2

The HIPC Initiative: Background and Critiques

Debt contracts are based on an expectation that debtors will repay. In the absence of such an expectation, creditors would not make loans, and all the potential benefits of intertemporal trade—of enabling savings decisions and acts of investment to be made by different persons—would be aborted. Despite this, there is a long history of debts not being serviced on the agreed terms and of debt contracts ultimately being renegotiated (box 2.1). Borrowers sometimes find themselves unable to service their debts on the contractually agreed terms or (in the case of governments) unable to do so without imposing unacceptable sacrifices on their populations. Eventually, creditors recognize this and have little recourse but to accept some losses. The HIPC Initiative, in its enhanced version, is merely the latest case in point.[1]

Sovereign lending to today's developing countries started in the 1820s, and so did the process of their defaulting on sovereign debts (Eichengreen and Lindert 1989). The consequences of defaulting were painful, but presumably paying full debt service would have been even worse. Defaulters got shut out of the international capital markets, often for extended periods. A brief summary of how default by today's developing countries fits into the long history of default on sovereign borrowing is provided in box 2.1, which ends with resolution of the 1980s Latin American debt crisis by the Brady Plan. That was directed to helping countries whose debts were primarily owed to the commercial banks. These were largely

1. By the time of publication, Argentina was in fact the latest case.

Box 2.1 A short history of sovereign lending and default

In 1989, then-Citicorp chairman Walter Wriston famously pronounced that ''countries don't go bankrupt.'' This is true in the sense that there is no official international bankruptcy procedure that allows sovereign nations to free themselves from their debt obligations. Yet the implication that countries cannot default on their debts runs contrary to the historical record. Default by governments is a practice as old as the concept of credit. Throughout history, numerous countries have refused to pay their bills, unilaterally written off debts incurred by previous governments, and reduced their (internal) debt obligations by printing more money.

The first known default occurred in the fourth century BC, when 10 of 13 Greek city-states owing debts to the Delos Temple walked away from their contractual obligations. Not long after, the island of Chios, with unsustainable debts, announced that it would simply cease paying its debts until economic conditions improved. Default in ancient times often took the form of currency debasement, rather than a declaration of bankruptcy. For example, during the three Punic Wars (241-146 BC), Rome reduced the metallic content of its monetary unit from 12 ounces to half an ounce, in a series of de facto government defaults.

The practice of default continued sporadically through the Middle Ages and into modern times. Indeed, a French minister of finance contended in the 18th century that ''each government should default at least once every century, in order to restore equilibrium''! During the 19th century, as the practice of lending abroad became more common, government defaults increased and most European nations partially defaulted on their debt commitments. Some defaulted multiple times; the worst culprit was Spain, with seven recorded defaults (Winkler 1933). The record in developing nations was similar: every Latin American nation without exception defaulted in the course of the 19th century.

These were not complete government bankruptcies, and they were justified by governments on a number of grounds. Some claimed unfair competitive advantage by trading partners as justification for default, others declared the debts of former governments null on taking office, and still others solicited the aid of creditors in rescheduling commitments because of economic recession.

Although the US federal government avoided outright default, many US states defaulted during this period. Many of these defaults were on Civil War debts; others were on bonds issued to failed enterprises, usually railroads or banks (Winkler 1933). Arkansas and Florida each defaulted three times during the course of the 19th century. The United States government repudiated the debts that had been incurred by Cuba while under Spanish rule at the conclusion of the Spanish-American War in 1898.

John Maynard Keynes first became famous for his opposition to the reparations obligations that were being imposed on Germany at the Versailles peace conference that followed the First World War in 1919. He argued against reparations and for the cancellation of the inter-Allied debts that had been incurred to finance the war. His objections were overruled, leading to the protracted debt difficulties that nurtured German grievances in the early 1930s. The international capital market collapsed in the wave of defaults that accompanied the Great Depression of the 1930s.

When a new international monetary order was designed at Bretton Woods in 1944, it was assumed that capital mobility had gone forever. The victors were careful to avoid the imposition of significant reparations on the vanquished at the end of the Second World War. So in the three decades following the war, sovereign defaults were rare. But the international capital market gradually revived: first in the form of foreign direct investment, then via creation of the eurodollar market; first among industrial economies, then more and more involving developing countries.

(box continues next page)

Box 2.1 *(continued)*

Defaults on bank loans became more common in the 1970s when money deposited in Western banks by members of the Organization of Petroleum Exporting Countries, as a result of successive oil shocks, prompted a surge in bank lending, especially in Latin America. US interest rate increases in the early 1980s, intended to bring inflation under control, led to a sharp increase in the cost of servicing this debt, as well as a decline in the terms of trade that eroded the ability to service debt. This prompted the Mexican moratorium of 1982, which led to the debt crisis and what is often referred to as the lost decade.

In 1989, US Treasury secretary Nicholas Brady introduced a plan to restructure the commercial bank debt owed by Latin America. Bank loans were replaced by securitized liabilities backed in effect by partial guarantees of the US government and reduced present values. The Brady Plan relieved the debt burden of countries whose indebtedness was primarily commercial. It did not cover countries whose outstanding debt was primarily to official (bilateral and multilateral) creditors, whose debts were instead handled as described in the text.

the middle-income developing countries,[2] to which the banks had been prepared to make loans during the years after the rise of the Organization of Petroleum Exporting Countries (OPEC) in the 1970s.

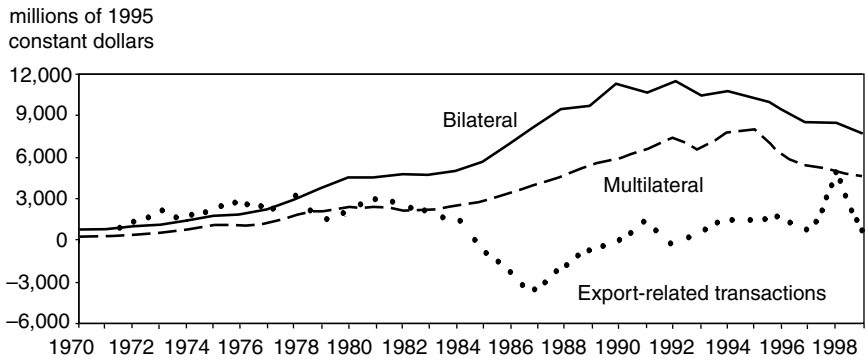
Most of the poorer (low-income) countries were never considered sufficiently creditworthy to be able to attract much commercial lending.[3] They were largely restricted to official finance, which came in three main forms. Two of these involved bilateral (government to government) loans: export credits, which were on more or less commercial terms; and official development assistance (ODA), which includes outright grants and loans with a grant element of at least 25 percent. The third form of official finance consists of loans from the multilateral institutions: the IMF, the World Bank, and the regional development banks, such as the African Development Bank.

Multilateral loans can in turn be divided into two types: ''hard-window'' loans, where borrowers' interest cost is related to the institution's own cost of borrowing, and ''soft-window'' or ''concessional'' loans. The latter are much more highly subsidized and are therefore directly funded by contributions that donor governments make to the banks' soft windows—

2. We use the World Bank's classification to distinguish between low-income and middle-income developing countries. Low-income countries had per capita GNP at or below $755 in 2000 (measured at market exchange rates); middle-income ones had per capita GNP between $755 and $9,266. Middle-income countries are split into lower-middle-income ones, with per capita GNP below $2,955, and upper-middle-income ones with a higher per capita GNP. Appendix B lists all the countries with a population of more than 1.5 million in each category.

3. Except for a few countries like Côte d'Ivoire, and for ''enclave'' extractive sectors, like minerals, oil, and plantation agriculture in a wider range of countries.

Figure 2.1 ODA loans to sub-Saharan Africa, 1970-99



Note: Export-related transactions include official export credits, loans to national private exporters (i.e., official loans to private export credit agencies to partially finance export credits extended by them to developing countries), and interest subsidies to national private exporters of DAC countries (subsidies to reduce the interest rate charged on private export credits).

Source: Organization for Economic Cooperation and Development, Development Assistance Committee (DAC) reporting system.

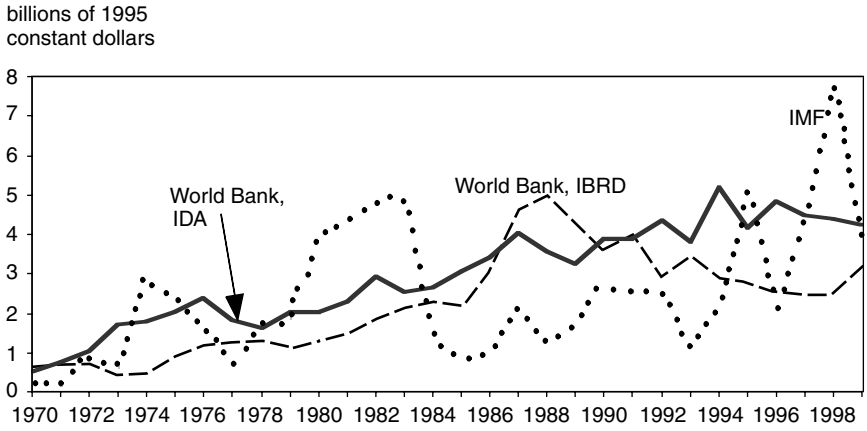
such as the International Development Association (IDA) in the case of the World Bank.

As is shown in figure 2.1, official loans to sub-Saharan Africa—which mostly consists of low-income countries, although there are also of course low-income countries elsewhere—increased rather gradually in both nominal and real terms until the early 1980s. At that time, many of these countries began to experience debt-servicing problems akin to those being confronted by their middle-income peers. Because their creditors were largely official institutions rather than private commercial banks, these problems were handled differently than those of the middle-income countries. The Paris Club was the main instrument used, initially simply to reschedule official debt.[4] But donors (especially the Europeans) more and more began to appreciate that low-income countries were likely to have difficulty servicing loans on the near-commercial terms characteristic of export credits, and so in the mid-1980s they phased out such lending and replaced it with higher levels of lower-interest ODA loans.

Multilateral lending also expanded vigorously during the 1980s. From the IMF and World Bank alone (not including the regional development banks), lending increased from less than $1 billion to about $6 billion

4. The Paris Club is an ad hoc group of official creditors that seeks to coordinate the restructuring of official bilateral debt when sovereign debtors encounter debt-servicing problems. The club has 19 permanent members, and other creditors are invited to participate on a case-by-case basis. Since its first meeting in 1956, the club has negotiated 336 agreements encompassing 76 debtor countries.

Figure 2.2 World Bank and IMF loan disbursements to low-income countries, 1970-99



IBRD = International Bank for Reconstruction and Development
IDA = International Development Association

Source: World Bank, *Global Development Finance* CD-ROM, 2001.

annually (in constant 1995 dollars), as is shown in figure 2.2. Lending by IDA tended to increase relative to that by the International Bank for Reconstruction and Development (IBRD, the hard window of the World Bank) after 1986, again reflecting an attempt to ease the terms confronting low-income countries. IMF lending more and more took the form of concessional lending from what was first called the Trust Fund, then the Structural Adjustment Facility, and then the Enhanced Structural Adjustment Facility; in the era of the enhanced HIPC Initiative, it was renamed yet again as the Poverty Reduction and Growth Facility.

In consequence, although low-income countries outside Asia grew much less in the 1980s than they had in the 1970s, they did not suffer the same precipitous decline in access to external credits as did the middle-income countries of Latin America. Although the countries subsequently labeled HIPCs did suffer a decline in ''net transfers on debt'' (which is loan disbursements minus debt service payments), total resource transfers remained positive for the group as a whole. Indeed, that was true for each individual HIPC except Côte d'Ivoire, which had borrowed more in the more costly commercial market. That is, the decline in debt transfers was fully compensated for by an increase in grants in the 1980s, and more than fully in the early (though not in the late) 1990s (see table 2.1). Most of these countries did not participate in the negotiations over commercial bank debt restructuring in the middle to late 1980s. In short, for the poorer countries there was no visible 1980s ''debt crisis.''

Table 2.1 Resource flows to HIPCs and all developing countries, 1980-99 (billions of constant 1995 dollars)

	HIPCs					All developing countries			
Flow	**1980-84**	**1985-89**	**1990-94**	**1995-99**	**Flow**	**1980-84**	**1985-89**	**1990-94**	**1995-99**
PPG disbursements	14.4	12.7	9.7	9.2	PPG disbursements	148.6	138.0	169.9	285.3
PPG debt service	6.8	8.4	7.0	8.8	PPG debt service	118.4	165.6	168.5	282.6
PNG disbursements	0.8	0.6	0.4	0.5	PNG disbursements	23.8	10.9	38.9	103.0
PNG debt service	1.1	1.1	0.7	0.7	PNG debt service	27.0	21.5	26.0	84.4
Net transfers on debt	7.3	3.9	2.4	0.1	Net transfers on debt	26.9	−38.2	14.2	21.3
Grants	6.7	10.1	14.5	11.6	Grants	23.7	32.2	50.3	45.6
Total net transfers	14.0	14.0	16.9	11.7	Total net transfers	50.6	−6.0	64.5	66.9

PPG = public or publicly guaranteed
PNG = private nonguaranteed

Note: Total net transfers are the sum of disbursements and grants less debt service. Net transfers on debt are loan disbursements less debt service.

Source: World Bank, *Global Development Finance* CD-ROM, 2001.

Table 2.2 Growth in HIPCs and other developing countries, 1980-99 (percent per year)

	HIPCs				Low-income countries				Middle-income countries			
Measure of growth	**1980-84**	**1985-89**	**1990-94**	**1995-99**	**1980-84**	**1985-89**	**1990-94**	**1995-99**	**1980-84**	**1985-89**	**1990-94**	**1995-99**
GDP growth	1.1	2.7	0.9	4.8	4.6	5.1	2.0	3.9	2.9	3.6	2.7	3.6
Population growth	2.7	2.7	2.6	2.5	2.3	2.3	2.1	2.0	1.6	1.7	1.4	1.2
Per capita GDP growth	−1.6	0.0	−1.7	2.3	2.3	2.8	−0.1	1.9	1.3	1.9	1.3	2.4

Sources: World Bank, *Global Development Finance* CD-ROM, 2001; HIPC Debt Sustainability Analyses.

The Heavily Indebted Poor Countries

However, the group of countries that eventually became the HIPCs already exhibited symptoms of increasing and potentially unmanageable debt in the 1980s. Debt-export and debt-GNP ratios were already higher in the HIPCs in the 1980s than in other developing countries[5] (figure 2.3). The comparison is less striking in terms of debt service because of the high proportion of concessional loans with relatively long grace periods before debt-service payments kick in, but the debt-service ratio was still high.[6] So the first common characteristic of the HIPCs is that they were already heavily indebted more than a decade ago.

The second common characteristic of the countries included in the HIPC Initiative is of course that they are poor; because their economies have not grown much, their peoples are generally as poor today as they were two decades ago. Of the total current population of HIPCs of 615 million, almost half live on less than $1 a day (World Bank 2000b, 9). With slow growth (see table 2.2), the number and even the proportion of poor people have increased in the past two decades. Real GDP per capita was lower in 1999 in 10 of the 21 HIPCs for which there are data than it was in 1960. It is because of their poverty—and the fact that poverty was getting worse rather than better, at least until the late 1990s—that the world feels a special concern for these countries.[7]

A third common characteristic of the HIPCs has been their high receipts of ODA. Gross transfers in the form of grants and loans from bilateral and multilateral donors and creditors in the past two decades amounted to about $445 billion in constant 1995 dollars. On average, net transfers (gross transfers minus debt service paid by them) to the HIPCs were about 10 percent of their GDP in the 1990s, representing as much as 60 percent of government revenue[8] and financing most public investment. This compares to an average for all other developing countries in the past

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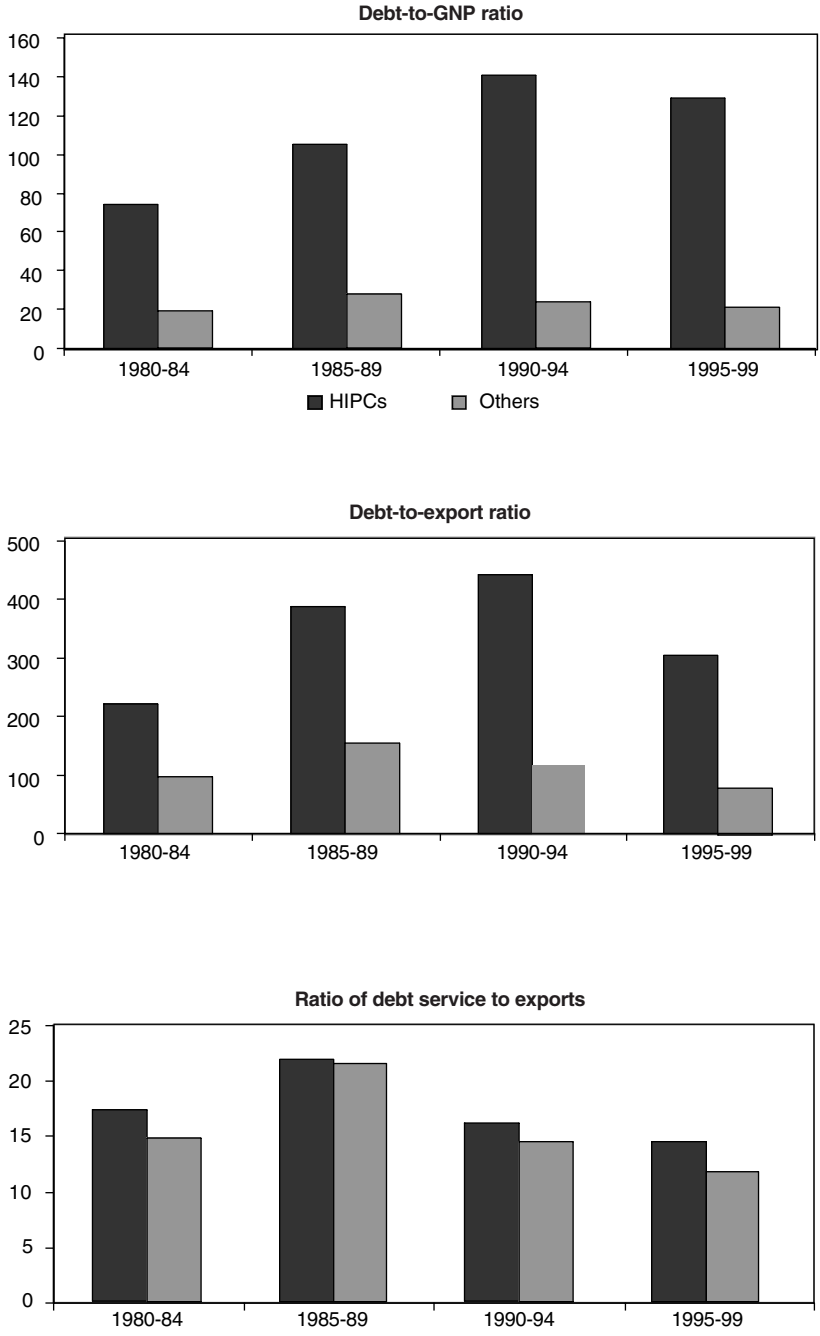
5. All figures, unless otherwise noted, are derived from the World Bank's *Global Development Finance* and *World Development Indicators* 2001 CD-ROMs, and are in constant 1995 US dollars (deflating by the US wholesale price index). When referring to HIPCs, we generally mean the 38 of the 41 countries deemed eligible for the HIPC Initiative as of December 2000 for which there are data (data are consistently unavailable for Liberia, Myanmar, and Somalia). Comoros was added to the list of eligible countries in 2001.

6. E.g., the concessional loans from the World Bank's IDA window have a 10-year grace period. This increased the debt-service ratio in the late 1990s as grace periods from the high level of lending in the 1980s ended.

7. The great majority of the world's poor live outside the HIPCs, in China (350 million), India (525 million), the Latin American countries (60 million), and elsewhere. Some of those countries are more able to raise and allocate resources internally to attack the poverty of their people.

8. Government revenue data are limited, and available for only 19 HIPCs in the 1990s.

Figure 2.3 Debt ratios of HIPCs and other developing countries
(percent)



Source: World Bank, *Global Development Finance* CD-ROM, 2001.

two decades of about 2 percent of GDP. Transfers often exceeded the government's own revenue collection. In some extreme cases, gross transfers were more than 60 percent of GDP (though only in tiny São Tomé and Principe have they exceeded the proportion in eastern Germany after reunification).[9]

The high levels of development assistance and the stagnation in exports and government revenue (which resulted from the low growth) combined to produce a more and more unmanageable stock of debt. The debt of the HIPC Initiative-eligible countries grew from about $59 billion in 1980 to $170 billion in 1999, which increased the average debt-to-export ratio from 199 to 414 percent and the average debt-to-GNP ratio from 31 percent in 1981 to 103 percent in 1999. The increase in annual debt-service obligations was far more muted, owing to the increasing levels of concessionality and the accumulation of annual arrears, from $7 billion in 1980 to about $9 billion in 1999. The debt-service ratio actually declined in the 1990s but was still a high 18 percent of exports in 1999.

This outcome was vastly different from that anticipated in the early days of foreign aid. For example, the Pearson Commission, which issued its report in 1969 and first formalized an aid target, suggested that industrial countries should commit themselves to a target of giving 0.7 percent of their GNP as foreign aid. The commission assumed that this would be a temporary effort and that the need for aid would be winding down by the turn of the century.[10] It was taken for granted that countries receiving aid would make sufficiently good investments to enable them to service low-interest loans without difficulty. But things did not follow that path in the countries that are now HIPCs, including in most of sub-Saharan Africa (Lancaster 1999).

Recent Debt Relief Initiatives

By the end of the 1980s, the accumulation of official public debt on the part of many low-income countries was more and more troubling donors. Given the continuing needs of recipient countries, including for help in strengthening health and education systems and other programs of human development, donors sought ways to sustain high positive net transfers, despite the growing volume of debt service to donors and to multilaterals now being paid by borrowing countries.

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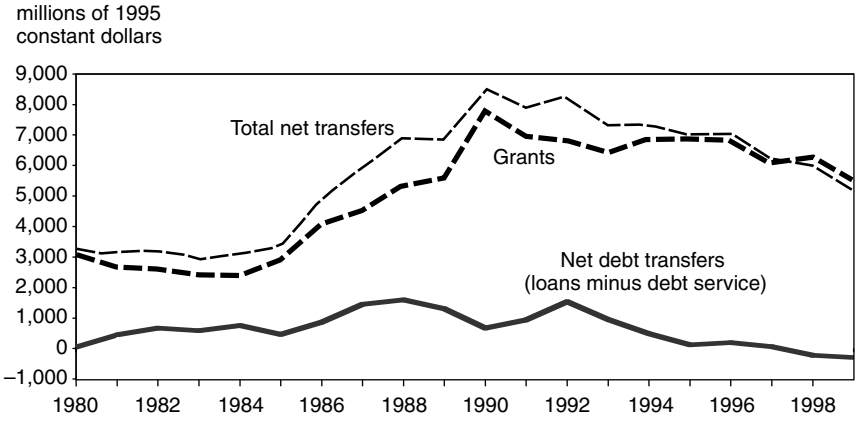
9. Transfers from west to east averaged $100 billion for the first half of the 1990s, representing approximately 100 percent of eastern Germany's GDP and 7 percent of western Germany's (Wurzel 2001).

10. The Commission on International Development was headed by former Canadian prime minister Lester Pearson (Pearson 1969). One of the authors of this study served as a research assistant on the staff of this commission.

Figure 2.4 Evolution of ODA disbursements from EU countries, 1980-99



Source: Organization for Economic Cooperation and Development, Development Assistance Committee reporting system.

One step was a foretaste of the current proposal that IDA switch some of its lending to grants: The European governments switched away from already highly concessional loans to straight grants, beginning in the mid-1980s and continuing into the 1990s. Figure 2.4 displays disbursements of grants and net loans from EU countries. It shows that in the middle of the 1990s the net debt transfer turned negative. However, this was for a long time offset by the increasing level of grants, so that the net transfer remained as large as before. Only in the mid-1990s did net transfers start to decline, although even then they remained positive.

In addition, bilateral donors began negotiating formal programs of official debt relief. These began in earnest in 1989 and intensified in the 1990s (box 2.2). Initial rounds were confined to a reduction in debt service, with donors reluctant to forgive debt stock—perhaps in an effort to preserve the principle of the sanctity of debt contracts, or perhaps because of accounting conventions. Whatever the reason, the consequence was a ballooning in the value of what had often started as nonconcessional export credits. By the mid-1990s, however, official donors were providing some countries the option of debt stock cancellation. The debt relief possibilities were directly linked to IMF programs and were deliberately ad hoc and case by case. These first rounds of official debt relief attracted relatively little public interest or attention.

The switch of bilateral donors from loans to grants, combined with the low level of private lending to most low-income countries, meant that by the mid-1990s an increasing proportion of the debt of the poorest countries

Box 2.2 Debt initiatives

- *Special Program of Assistance for Africa, 1987:* Informal donor association managed by the World Bank to provide bilateral debt relief, IDA credits for IBRD debt service relief, and funding for commercial debt buybacks. Available to African IDA-only borrowers with ratios of debt service to exports above 30 percent (initially 21 countries).
- *Paris Club: Toronto terms, 1988:* First agreement by Paris Club creditors to implement new treatment on the debt of low-income countries. The level of reduction was a uniform 33.33 percent.[1]
- *Brady Plan, 1989:* The World Bank and IMF facilitated debt and debt service reductions by commercial bank creditors. Most Brady deals went to middle-income countries.
- *IDA Debt Reduction Facility, 1989:* Established to restructure and buy back commercial debt with IDA credits (average 88 percent discount). Available to low-income countries (heavily indebted IDA-only borrowers). Funded from IBRD net income transfer.
- *Paris Club: Houston terms, 1990:* Agreement to implement a new treatment of the debt of the *lower-middle-income* countries. Houston terms had three components: repayment periods lengthened to or beyond 15 years and ODA repayment periods lengthened up to 20 years with a maximum 10-year grace period; ODA rescheduled at a concessional rate; and the introduction of bilateral debt swaps.
- *Paris Club: London (''enhanced Toronto'') terms, 1991:* Debt service reduced 50 percent on nonconcessional bilateral debt (12-year grace period, 30-year maturity).
- *Paris Club: Naples terms, 1995:* Debt service reduced 67 percent on nonconcessional bilateral debt (16-year grace period, 40-year maturity). Option of debt stock cancellation (5 stock deals processed).[2]
- *HIPC Initiative (HIPC I), 1996:* Debt stock reduction to bring debt-export ratio under 200 percent for 41 heavily indebted poor countries. Participation of multilateral creditors.
- *Paris Club: Lyon terms, 1996:* Agreement within HIPC framework for 80 percent relief on nonconcessional bilateral debt for HIPC Initiative-eligible countries.
- *Enhanced HIPC Initiative (HIPC II), 1999:* Increased stock reductions to bring debt of HIPCs to under 150 percent debt-export ratio. Interim debt-service reduction between decision and completion points. Relief conditioned on the completion of comprehensive Poverty Reduction Strategy Papers.
- *Paris Club: Cologne terms, 1999:* Agreement within HIPC framework, non-ODA credits canceled up to 90 percent or more if necessary in the context of the HIPC Initiative (including topping up). ODA credits rescheduled at an interest rate at least as favorable as the original concessional interest rate applying to these loans (40-year terms, with 16-year grace period and progressive repayment).

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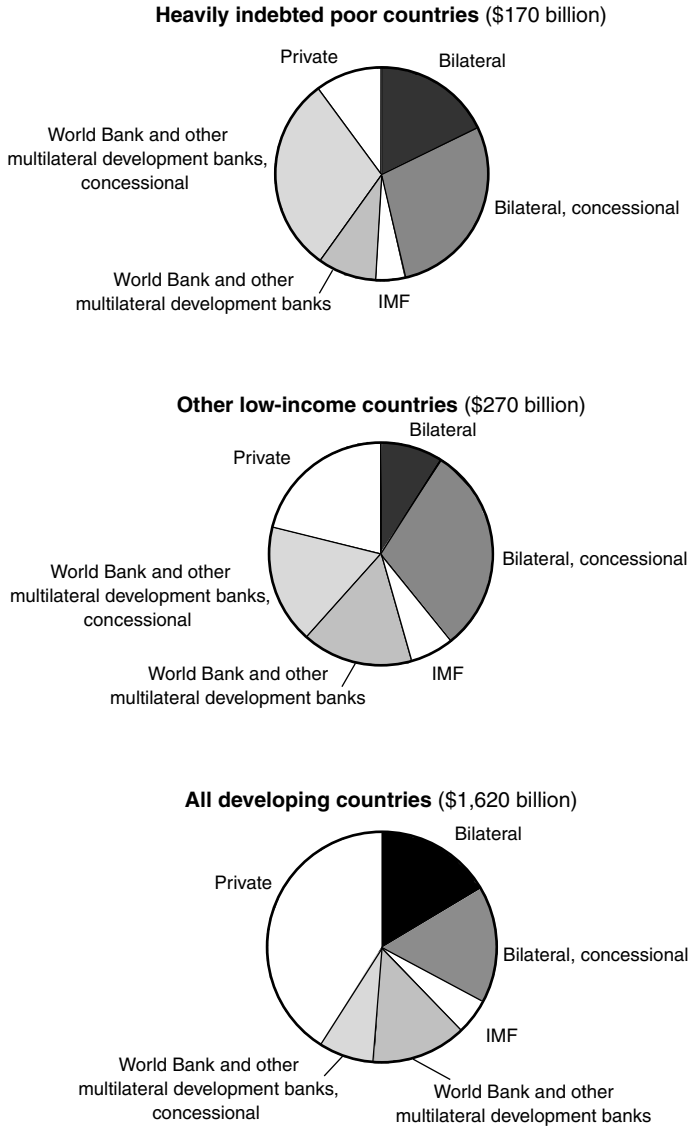
1. Paris Club debt reduction decisions are made according to five principles: case-by-case decision making, consensus, conditionality (the existence and continuation of an IMF program), solidarity, and comparability of treatment.

2. The option of stock treatments was and is implemented ''on a case-by-case basis, for countries having established a satisfactory track record with both the Paris Club and IMF and for which there is sufficient confidence in their ability to respect the debt agreement'' (Paris Club Web site, http://www.clubdeparis.org).

Figure 2.5 Breakdown of debt by creditor, nominal debt stock, 1999



Source: World Bank, *Global Development Finance* CD-ROM, 2001.

was owed to official multilateral creditors, notably the IMF and World Bank. This was especially true of the HIPCs. Figure 2.5 shows the debt of the HIPCs, other low-income countries, and all developing countries broken down by creditor. It shows that debt owed to multilateral institutions represented 44 percent of the HIPCs' total debt and 25 percent of the

debt of all developing countries, whereas publicly guaranteed commercial debt made up only 10 percent of HIPC debt but 42 percent of developing-country debt. It became evident that the overall debt burden of the poorest countries, especially the HIPCs, could not easily be handled while continuing to treat the multilaterals as preferred creditors (Martin 1997).

The multilaterals have always been treated as ''preferred creditors'' in the sense that their credit was recognized, by debtors and all other creditors, as senior to all other debt—first in line for repayment, and payable in full even if other debt cannot be serviced. Because the multilaterals are preferred creditors, failing to repay them means a debtor will be liable to be cut off from all other debt financing, including for short-term trade credits. In the official donor community, defaulting to the multilaterals is seen as virtually tantamount to withdrawal from the international community of nations. So for both financial and political reasons, the official donors went to great lengths to help ensure that a poor debtor country (other than a rogue state) did not fall into arrears to the preferred multilateral creditors.

The first HIPC program was negotiated in 1996 and was notable for two reasons. First, it not only explicitly emphasized debt-stock reduction, but it keyed the extent of debt-stock reduction to what would be needed in a particular country to achieve ''debt sustainability.'' This was in contrast to previous relief under the Paris Club, where (for example) the Naples terms provided a uniform 67 percent reduction for all countries that qualified. Instead, an attempt was made to calculate what would be needed to enable each country to exit the process of constant rescheduling and resume normal relations with its creditors, where it serviced all its remaining debt, that is, where it achieved debt sustainability. The benchmark was set at 200 percent debt-export ratio; countries above that level could become eligible.

Second, for the first time debt relief included reduction of debt owed to the multilateral institutions—the IMF, the World Bank, and the regional and subregional development banks.[11] This was judged necessary because the switch from loans to grants by the bilaterals meant that a large and growing share of debt service was being paid to the multilaterals. However, partly to maintain this formal status as preferred creditors, the institutions were not to write off the debt owed to them on their own books. Instead, the debt service owed to them was to be paid to them through special trust funds created for that purpose. The trust funds are financed by direct contributions from governments and, in the case of the World Bank, by transfer of some of its net income from its ordinary (non-IDA) lending.

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11. See appendix A for a complete list of multilateral institutions participating in the HIPC Initiative.

The technical design of the original HIPC program was conceived by IMF and World Bank staff (and approved by the shareholders through the boards of the two institutions) along traditional lines of conditionality. Debtor countries would become eligible for the HIPC program (reach the ''decision point'') only when they had maintained stable macroeconomic conditions under approved IMF programs for at least 6 years; and would receive a permanent reduction in their official debt stock (reach the ''completion point'') only after another 3 years of satisfactory policy.

The World Bank and IMF predicted in 1996 that 20 of the 40 countries then eligible would eventually reach the completion point, and that the HIPC Initiative would provide a total debt-stock reduction of $8.2 billion (about 20 percent of their outstanding debt) in terms of net present value (NPV).[12] After nearly 3 years in the process, however, only 6 countries—Bolivia, Burkina Faso, Côte d'Ivoire, Guyana, Mozambique, and Uganda—had reached the decision point, and only Uganda had reached the completion point. The official creditors—under strong pressure from the Jubilee movement, and frustrated with the stringent eligibility requirements and slowness of the process—came back together in 1999 and agreed to an ''enhanced'' HIPC framework to provide more and faster debt relief for more countries, mainly in Africa.

The Enhanced HIPC Framework

The enhanced HIPC framework was agreed to by the G-7 at their July 1999 summit at Cologne in Germany and endorsed at the annual meetings of the IMF and World Bank that September. The terms of the enhanced framework reduce the time period before the decision point to less than 3 years, reduce eligibility standards to allow more relief to more countries, and alter the delivery structure to provide for greater debt-service relief between decision and completion points. Under the enhanced initiative, a country is eligible if:

- its per capita income is low: access is limited to countries entitled to borrow on IDA-only terms from the World Bank and from the IMF's Poverty Reduction and Growth Facility;[13]

12. All NPV calculations are from the World Bank and are made using a conventional 7 percent discount rate. Projections of the total relief provided by the HIPC Initiative continued to change, as countries' individual timelines and eligibility requirements were analyzed. By 1999, before the enhanced HIPC Initiative, the projection for relief under HIPC I had increased to $12.5 billion for 29 countries.

13. As we discuss in chapter 5, some low-income countries, including Indonesia, Nigeria, and Pakistan, are not IDA only because they have (or has) some access to private capital markets, and thus are not eligible for the HIPC Initiative.

- it can demonstrate a good track record of reform (in principle over 3 years) at the time when the program is approved (the decision point);
- either the ratio of its net present value of debt to exports exceeds 150 percent; or
- for countries with open economies (a minimum 30 percent export-GNP ratio) and substantial tax revenue (a minimum of 15 percent of GNP), the ratio of the NPV of debt to tax revenue exceeds 250 percent.[14]

Countries begin receiving debt-service relief from multilateral creditors as soon as they reach the decision point; that is, the annual flows of debt service due are immediately reduced. The actual debt-stock reductions are delayed until the completion point.

In contrast to the original program, conditioned primarily on macroeconomic stability, the enhanced HIPC program also puts new emphasis on countries' demonstrating a firm commitment to reducing poverty by using resources that would otherwise have been used for debt service. In an effort to make sure that the released resources are in fact used for that purpose, eligibility under the enhanced framework is directly linked to agreement on a new Poverty Reduction Strategy Paper. Reflecting the donors' current enthusiasm for participation, this is to be drawn up through a process of dialogue primarily with civil society groups and other domestic stakeholders, with the aim of ensuring local ownership of a development program strongly focused on poverty reduction.

Under public pressure generated by the Jubilee movement, the IMF and World Bank pressed hard to get a lot of countries to their decision points by the end of 2000.[15] As a result, 12 additional countries were approved for decision points in the final two months of 2000, for a total of 22 countries. Chad reached its decision point in early 2001. The first 23 HIPCs will be entitled to nominal debt relief of $33.9 billion ($20.5 in NPV terms) when they reach their completion points. Annual debt-service savings during 2001-03 for those countries are estimated at $1.1 billion, in comparison with debt service paid in 1998-99 of $9.4 billion (World Bank 2001a, table 2).[16] The reduction in debt service as compared to debt service *actually owed* is substantially larger, at $2.4 billion (with the

14. This option was included to avoid the possibility that some countries with high ratios of exports to GDP would fail to qualify despite having a debt that was very burdensome to service. The option had in fact been developed and applied (to Côte d'Ivoire) before 1999.

15. Not all the nongovernmental organizations (NGOs) in the Jubilee movement supported the rush to maximize the number of countries getting to the decision point by the end of 2000. At least one NGO reports that in one or two countries their local counterparts feared that the benefits would go only to corrupt governments and insider cliques.

16. Drop the Debt (2001, 9) quantifies the savings as only $0.7 billion, on the basis of a comparison with 2001-05 instead of 2001-03.

difference being the extent to which HIPCs were failing to pay debt service and thus building up arrears). A further 2 countries, Ethiopia and Ghana, reached decision points by February 2002, for a total of 25. Of these, 4 countries have by now reached completion points under the enhanced framework and have actually had their debt stock reduced.

Forty-two countries have now been identified as eligible for the HIPC Initiative. These are shown in table 2.3, divided into five groups. The first consists of the 4 countries that have already reached completion point: Bolivia, Mozambique, Tanzania, and Uganda. The second consists of the 21 other countries that have already reached decision point; all except 3 (Guyana, Honduras, and Nicaragua) are African countries. Third are 12 countries, all in Africa except Myanmar, that are expected to reach decision point in the future; 9 of these are suffering internal conflicts, which is likely to preclude their rapid establishment of the good track record of economic management needed to qualify them for decision point.

The fourth category consists of 4 countries that now satisfy the conditions for the HIPC status but are unlikely to need HIPC relief because ''traditional mechanisms'' of debt relief, meaning the terms now on offer from the Paris Club, are expected to reduce their debt ratios below the critical level (90 percent of both Angola's and Vietnam's large debt burden is owed to bilateral creditors). In the last category is just Lao PDR, which has been tempted by Japanese offers of new aid not to seek HIPC relief. Japan is the one donor country that is reluctant to commit to the HIPC Initiative; instead, it would prefer countries to preserve the appearance of the sanctity of debt contracts by continuing to take on ever more unserviceable debt to maintain the fiction of servicing their existing debt.

Table 2.4 presents debt data for the 42 HIPCs. The top part of the table presents data for the 24 countries that had reached decision point by January 2002 (the first two categories identified above, with the exception of Ghana); the bottom part deals with the remaining 18 countries. The first column shows the nominal value of publicly guaranteed debt outstanding in 1999 before the enhanced HIPC Initiative started. This varied from a mere $294 million for tiny São Tomé and Principe (population 140,000) to $20.8 billion for Vietnam with its 80 million people (for a total of $170 billion). Because most of this debt is highly concessional, however, the NPV of the debt, shown in the second column, is in most cases substantially less than its nominal value, totaling about $130 billion for the 42 HIPCs.

The third column of table 2.4 shows the first of the traditional measures of how burdensome the debt is: the ratio of debt (specifically, of the NPV of debt) to exports. HIPC I aimed to reduce this ratio to no more than 200 percent, on the argument that history showed that larger values than that usually proved to be unsustainable; HIPC II reduced the target to 150 percent, to allow some leeway for debt burdens to increase in the

Table 2.3 Heavily indebted poor countries

Completion point (4)	Decision point (21)		Future decision points (12)	(Potentially) sustainable cases (4)	Not seeking relief (1)
Bolivia	Benin	Madagascar	Burundi[a]	Angola[a]	Lao PDR
Mozambique	Burkina Faso	Malawi	Central African Republic[a]	Kenya	
Tanzania	Cameroon	Mali	Comoros	Vietnam	
Uganda	Chad	Mauritania	Congo, Democratic Republic of[a]	Yemen	
	Ethiopia	Nicaragua	Congo, Republic of[a]		
	Gambia	Niger	Côte d'Ivoire		
	Ghana	Rwanda[a]	Liberia[a]		
	Guinea	São Tomé and Principe	Myanmar[a]		
	Guinea-Bissau[a]	Senegal	Sierra Leone[a]		
	Guyana	Zambia	Somalia[a]		
	Honduras		Sudan[a]		
			Togo		

a. Affected by conflict.

Source: World Bank HIPC Web site, http://www.worldbank.org/hipc.

Table 2.4 Debt statistics for HIPCs

Countries that have reached decision point

Country	Debt out-standing (nominal)	Debt out-standing (NPV)	NPV of debt-to-exports	NPV of debt-to-GNP	Ratio of debt service to exports	Ratio of debt service to GNP	Estimated total relief (nominal)[a]	Estimated total relief (NPV)[a]	Ratio of NPV relief-debt (percent)	Estimated ratio of debt service to exports	Estimated ratio of debt service to GDP
Benin	1,419	950	148	40	11	3	460	265	28	9.4	1.4
Bolivia[b]	4,606	2,974	193	37	32	6	2,060	1,302	44	12.1	3.0
Burkina Faso	1,499	631	158	25	16	3	700	398	63	9.2	1.1
Cameroon	7,802	6,601	292	76	24	6	2,000	1,260	19	8.2	2.5
Chad	1,142	656	208	43	10	2	260	157	24	8.9	1.3
Ethiopia	5,551	3,529	374	55	17	3	n.a.	n.a.	n.a.	n.a.	n.a.
Gambia	453	258	103	67	9	6	90	67	26	8.5	3.1
Guinea	3,375	2,415	294	71	16	4	800	545	23	8.7	3.5
Guinea-Bissau	944	709	1,222	348	16	5	790	416	59	5.4	1.7
Guyana	1,214	867	n.a.	140	n.a.	17	1,030	585	67	5.2	7.1
Honduras	4,288	3,296	122	63	14	7	900	556	17	5.8	3.1
Madagascar	4,358	2,943	304	80	17	5	1,500	814	28	5.5	1.3
Malawi	2,608	1,482	246	84	11	4	1,000	643	43	10.5	2.9
Mali	3,038	1,429	193	57	14	4	870	523	37	8.1	2.3
Mauritania	2,072	1,567	422	170	28	11	1,100	622	40	13.4	4.5
Mozambique[b]	5,019	2,731	167	28	20	3	4,300	1,970	72	4.8	1
Nicaragua	6,413	5,541	475	271	16	9	4,500	3,267	59	13.4	5.2
Niger	1,604	1,089	362	55	17	3	900	521	48	14.1	1.9
Rwanda	1,261	696	655	36	30	2	810	452	65	7.7	0.6
São Tomé and Principe	294	190	1,285	450	29	10	200	97	51	7.4	4.6
Senegal	3,618	2,495	169	53	16	5	850	488	20	7.4	3.1
Tanzania[b]	6,385	4,613	370	53	16	2	3,000	2,026	44	8.6	1.4
Uganda[b]	3,217	1,748	225	27	24	3	1,950	1,003	57	4.7	0.7
Zambia	4,566	4,074	548	172	47	15	3,820	2,499	61	11.4	3.7

Countries still to be considered

Country	PPG debt outstanding (nominal)	PPG debt outstanding (NPV)	NPV of debt-to-exports	NPV of debt-to-GNP	Ratio of debt service to exports	Ratio of debt service to GNP
Angola	9,248	7,226	133	244	20	37
Burundi	1,062	636	1,009	90	43	4
Central African Republic	854	528	343	51	11	2
Comoros	182	120	251	62	15	4
Congo, Democratic Republic of	8,600	8,060	n.a.	n.a.	n.a.	n.a.
Congo, Republic of	3,961	3,751	209	226	0	0
Côte d'Ivoire	10,319	9,509	172	91	18	10
Ghana	5,957	4,302	164	56	18	6
Kenya	5,517	4,358	163	42	22	6
Lao PDR	2,524	1,385	289	99	8	3
Liberia	1,371	1,318	n.a.	n.a.	n.a.	n.a.
Myanmar	5,333	3,992	n.a.	n.a.	n.a.	n.a.
Sierra Leone	1,133	806	1,119	124	29	3
Somalia	2,013	1,792	n.a.	n.a.	n.a.	n.a.
Sudan	9,567	8,970	1,018	102	6	1
Togo	1,345	1,010	194	73	7	3
Vietnam	20,884	19,458	136	68	10	5
Yemen	4,138	3,188	81	52	4	2

n.a. = not available

NPV = net present value
PPG = public or publicly guaranteed

a. Estimated relief includes enhanced HIPC and all traditional debt reduction mechanisms (Paris Club, etc.).

b. Reached completion point.

Source: World Bank, *Global Development Finance* CD-ROM, 2001 (GDF). The 2nd through 7th columns are for 1999. The NPV of publicly guaranteed debt for non-decision-point countries is calculated by discounting the nominal PPG figures by the ratio of nominal to net present value of total outstanding debt, table A1.4. The 8th and 9th columns are from World Bank, "HIPC Initiative: Status of Country Cases Considered under the Initiative," October 2001. The 11th and 12th columns are from World Bank, "Financial Impact of the HIPC Initiative," October 2001.

future without pushing countries straight back into unsustainability. It can be seen that almost all the countries were at more than 150 percent and most were at more than 200 percent, with São Tomé and Principe the highest at a staggering 1,285 percent. The fourth column shows the ratio of the NPV of debt to GNP, the other traditional measure of the burden of a debt stock, where 40 percent is a traditional rule of thumb for the maximum comfortable level and 60 percent for severe indebtedness. The majority of the countries were way over even the higher level, with São Tomé and Principe again the highest at 450 percent.

The next two columns of table 2.4 look at the burden of debt service, first in terms of the debt-service ratio (the percentage of export revenue that is needed to service the debt) and then in terms of the percentage of GNP used in servicing the foreign debt. One thinks of 15 percent as a normal figure for the debt-service ratio and 25 percent as a high figure. Despite the concessional nature of most debt, 24 of the 39 countries for which data are available had debt-service ratios exceeding 15 percent, and 5 of these had ratios of more than 25 percent. If a normal level of foreign debt is 40 percent of GNP and servicing concessional debt costs about 5 percent of the debt stock each year, then a norm for the ratio of debt service to GNP would be 2 percent,[17] a level exceeded by no fewer than 36 of the 39 HIPCs for which data are available.

These data leave little reason to doubt that all the HIPCs, except Yemen and perhaps Benin, were overindebted by at least one measure, often severely so. How much does enhanced HIPC promise to remedy that? This question can only be answered for the countries that have already reached the decision point and therefore have received a quantitative promise of debt relief.

The last five columns in the upper panel of table 2.4 therefore show statistics about the relief that countries have been promised under the HIPC Initiative. First is the figure for the nominal value of debt relief (including that provided through traditional mechanisms like the Paris Club as well as the initiative itself), and then its net present value. The next column divides the NPV of debt relief by the NPV of debt to calculate the percentage of the debt burden that is being relieved, which varies from 17 percent in Honduras to 72 percent in Mozambique. The penultimate column shows the estimated post-HIPC Initiative debt service ratio, which is everywhere brought down to less than 15 percent and is often substantially less.[18] The final column shows the estimated post-HIPC Initiative percentage of GNP that will be spent on servicing foreign debt, which varies rather substantially from a low of 0.6 percent in Rwanda to a high of 5.3 percent in Guyana.

17. A level that we subsequently argue would be reasonable as well.

18. The estimates come from World Bank and IMF (2001a).

Critiques of the Enhanced HIPC Initiative

If the IMF and World Bank hoped that the enhanced HIPC Initiative would evoke a chorus of praise from Jubilee for their response to its calls for debt relief, they must have been sadly disappointed. Within months of announcing to the world that they had slightly overachieved their target of having half the HIPCs reach decision points by the end of 2000, a flood of papers with titles like *Rethinking HIPC Debt Sustainability* (Eurodad 2001), *Still Waiting for the Jubilee* (Roodman 2001), *Debt Relief: Still Failing the Poor* (Oxfam 2001), *Reality Check: The Need for Deeper Debt Cancellation and the Fight Against HIV/AIDS* (Drop the Debt 2001) and *HIPC—Flogging a Dead Process* (Pettifor, Thomas, and Telatin 2001) were rolling off the press.

The many critiques of the current debt relief initiative can be put into two broad categories. These represent two different perspectives on the underlying causes of the failure of development assistance programs in the poorest countries. The first is perhaps more prevalent among Group A and the second among Group B, but it is possible to see some validity in both (as we do).

The ''foreign aid down the rathole'' argument goes as follows.[19] Debt relief and other forms of aid have been too great and too easy to get. Recipient governments are often wasteful and corrupt. Even in the best cases of reasonably adequate governance, aid and debt relief simply relieve countries' immediate budget constraint, allowing them to persist with bad economic policies. The solution is tough conditionality on good macroeconomic policy and on good governance, and if conditionality does not work, a high level of *selectivity*, rewarding countries with debt relief and new aid only when they have demonstrated adequate performance in economic management and governance.

The official donors and creditors share some blame for providing too many loans (and grants), driven by a combination of political and commercial motives (bilateral donors) and bureaucratic incentives combined with overeager professionalism and lack of accountability (IMF and World Bank staffs). They need to become more disciplined and selective in providing debt relief and in making loans and grants.

The second is the ''poverty trap'' argument.[20] Under this argument, debt reduction is too small and tied to conditionality that is onerous and misguided. Given poor countries' often troubled colonial and postcolonial histories, ethnic fragmentation, high burdens of tropical disease, depen-

19. This argument is represented by Easterly (1999), by Thomas (2001), and in some measure by Burnside and Dollar (2000).

20. This argument is represented by Sachs et al. (1999), Pettifor, Thomas, and Telatin (2001), and Oxfam (2001).

dence on primary commodities with declining and unstable prices, and often small size, debt relief and other forms of aid have been far from adequate to allow them to escape poverty and put them onto a growth path.[21] The problem is not too much but too little aid, and way too much existing debt. Of course there has been some waste, but incompetent and corrupt government is an outcome as much as a cause of poverty and underdevelopment. Moreover, the structural adjustment and other economic policies pushed by official creditors have been inappropriate for such countries, making matters worse rather than better, and rewarding the elites while burdening the poor.

From this perspective, much more of the blame goes to creditors and donors. Too much of the lending was wasteful and *inefficient*, sustaining donors' own bureaucracies and financing purchases of their goods and the use of their high-cost consultants. Worst of all, much was politically motivated, incurred in dubious situations that call its legitimacy into question. Loans were made to rulers more concerned to increase their personal or family wealth than to promote any concept of the social good. Loans were made to purchase armaments for which there was no pressing national need; indeed, these arms were sometimes used to suppress the population. Lending financed theft and capital flight by the elite and the corruption associated with building white elephants rather than capital assets that were of value to the population of the borrowing countries. Should countries be expected to service such debt? Does elementary justice not demand that it be canceled?

Some who focus on this perspective go on to argue that well-financed international creditors such as the IMF and World Bank should take their losses and write off the bad loans.[22] To impose more future accountability on official creditors, there should be an independent bankruptcy procedure—where the creditors are not the arbiters of losses for which they are partly responsible, as is now the case.[23] The government donors, especially the stingier United States, should be much more generous, with *additional* contributions to finance the debt write-off as well as new aid. Debt relief and new aid should be linked to programs that ensure that the poor have voice and power in the way government allocates new resources, and indeed all its resources. The solutions, in other words, are

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21. Birdsall and Hamoudi (2002) identify a group of 34 ''most commodity dependent'' countries (out of a set of 137 countries, using data from Statistics Canada's World Trade Analyzer). Of these, 21 are HIPCs. Further, of the current HIPCs, those less dependent on commodities have performed better and reached the decision point faster (10 of the 12 HIPCs yet to reach the decision point are in Birdsall and Hamoudi's ''most commodity dependent'' category).

22. This is a central argument of Roodman (2001).

23. This is the position taken by Pettifor, Thomas, and Telatin (2001) and Raffer (2001).

more creditor accountability, more donor generosity, and more emphasis on participation by the poor and civil society groups.

We ourselves partly agree with both points of view. We would combine their perspectives, summarizing the failure of past assistance programs manifest in the HIPCs' unsustainable debt in three broad categories (our proposals below for additional relief and a new aid architecture respond to this assessment):

- First, and probably most important in the short run, is a characteristic of many HIPCs associated with the poverty trap argument: their vulnerability to adverse, largely unpredictable shocks. Commodity price shocks leading to deteriorations in the terms of trade are the quintessential case in point, but hurricanes and other climatic disasters, and civil conflicts sometimes imported from neighboring countries, have also afflicted them.
- Second, and probably most important in the long run, are the failures of leadership associated with the view that much foreign aid goes down the rathole. These sometimes contributed to civil conflict; they sometimes took the form of bad governance (from straight looting by the leadership to a failure to stand up to vested interests on behalf of the common good); and they sometimes involved misguided policy choices, from a resort to inflationary finance to the neglect of the social sectors.
- Third is bad lender behavior and the sometimes well-intentioned missteps of donors that both sets of critics point out: pushing exports embodying inappropriate technology by the offer of export credits, and pushing loans to satisfy lending targets even when recipient government programs were not credible and the projects to be financed were of dubious value.

Of course, all these factors interact. A well-governed country suffering repeated adverse shocks will seek to diversify its economy, but that does not happen where governance is weak. And a well-governed country will resist the lure of export credits unless the goods being offered are really needed, but that is a secondary consideration in a country where the decision makers are motivated by the chance of getting a cut of the proceeds. In these circumstances, debt escalates but the ability to service it does not.

No one is particularly satisfied with the changes introduced through the 1999 enhanced HIPC Initiative. For the first set of critics worried about a foreign aid rathole, the enhanced initiative retains some traditional conditionality. The IMF must still give the nod that macroeconomic policies are adequate for a country to reach the first step in the process, the decision point. But the changes do not address the deeper concern about

poor governance and overeager donors. They reflect increased political pressure to deepen and speed debt relief, and may actually make it easier for debtor countries to continue wasting resources and for donors to avoid the tough decisions more discipline would entail.

The changes respond more directly to the second set of critics calling for more debt relief and more aid to help countries escape poverty traps. The enhanced HIPC Initiative is bigger (more costly for donors) and faster—countries can reach the completion point within months instead of as long as 9 years. It also embodies an important change in the philosophy of conditionality by requiring demonstrated participation by the population in formulating the program to reduce poverty before debt-stock reduction is finalized. But for the second set of critics, the changes are still too small, too onerous for debtor countries, and leave too much control in the hands of official creditors, who bear considerable responsibility for creating the problem in the first place.

On the amount of debt relief, the second set of critics has raised three technical issues, which we now explore. The first issue is that the key criterion for identifying the countries that are eligible for debt relief, and which in most cases determines the extent of relief to which they are entitled, is inappropriate (Eurodad 2001, 2000). As was explained above, that key criterion is the ratio of the NPV of the stock of debt to exports. The criticism is that this is not really germane to whether a debtor country can afford to divert resources away from key social expenditures to service outstanding debt. Limiting such diversions was proclaimed to be an underlying purpose of the HIPC Initiative: that is reflected in the conditionality attached to the initiative, which is designed to ensure that the freed resources are indeed used for social programs and for other investments most likely to reduce poverty.

It is quite possible for a country with a high export-GNP ratio to simultaneously have a moderate debt-export ratio and a high percentage of its tax revenue preempted for debt service, thus threatening its ability to provide adequate social services to its population. The enhanced HIPC Initiative acknowledged that this could create a problem, and provided that a country with a high export-GNP ratio could qualify for debt relief under an alternative criterion. If its tax revenue was at least 15 percent of GNP (a requirement intended to avoid countries getting debt relief without making a serious effort to address their own problems), then its debt stock could be reduced to 250 percent of fiscal revenue. Thus the enhanced initiative acknowledged the problem, but the solution it chose left countries with sharply differing burdens of debt service relative to GNP, as inspection of the final column of table 2.4 (for the countries to have reached decision points) reveals.

The European Network on Debt and Development (Eurodad) argues that the logical approach would be to calculate the maximum affordable

level of debt service and use that to calculate what percentage of the debt stock needs to be canceled, rather than decide to cancel a part of the stock of debt based on a comparison with exports. Those who subscribe to this line of thought are prone to make comparisons showing that spending on debt service exceeds that on health in some HIPCs (Drop the Debt 2001; Pettifor, Thomas, and Telatin 2001).

Eurodad also argues that debt reduction should be tailored to the circumstances of each individual HIPC. They suggest a formula that takes government revenue (including grants) and compares it to a minimal level of essential expenditure, consisting of country-specific estimates of the social expenditure necessary to achieve targets for health, AIDS, education, water supply, and sanitation (Eurodad 2000). (Somewhat quixotically, spending on things like security and parliaments is labeled ''inessential'' and assumed to come out of the pool also legitimately available for debt service.) They propose that 30 percent of the excess of revenue after providing for this basic level of essential public expenditure on the social sectors should be devoted to debt service. In the case of 10 countries, there would be no excess at all, which leads Eurodad to advocate 100 percent debt cancellation in those cases. Other countries would have their debt reduced to the extent needed to cut debt service to an ''affordable'' level. Where even that did not suffice to finance the minimal package of social expenditures, Eurodad advocates additional grants.

Debt campaigners contend that the likely reason donors have not adopted that approach is that it would raise the cost above what is politically acceptable. They believe that the scope of the HIPC Initiative and thus the guidelines used to define the initiative (e.g., the debt-export ratio vs. the development needs of the poorest countries) have been constrained by the political limits to the creditors' willingness to pay. And indeed, even the enhanced initiative is not fully financed, in the sense that the HIPC Trust Fund will require additional donor contributions if the multilateral development banks are to continue to be reimbursed for the cost of the HIPC Initiative after 2005. Some debt campaigners (Drop the Debt 2001; Oxfam 2001) and Roodman (2001) oppose the attempt to insulate multilateral development banks in the first place. They argue that the World Bank and IMF could afford to cancel all the debts owed to them by the HIPCs without threatening their financial integrity. Drop the Debt (2001) retained an accounting firm (Chantrey Vellacott) to investigate whether the World Bank's triple-A credit rating would be threatened if it drew on its capital to cancel HIPC debt; it concluded that the rating would be safe.

Moreover, a related argument is that forgiving unpayable debts is simply accepting reality, not doing debtors a favor (Roodman 2001). Cohen (2000) has used a model estimated on data from the Latin American debtor countries to infer what the market value of HIPC debt would have

been in the absence of a willingness by the donors to extend new finance to enable debt service to be paid. He concludes that on average a reduction of the debt-export ratio from 250 to 150 percent was worth only about a tenth of the nominal write-down. That implies that about 90 percent of the debt reduction ought to be counted as a loss (bad debt), and only the remaining 10 percent as ODA.[24] Other comparisons suggest a figure in the same ballpark. For example, in the 1980s the commercial bank debt of Bolivia (now a HIPC) was quoted at under 10 cents on the dollar before the Brady Plan. And the US government, which is mandated by Congress to estimate the present value of its loan portfolio and expense reductions in value as they occur, applies a 92 percent discount to its HIPC debt (GAO 2000).

These calculations imply that deeper debt relief, to the point where it accepts the reality of what the debt is really worth, would not actually cost donors much. (It is true that at last count about 85 percent of the debt service due was still being paid, but the reconciliation between these figures is to be found in the tendency we have already noted for donors to direct new disbursements to countries that would otherwise encounter difficulty in servicing their debt. Defensive lending can be considered a form of de facto debt reduction.)

The second issue is that, even if the debt-export ratio were to be accepted as the appropriate criterion for calculating the extent of debt relief, the 150 percent benchmark is dubious. Pettifor, Thomas, and Telatin (2001) argue that this figure is essentially arbitrary, being based on no more than a rule of thumb. Eurodad (2001) concedes that the rule of thumb is based on a certain empirical regularity: the finding that defaults become much more common when debt-export ratios exceed something like 200 percent. But, it argues, that empirical regularity is based on the experience of a different group of countries, most of which were much richer than the HIPCs, and therefore found it less difficult to mobilize the resources needed to service debt.

The third issue relates to the debt sustainability analyses that the World Bank-IMF team has been conducting to decide whether HIPC debt relief is enough to make the countries' debt burdens sustainable (Eurodad 2001; Pettifor, Thomas, and Telatin 2001; Culpeper and Serieux 2001). These are projection exercises, designed to test whether the proposed debt reductions are large enough to enable countries to keep their debt-export ratios below 150 percent in the longer term (interpreted as out to the year 2017).

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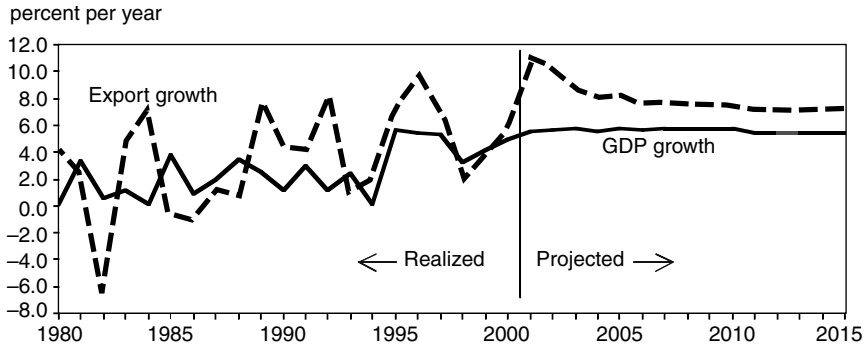
24. Most of the debt campaigners' literature does not recognize this discrepancy. Cohen's analysis also illustrates the fact that a write-down increases the value of the remaining debt. E.g., were they provided the opportunity in a commercial market to reduce their total debt stock from 150 to 100 percent of exports by buying it back themselves, the estimated discount (based on the Latin American data) would be 70 percent rather than 90 percent.

Figure 2.6 Realized and projected annual growth rates, 1980-2015



Note: HIPC growth rates are calculated as simple averages of World Bank DSA data.

Source: World Bank, *Global Development Finance* CD-ROM, 2001, and HIPC Debt Sustainability Analysis (DSA) documents.

To undertake such projections, it is of course necessary to project a path for exports (as well as new borrowing). The forecast is that on average the growth of exports in nominal terms of the 22 HIPCs that had already reached decision point in early 2001 will accelerate from 4.6 percent a year in the 1990s to 8.6 percent a year during the present decade (World Bank and IMF 2001a, table 7). A major reason for this improvement is that their terms of trade are forecast to improve at 0.5 percent a year, instead of deteriorating at 0.7 percent a year as they have in the past decade. The main criticism is that these export projections are too optimistic; though some recovery in their terms of trade is not impossible, the secular tendency for more than a century has been for some deterioration. Figure 2.6 displays just how much better the projected performance is than the historical performance has been.

Not only are the central forecasts asserted to be on the optimistic side, but critics note that these countries have historically been subjected to severe shocks, for which the analysis makes no allowance (Pettifor, Thomas, and Telatin 2001; Oxfam 2001; Culpeper and Serieux 2001). This again is illustrated in figure 2.6. There is no question but that the assertion is correct, but of course it is difficult to build shocks into projection models, because shocks are by definition unforecastable.

Clearly, it is important that *policy* should allow for the likelihood that countries will periodically be subjected to shocks, even if shocks cannot sensibly be incorporated into a projection model. Indeed, the World Bank and IMF could counter that a purpose of reducing the debt-export benchmark from 200 to 150 percent was precisely so that likely shocks would not push countries straight back into unsustainable territory above 200 percent. They also announced in August 2001 a procedure whereby a new debt sustainability analysis would be conducted at the completion

point (World Bank and IMF 2001b). Any country that was established to have suffered a severe exogenous deterioration in its circumstances after decision point that threatened to jeopardize its debt sustainability might be entitled to additional relief at completion point, beyond what was promised at decision point.

Oxfam (2001) criticizes the projections of economic growth, rather than of export growth, as also being implausibly optimistic (again, see figure 2.6). In particular, it argues that the forecasts of growth for the African countries have failed to factor in the devastating effects of the HIV/AIDS epidemic on future growth. This might not affect the debt-export ratio, but it would matter in two other key ways. First, it would imply a lower rise—or no rise at all—in living standards over time. Second, it undermines the plausibility of the benign scenarios of a declining level of debt service as a share of government revenue that were presented in World Bank and IMF (2001a, table 7).

We said that this chapter would provide background about, and present the principal critiques of, the current HIPC Initiative. We have summarized our assessment of how the HIPC debt problem occurred in the first place, and we have described the many issues raised by various critics of the initiative as fairly as we can. We turn now to offering our own judgment on which of these critiques makes sense and on what sorts of actions should be adopted in response.