0.3	0.5
Mauritania	5.2	1.6	41.8	36.0	54.4	48.5	11.1	7.4	0.3	0.6
Mozambique	5.8	..	13.0	21.0	30.0	25.0	..	..	..	..
Uganda	6.2	6–7	..	..	Rising very slowly		5.1	1.9	10.1 <sup>a</sup>	8.7 <sup>a</sup>
U.R. of Tanzania	5.8	11.8	13.8	16.7	27.4	27.6	9.1	6.1	2.3	2.3

Sources: UNCTAD secretariat estimates based on IDA/IMF (1999b), tables 10 and 11; IDA/IMF (2000a), tables 4 and 7; IMF/IDA (2000a), box 3; IDA/IMF (2000b), tables 8 and 9; IMF/IDA (2000b), box 6 and table 9; IMF/IDA (1997b), box 1 and table 1; IMF/IDA (1998), box 1 and table 1. Growth rates are annual averages (per cent).

a Private transfers.

route is to decide the depth, breadth and speed of debt relief according to criteria of debt sustainability but to design the debt relief process in such a way that it promotes poverty reduction. The HIPC Initiative takes the second route. This is not necessarily the wrong choice. However, it is wrong to assume that “the *only* way to ensure that there is a robust link between debt relief and poverty reduction is by ensuring that HIPC Initiative debt relief is an integral part of broader efforts to implement outcome-oriented poverty reduction strategies.” (IMF/IDA, 1999b: 19; emphasis added). Moreover, simple comparison of HIPC relief with some proposals based on the first route indicates that the indirect approach it is likely to lead to less debt relief, provided more slowly, for fewer countries.<sup>15</sup> It is this that perhaps leads to the mix of congratulation and scepticism with which some observers have greeted the enhanced HIPC Initiative. Box 9, quoted from a paper on Rwanda by W. Nyamugasira presented at the ECA HIPC Review Seminar in 1999, exemplifies this dual response.

Following this indirect route, the enhanced HIPC Initiative seeks to strengthen the link between debt relief and poverty reduction, on the one hand, by providing incentives for Governments to adopt pro-poor economic reforms (through the new policy conditionality and the PRSP process), and, on the other hand, by seeking to ensure that resources released through debt relief will be channelled into increased social expenditures on health and education, and into poverty action funds. Of these two means, the latter is politically significant as it can reduce the force and impact of one of the most compelling popular critiques of the HIPC I, which entailed comparison between debt service payments and social expenditures. However, it is the former – strengthening requirements and incentives for government to adopt pro-poor economic reforms and development policies – which is likely to be more important for poverty reduction in practice.

There are two reasons. First, as indicated earlier, the magnitude of additional resources which will be released through HIPC assistance is not great, particularly in the near-term. Table 38 shows recent levels and projections of debt service payments and social expenditure in Mali, Mauritania, and the United Republic of Tanzania over the period 1995–2002, as reported by IDA and IMF. Debt service due was 112 per cent of total social sector spending in Mali during 1995–1997, 184 per cent of total social sector spending in Mauritania in 1997–1998, and 228 per cent of total social sector spending in Tanzania during 1995/1996 to 1997/1998. When these countries begin to receive HIPC assistance, it is expected that there will be a dramatic drop in these ratios. The IDA and IMF documents report a fall to 43 per cent of total social spending in Mali in 2000–01, and to 76 per cent of total social spending in Mauritania in 2000–02. But in practice, debt service actually paid in these countries during the pre-HIPC periods stood at 59 per cent of total social spending for Mali, 115 per cent for Mauritania, and 75 per cent for Tanzania.

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*Debt service due was 112 per cent of total social sector spending in Mali during 1995–1997, 184 per cent of total social sector spending in Mauritania in 1997–1998, and 228 per cent of total social sector spending in Tanzania from 1995/1996 to 1997/1998.*

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#### BOX 9: THE FABLE OF THE GOATS: A SOUTHERN PERSPECTIVE ON POVERTY AND THE HIPC INITIATIVE

“Heavily indebted countries are also poverty stricken. That is a given. Where poverty abounds, debt overhang and debt servicing are unsustainable. That is also a fact. The HIPC Initiative is a welcome attempt at addressing these unacceptable states of affairs. A farmer has lost his goats which represent the few assets in the form of money, dignity and confidence [which he has]. A neighbour from a village to the north joins the farmer in the search for the lost animals. He [the neighbour] works harder even than the farmer but in reality he does not want the farmer to find his lost treasure. The search for solutions to poverty are questions of the will, and of integrity, for the neighbour knows where the goats are.”

Source: Nyamugasira, 1999: 1.



TABLE 38: DEBT SERVICE PAYMENTS AND SOCIAL SECTOR EXPENDITURES IN SELECTED LDCs, 1995–2002

	United Republic of Tanzania		Mauritania		Mali <sup>a</sup>	
	1995/96–1997/98	2000/01–2002/03	1997–98	2000–02	1995–97	2000–01
Total social sector expenditure (\$ millions)	213.4	..	77.5	109.4	125.8	215.0
of which:						
Health	60.8	..	17.9	24.2	48.3	81.0
Education	152.5	..	53.1	60.5	77.4	135.0
Total debt service paid	160.1	146.5	89.4	82.3	74.4	93.4
% of total social sector expenditure	75	..	114	75	59	43.0
Total debt service due	480.5	146.5	142.9	82.3	139.5	93.4
% of total social sector expenditure	225	..	184.4	75	111	43.0

Source: IMF/IDA (1999e), table 6; IDA/IMF (2000a), box 4.3; IDA/IMF (2000B); IMF/IDA (1998), box 4.

a Assistance under HIPC I.

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*There is a large gap between more social expenditures and the realization of better social outcomes and reduced poverty rates.*

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Thus the difference between debt service actually paid pre-HIPC and debt service due in 2000–2002 after preliminary HIPC assistance is only a reduction of \$13.6 million for the United Republic of Tanzania and a reduction of \$7.1 million for Mauritania, whilst payments increase for Mali debt service. It must be stressed that the Mali figures are based on calculations of HIPC I, and that Tanzania and Mauritania are only expected to reach completion point in 2001/2002 and July 2002 respectively, and so deeper HIPC assistance can be expected thereafter. But these figures give some idea of the magnitude of additional resources which will become available in the near future and also show that the future behaviour of the ratio of debt service paid to total social sector expenditure will depend significantly on the ability to increase social spending, which is projected in these figures to increase by 41 per cent between 1997–1998 and 2000–2002 in the case of Mauritania, and by 72 per cent between 1995–1997 and 2000–2001 in the case of Mali.

Secondly, there is a large gap between more social expenditures and the realization of better social outcomes and reduced poverty rates.<sup>16</sup> There are major problems of reaching the poor through social spending, and even if this is successful, long-term poverty reduction depends on economic growth and the expansion of employment opportunities and productivity per worker. Channelling small amounts of HIPC assistance into social spending is more likely to provide short-term poverty relief than long-term poverty reduction.

## G. The PRSP process: a preliminary assessment

From this it follows that the most effective way in which the HIPC Initiative may be expected to strengthen the link between debt relief and poverty reduction is through its impact on the content of the national policies of LDC HIPCs. But how effective will the Poverty Reduction Strategy Paper (PRSP) process be?

Some observers are concerned that the PRSPs will not entail any major change in the policies which countries were pursuing under the Policy Framework Papers (PFPs). For these observers, the change from ESAF to PRGF is cosmetic, entailing the repackaging of old economic reform programmes in a new poverty language. Since few PRSPs have been completed, it is early to make a judgement on this. However, there is no reason to doubt that the international



community is seriously intent on promoting poverty reduction, and there is every reason to believe that the PRSPs will seek to enhance the quality of growth by making it more pro-poor. But the central issue is that the efficacy of the PRSP process in poverty reduction in LDCs will depend not simply on its effects on the quality of growth but also on its effects on the rate of growth.

It should be noted in this respect that the scenarios which are being constructed to assess the medium-term outlook of debt sustainability for LDC HIPC countries assume, in most cases, that higher growth rates will be achieved than those achieved under the ESAF programmes. These growth rates are still below the growth rates which economists suggest are necessary for reducing extreme poverty by half by 2015 (table 39). Nevertheless, if the rates of economic growth which are forecast are actually achieved, and if growth-distributional dynamics are managed in a way to ensure that the quality of growth is pro-poor, this will have a major impact on poverty. But the policy issue is how to achieve these higher economic growth rates.

The ESAF-programme experience is not encouraging in this regard since the favourable growth rates during 1996–1998 were founded on positive terms-of-trade movements. In assessing the PRSPs therefore, the basic question is how they can promote faster and sustained growth. In short, in the words of the Deputy Managing Director of the IMF, Eduardo Aninat, “Why should we expect better results this time around?” (Aninat, 2000: 4).

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*The central issue is that the efficacy of the PRSP process in poverty reduction in LDCs will depend not simply on its effects on the quality of growth but also on its effects on the rate of growth.*

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## 1. GROWTH ACCELERATION THROUGH ENHANCED OWNERSHIP?

One possible reason for expecting accelerated growth is that economic reforms will now be nationally owned, participatory and developed through partnership between the international creditor-donor community and national authorities. The idea that past reform programmes did not achieve the expected results because Governments did not own the economic reforms is now widely canvassed. The next chapter will consider the issues of ownership and partnership in broader terms, but here some specifics of the problem of implementing national ownership in relation to PRSPs will be addressed.

As noted earlier in this chapter, enhanced “ownership” is expected to be achieved through the Government taking the lead in the preparation of the PRSP, including the animation of a participatory process (which is expected to increase public accountability) and the drafting of the action plan. This is

TABLE 39: REAL GDP GROWTH RATES IN HIPC-LDCs:  
ACTUAL, FORECAST AND REQUIRED TO MEET POVERTY REDUCTION TARGETS  
(Per cent)

	Actual 1994–98	Forecast <sup>a</sup> 2000–05	Required <sup>b</sup> 2000–15
Burkina Faso	4.6	5.7	6.8
Guinea	4.5	5.8	7.3
Mali	4.9	5.0	7.7
Mauritania	4.4	5.2	7.7
Mozambique	8.1	5.8	8.9
Uganda	7.7	6.2	8.1
United Republic of Tanzania	3.3	5.8	8.0

Source: UNCTAD secretariat estimates.

<sup>a</sup> See table 39.

<sup>b</sup> Economic Commission for Africa estimates of growth rates required to reduce headcount poverty rates by half by 2015 (Economic Commission for Africa, 1999: table A11.7).

certainly likely to bring benefits in the sense that strategies should more closely reflect different national contexts and not be replica blueprints carried from one country to another. However, how national ownership will work in practice depends on the relationship between national authorities and international creditor-donors.

This relationship is certainly likely to be complex. Since 1996, attempts have been made by the World Bank to promote the ownership of country assistance strategies (CAS) by the Government and people of the client country. Evaluation of this experience suggests that rather than providing ownership, the shift to participatory CAS is most accurately described as “an attempt by the Bank – the owner of the CAS – to enhance the relevance and effectiveness of the CAS while also generating a sense of shared ownership among interested parties in country government and civil society” (McGee and Norton, 2000: 21). The PRSP may be different. However, national ownership is still not totally unconstrained.

First, what is being owned is a model conceived by the Bank and the Fund which is keyed in to the achievement of international development targets which have been selected by the OECD as a subset of international development targets set in all the global conferences of the 1990s. What is owned is not the development agenda itself, but rather the means of implementing this agenda.

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*The preparation of PRSPs is very demanding, and in a number of LDCs the technical capabilities for producing poverty reduction strategies may be weak.*

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Secondly, it is clear that the preparation of PRSPs is very demanding, and in a number of LDCs the technical capabilities for producing poverty reduction strategies may be weak. It is likely that the design of the programmes will draw upon the expertise of the Bank and the Fund, and indeed they are expected to provide national authorities with advice in their appropriate areas. But the giving of advice will have to be very open-ended if it is not to undercut the goal of genuine national ownership. Initial evidence on this is discouraging. A recent field survey of bilateral donor views of how the PRSP process is working found that the staff of the Bretton Woods Institutions were perceived to be in the driving seat in most cases, including in the United Republic of Tanzania and Zambia. Significant degrees of government co-leadership were perceived only in Ghana, Mozambique and Uganda (SPA, 2000: 10, reported in Killick, 2000).

Thirdly, the country-prepared PRSP will be presented to the Boards of the Fund and the Bank for endorsement. This endorsement process is critical for the degree to which genuine national ownership of the policies is created. The test case would arise if countries produce nationally owned strategies which do not incorporate all the elements of the poverty reduction approach favoured by the IFIs. It is unclear whether this would be endorsed or not. However, it may not reach open disagreement. Another feature of the joint assessment is that it would not be sight unseen. Indeed, it is envisaged that a joint Bank–Fund mission will be needed to prepare for the presentation of the PRSP to the Boards. This mission “would discuss with the authorities any modifications to the strategy which might be considered necessary to allow managements to recommend to the Boards that the PRSP be endorsed “ (IMF/IDA, 1999d: 16). The views of the mission should be shared more widely with participants in the participatory process and “would be an important input into the authorities’ decision as to at what stage, and in what form, they wished to present the PRSP for consideration by the Boards” (p. 16).

The overall result is that the country-owned policy could be altered to fit expectations. As it is put, “It is expected that, as under current arrangements, in general, authorities would only wish to seek a discussion of their PRSP when

managements would recommend its endorsement" (p. 16). In essence, this could imply that ownership is actually deeper internalization of the norms of the IFIs.

## 2. GROWTH ACCELERATION THROUGH POVERTY REDUCTION?

A second reason why economic growth could be expected to accelerate with the new generation of economic reforms under PRSPs is that pro-poor policies will actually be growth-enhancing. This idea is intuitively appealing. But it cannot be assumed as given. Most recent poverty research has focused more on the question of whether economic growth leads to poverty reduction, and the policies through which poverty-reducing effects of economic growth can be maximized, than on whether poverty reduction leads to economic growth and the policies through which the growth-enhancing effects of poverty reduction can be maximized.

Indeed, there is a danger that rather than poverty reduction promoting economic growth the contrary will pertain. That is to say, an overconcern within PRSPs with short-term results in terms of increasing the consumption per capita of the poor may easily conflict with the need to increase savings, investment, efficiency and exports, which are the bases for accelerated economic growth, a durable exit from the debt problem and also long-term poverty reduction. There is, to be sure, some awareness of possible trade-offs between the goals of poverty reduction and growth within the operational guidelines for PRSPs. The effort to integrate macroeconomic policies, structural reforms and social policies within PRGF programmes and PRSPs is particularly concerned with the need to ensure that increased social expenditure associated with poverty reduction is compatible with macroeconomic stability, and does not trigger inflation which then eats into the real incomes of the poor. But it is generally assumed that structural reforms including trade liberalization, financial liberalization, agricultural pricing reforms and privatization are all compatible with poverty reduction. As the recent robust debates on the draft of the World Bank's *World Development Report 2000/01* indicate, there is a wide spectrum of opinion on this issue. It may well therefore be the case that the addition of poverty conditionalities within IMF and World Bank adjustment programmes is putting countries in an impossible position, in which they are trying to meet policy objectives which are irreconcilable in the short run.

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*An overconcern within PRSPs with short-term results in terms of increasing the consumption per capita of the poor may easily conflict with the need to increase savings, investment, efficiency and exports, which are the bases for accelerated economic growth, a durable exit from the debt problem and also long-term poverty reduction.*

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Experience also shows that an initial effect of the PRSP process has been to raise expectations amongst all sectors of society. This is putting Governments in an exposed, high-risk position. These expectations are difficult to manage, particularly given the paucity and slowness of resources released through the HIPC process.<sup>17</sup> The PRSP process carries the danger, therefore, that it may revive and reinforce populist impulses.

It is certainly possible that poverty reduction could become integral to the acceleration of capital accumulation in LDCs. But this would require a pluralistic view of appropriate development strategies which allowed the types of mesopolicies discussed in the last chapter. Unfortunately, PRSPs are being rushed into place in situations where all the trade-offs and synergies between growth and poverty reduction are not well understood. Their implementation in low-income countries should rightly be recognized as an experimental process, the brunt of whose outcomes will be borne by the people of the countries which are implementing the PRSPs, and which indeed have to do so, in order to gain access to concessional finance and debt relief.

### 3. GROWTH ACCELERATION THROUGH DEBT RELIEF?

Finally, it is possible that growth acceleration will occur because of the removal of the debt overhang and also the easing of the crowding-out effects of debt service payments. In practice, this is the surest way in which the link between debt relief and poverty reduction is likely to be achieved. However, its realization depends on the scale of debt relief and on complementary aid flows, which are sufficient and sufficiently predictable to ensure both a private sector expectations shock which boosts private investment and an easing of the government budget constraint so that the Government can make the public investments necessary to enhance productive capacity. But the evidence of the scale of relief and the medium-term outlook presented in sections D and E makes this unlikely.

A particular worry here is that, as shown in chapter 4, levels of ODA to LDCs have in the recent past been closely related to levels of indebtedness. If the behaviour of the international creditor-donor community in the 1990s continues under the HIPC Initiative, it is likely that to the extent that the Initiative succeeds, aid flows will decline. Indeed, recent estimates suggest that "large amounts of aid are being diverted from bilateral budgets to fund relief by multilateral institutions... . The total amounts represent more than 50 per cent of bilateral donor aid flows to HIPCs in 1998: though their disbursements will be spread over several years, there is strong evidence of aid diversion to fund debt relief" (Martin, 2000: 9). All observers agree that such substitution will undermine the effectiveness of the Initiative.

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## H. Conclusions and policy implications

The main finding of this chapter is that for the LDCs, current expectations regarding the impact of the implementation of the enhanced HIPC Initiative are unrealistic. As the Report to Congressional Committees of the United States General Accounting Office has rightly put it, "the initiative is not likely to provide recipients with a lasting exit from their debt problems, unless they achieve strong sustained economic growth" (GAO, 2000: 9). Unfortunately, the Initiative is not designed in such a way that it contributes enough to creating either the national or international conditions for "strong sustained economic growth" in the recipient countries.

The problem is more fundamental than the speed with which countries reach a point where they can receive debt relief, although that has been, and even with enhancements remains, painfully slow. Rather, it is a question of the scale and timing of debt relief, the conditionalities attached to it, and its financing.

The primary role of debt relief should be to enable countries which are in a situation where their debt burden undermines economic growth and public and private investment to make a fresh start. The cases of Indonesia and Egypt show that this is best achieved through a significant upfront reduction of debt stocks. But debt relief within the HIPC Initiative is not working like this. Rather, it is functioning like ODA, which is being provided in the form of a reduction in contractual debt service obligations on official debt rather than in the form of official capital inflows. The requirement to ensure that resources released through HIPC assistance are used for poverty reduction further reinforces this role which debt relief has been given.

The magnitude of the cash-flow benefits of HIPC assistance is small relative to net resource inflows and relative to aid flows to the LDC HIPCs, and it is unlikely to be sufficient to achieve the objective of a lasting exit from their debt problems, even if delivered in full. The medium-term forecasts of a durable exit from the debt problem are over-optimistic. They depend on rates of economic growth within HIPC LDCs, in most cases over and above rates in the 1990s, achieved with very high and stable export growth rates and without an increasing import intensity. The lessons from the forecasting experience under HIPC I, as well as the volatility of export earnings in LDCs, suggest that these expectations are unlikely to be met. The most probable outcome if export earnings are not achieved will be reduced imports and lower growth. This is all the more likely as thresholds of debt sustainability are set at levels at which, when countries receive new concessional loans to finance essential physical and social infrastructure after receiving HIPC assistance, the debt overhang persists for a number of years and there is no cushion against adverse external shocks.

The “implicit assumption” of the forecasts which underpin the medium-term prediction of debt sustainability is, as GAO (2000) points out, that “the process of preparing and implementing a poverty reduction strategy will result in a more effective and productive use of resources, leading to both economic growth and poverty reduction” (p. 14). Indeed, the rationale for the new policy conditionality is to ensure that resources released through debt relief are productively utilized for poverty reduction. The way in which PRSPs will work in practice over the long term is still unclear. But it is difficult to see how they will deliver accelerated growth, particularly as they are a new and untested policy mechanism, being put together on the ground in a rush. The way in which short-leash policy conditionality worked in the past under ESAF economic reforms, with interruptions to aid flows and uncertainty undermining effectiveness, does not augur well for the PRGF. Moreover, there is a danger that the extension of policy conditionality which stems from linking debt relief and poverty reduction will actually divert attention from the fundamental task of increasing domestic savings and the volume and productivity of investment, and promoting exports. The laudable attempt to increase domestic ownership of reform programmes may easily be undermined through low domestic policy capacities, and a narrow view of acceptable programmes within the endorsement process.

Finally, there is a danger that, even within its own limited terms, the Initiative will be underfinanced or financed through the diversion of aid resources. One positive aspect of the recent situation is that a number of OECD Governments have declared that they are cancelling bilateral ODA debts. But how this is happening is complicated.<sup>18</sup> Moreover, budgetary and other constraints are making it difficult for many creditors, particularly smaller multilateral organizations, to find their share of the necessary financing. In addition to this, non-OECD creditors have expressed a feeling of exclusion from the design and implementation of the Initiative, and this is making it hard for the HIPC LDCs to achieve comparable treatment from these creditors which is necessary in order to secure the projected debt service relief.<sup>19</sup> The danger that debt relief will be substituted for development assistance becomes all the more likely as HIPC assistance is functioning as development assistance. But if this occurs, the effectiveness of the Initiative will necessarily be undermined.

There are three main policy implications of the foregoing analysis. First, there is a need for deeper, faster and broader debt relief which is based on lower thresholds for judging debt sustainability, more realistic forecasts of economic growth, exports and imports, and more upfront extinction of debt stocks and the front-loading of debt service relief.<sup>20</sup> The major obstacle to deeper debt relief is

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*The medium-term forecasts of a durable exit from the debt problem are over-optimistic.*

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*Assessment of the real financing costs of debt relief to creditors should also take account of the benefits of removing the debt overhang from official creditor-donors, which is a necessary condition for enhanced aid effectiveness.*

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how it can be financed. The degree of enhancement which occurred with the shift from HIPC I to HIPC II was constrained by the need to ensure that additional costs could be met (World Bank, 1999), and even now it is proving difficult to ensure that HIPC II is adequately financed. It is therefore imperative that international policy efforts focus clearly on the financing bottleneck affecting debt relief for poor countries. Costs of debt reduction need to be calculated in a way which takes account of the risk of non-payment (see Cohen, 2000). Assessment of the real financing costs of debt relief to creditors should also take account of the benefits of removing the debt overhang from official creditor-donors, which, as argued in chapter 4, is a necessary condition for enhanced aid effectiveness.

No durable exit from the debt problem will be possible unless domestic policies promote faster economic growth. Policies should be based on lessons learned from the adjustment period under ESAFs as well as on retooling to add a pro-poor dimension to economic policy. As argued in chapter 4, there is a need for more pragmatic policies which focus on the fundamentals of increasing investment, productive capacities, productivity, savings and international competitiveness. Poverty reduction ultimately depends on rapid economy-wide growth and meso policies which effectively ensure that such growth is translated into positive outcomes in terms of poverty reduction at the individual and household levels. The reorientation of public expenditure towards social sectors, and within the latter towards basic health and education, is certainly an aspect of such mesopolicies. However, the necessary meso policies should be market-oriented, as well as State-centric, focusing on public action to animate private enterprise through the promotion of agricultural investment and productivity growth, and business development,<sup>21</sup> as well as on public investment in physical and social infrastructure.

It is essential that the tension between policy conditionality and domestic ownership be managed in a way which accepts a pragmatic view of the key policy ingredients for accelerating growth, and actively promotes a pluralistic conception of development strategies which is not wedded to a single model. As the declaration of the second HIPC ministerial meeting held in Geneva in June 2000 suggested, "There needs to be few, clear and realistic conditions, based on things that government can actually control" (p. 3). Strengthening the capacity of debtor countries to implement effective debt management policies is also important. One immensely positive side effect of the HIPC Initiative is that it is impelling capacity improvement in debt management. But further technical assistance is required in order to enable debtor countries to participate as equal partners in the HIPC process. Full domestic ownership of the debt sustainability analysis is a sine qua non for full domestic ownership of a poverty reduction strategy.

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Finally, it is imperative that domestic development strategies be supported by an appropriate international policy environment. The Progress Report of April 1999 by the Managing Director of the IMF and the President of the World Bank on the HIPC Initiative explicitly argues that the HIPC Initiative "needs to be reinforced by wider actions by our better-off members". In particular:

First, larger ODA flows should be provided to HIPCs and these flows concentrated on those countries implementing strong policies... Second, trade liberalization [in industrial countries] needs to be reinvigorated so that the export products of HIPCs – which are largely raw materials and agricultural products – have unrestrained access to industrial country markets. We urge redoubled efforts on both the aid and trade fronts:



without such efforts, the HIPC Initiative cannot by itself achieve sustained poverty reduction (IMF/World Bank, 1999b: 3).

In effect, there can be no such thing as a good poverty reduction strategy in a bad international enabling environment. Poverty reduction cannot be dealt with by focusing on national determinants alone, but must be treated as an international issue. Realizing international development goals will require international development means.

## Notes

1. For discussion of the lessons of the resolution of the debt problem in middle-income countries in the 1980s for poor countries, see Cline (1997).
2. A useful summary of these debt relief mechanisms is OECD (1997).
3. Daseking and Powell (1999:8) describe the situation in the 1980s as follows: "The secondary market prices for low-income country private debt, where they existed at all, were typically below those of the middle-income countries, but export credit agencies continued to argue publicly that official exposure would eventually be recovered in full...and [they] were not generally obliged to follow the accounting practices required of other commercial lenders and insurance companies. Throughout the 1980s, therefore, ECAs generally reported the value of their sovereign claims at full contractual value and had not made any provisions for bad and doubtful debt. These accounting practices allowed bilateral creditors to continue to provide comprehensive rescheduling or refinancing of payments falling due, without paying much attention to the medium term prospects for ultimate repayment of these debts".
4. The present value of the debt is usually, though wrongly, referred to as the "net present value". For a important discussion of this issue, see Cosio-Pascal (1997).
5. A full analytical summary of proposed changes to the HIPC Initiative can be found in IMF/IDA, (1999a), whilst a listing of key changes can be found in IMF (2000b). For an insider's view of the political process behind the introduction and enhancement of the HIPC Initiative, from someone who was an official in the international finance area of the United Kingdom Treasury from 1986 to 1994 and United Kingdom Executive Director at the IMF and World Bank from 1994 to 1997, see Evans (1999).
6. The way in which floating completion points are related to performance assessment is clearly set out in IMF/IDA (1999a: 14 – 17).
7. The following account draws on IMF (1999), and the evolving discussion of PRSPs is set out in IMF/IDA (1999b); IMF/World Bank (1999a); IMF/IDA (1999c); IMF/IDA (1999d); World Bank (2000a); IMF/World Bank (2000); World Bank (2000b).
8. For a recent critical statement of the negative effects of conditionality within HIPC II, see Killick (2000).
9. The situation of Benin has, however, been reassessed under HIPC II, and a debt reduction package was announced on 18 July, 2000.
10. IMF (2000b); IMF/World Bank (2000). This excludes the Gambia, which was added to the list of HIPCs in late August.
11. This estimate is from [www.worldbank.org/hipc/faq/faq.html](http://www.worldbank.org/hipc/faq/faq.html).
12. For full assumptions, see documents referred to in table 35.
13. For a discussion of these indicators, see IMF (1998; 2000a), and Cosio-Pascal (1997).
14. In the case of Uganda, for example, the baseline scenario assumed constant real coffee prices for most of the projection period, but the differential between the peak and the trough of the most recent coffee price cycle in the 1990s exceeded 200 per cent of the trough price, and the average deviation of coffee prices in the previous nine years (the length of the latest full coffee cycle) from a 25-year trend was 22 per cent of the trend price. Moreover, the baseline assumed an income elasticity of imports of 0.95, whereas for the four years before the forecast, real GDP increased at about 8 per cent per annum, with real imports increasing at 12 per cent per annum (i.e. on income elasticity of 1.5). Another example of such optimistic forecasting is that of Bolivia, where national government officials proposed to replicate, during the HIPC I negotiations, the last two large price shocks experienced by the country, but the vulnerability analysis simulated the effects of a price shock which was one third of that proposed. The Ugandan figures are taken from IMF/IDA (1997a: 22–25), whilst the Bolivian example is drawn from Comboni (2000).
15. Amongst the interesting proposals which take the direct route are CAFOD (1998) and Sachs et al. (1999).
16. For a sophisticated discussion of this issue, see Heller and Schiller (1999).

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17. These points were raised in the Declaration of the second HIPC ministerial meeting, Geneva, 7 June 2000, organized by Debt Relief International.
18. See Debt Relief International (2000b: 5) which reports that "Some governments are cancelling only pre cut-off aid (ODA) debt, some pre post cut-off date debt. Others are cancelling export credit debt as well. Most (with the notable exception of Canada, the UK, the US and some other like-minded governments) seem determined to delay their cancellations until completion points, which means that most HIPCs will not see them until well into the new millennium".
19. This was stressed in the Declaration from the second HIPC ministerial meeting, held in Geneva on 7 June 2000.
20. Proposals set out in United Nations (1999) are still relevant. Recent research has questioned in particular the fiscal thresholds for sustainability and has proposed a reduction of PV debt-to-fiscal revenue criterion by more than one third from its HIPC II level to 155 per cent, as well as a lowering of the qualifying criteria for application of this threshold (see Martin, 1999).
21. On the importance of meso policies within anti-poverty strategy, see Gore and Figueiredo (1997).

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