EBD/08/89
Correction 1

December 23, 2008

To: Members of the Executive Board

From: The Secretary

Subject: **Heavily Indebted Poor Countries (HIPC) Initiative and Multilateral Debt Relief Initiative (MDRI)—Status of Implementation**

The attached corrections to EBD/08/89 (8/28/08) have been provided by the staff:

Factual Errors Not Affecting the Presentation of Staff's Analysis or Views

Page 16, para. 10, line 6: for "an additional US$17.8 billion"
read "an additional US$17.9 billion"

Page 19, Figure 2: IMF number increases from US$4.0 billion to US$4.1 billion after MDRI.

Page 20, Table 3 (in the main text): the 1st, 3rd, 11th, and 13th rows have been modified in the last column, to reflect the increase of the NPV of debt to post-completion point countries from US$3.3 billion to US$3.5 billion.

Page 37, para. 44, line 3: for "Most of this reduction (76 percent)"
read "Most of this reduction (77 percent)"
Figure 5: Chart shows that debt after MDRI is lower for post-completion point countries than in the previous version.

Questions may be referred to Mr. Joly (ext. 34674), Mr. Perone (ext. 38760), and Ms. Unigovskaya (ext. 35641) in SPR.

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Att: (4)

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Box 1. Debt Relief, Poverty-Reducing Expenditures (PRE), and Revenue Mobilization

Debt relief could contribute to higher PRE in two ways. First, debt relief creates fiscal space that may be used for PRE. Second, a reduction in the debt stock eases the government's intertemporal budget constraint, and may facilitate borrowing to raise PRE. The first effect would be limited if debt relief is provided in the form of arrears clearance, which would not reduce debt service due. The latter channel may not work in countries which are still credit constrained, like HIPCs in the interim period.

Empirical research on the effect of debt relief on PRE has been sparse, mainly due to difficulties in obtaining consistent data across countries.[1/] Usually PRE include expenditures on health and education, but also in some countries capital expenditures on infrastructure, land irrigation, etc. The results of recent studies have been mixed:

- Chauvin and Kraay (2005) focused on the effects of debt relief on expenditures on health and education and did not find any significant effect. However, partly due to difficulties in obtaining debt service relief data, this study only looked at the effect of the reduction in debt stocks.
- Thomas (2006) attempted to take into account a number of factors that may affect social expenditure (defined as expenditure on health and education), in addition to debt relief. Among those factors are foreign aid, output per capita, urbanization, and a target variable—the literacy rate. The study includes both LICs and MICs (110 countries) over 1985-2004. The results suggest that a decline in debt-service costs helps raise health and education expenditures significantly in LICs (a 1 percent decline in debt service increases these expenditures by 0.35 percent of output in the long run).
- Cassimon and Van Campenhout (2006), using vector autoregressive techniques, found a positive effect of debt relief on overall investment spending, rather than PRE, in African HIPCs.

A related issue concerns the effect of aid, including in the form of debt relief, on incentives to collect revenue. Some argue that aid, especially in the form of fungible grants, could reduce the incentive to collect more revenue, particularly when it entails politically difficult decisions.[2/] If true, the impact of debt relief on freeing up financial resources for PRE could be diminished. The counterargument, however, is that debt relief allows revenue efforts to be used on domestic programs, rather than for the service of external debt; in this sense, revenue efforts have more direct benefits for the population and are easier to justify and undertake.

- In a survey of earlier studies, Gupta, Powell, and Yang (2006) found that the empirical evidence on how aid flows affect domestic revenue collection is mixed, with the magnitude, sign, and significance of the impact of aid varying by study. With a few notable exceptions, however, the impact of aid is found to be either negative or insignificant.
- Two recent studies on HIPCs do not find evidence of adverse effect of debt relief on revenue efforts. Cassimon and Van Campenhout (2006) found a significant positive response of tax revenue to debt relief. Kpodar and Unigovskaya (forthcoming) compare the revenue effort of HIPCs to that of other LICs (a sample of other PRGF-eligible countries is used as a control group) using panel data analysis. They find no evidence of an adverse effect. The result of both studies, however, should be treated with caution due to data limitations.

[1/] See: Chauvin and Kraay, "What Has 100 Billion Dollars Worth of Debt Relief Done for Low-Income Countries?" (September 2005). Available at SSRN: http://ssrn.com/abstract=818504; and Thomas, "Do Debt-Service Savings and Grants Boost Social Expenditures?", IMF Working Paper No. 2006/180. Available at: http://www.imf.org/external/pubs/cat/longres.cfm?sk=19272.0.

[2/] See: Cassimon and Van Campenhout, "Aid Effectiveness, Debt Relief and Public Finance Response. Evidence from a Panel of HIPCs", WIDER Research Paper No. 2007/59, Helsinki: UNU-WIDER; Kpodar and Unigovskaya, "Does debt Relief Under the HIPC Initiative Undermine Domestic Revenue Mobilization Effort?", IMF Working Paper, (forthcoming); and Gupta, Powell, and Yang "Macroeconomic Challenges of Scaling Up Aid to Africa", IMF, 2006.

C. Conclusions

10. **The Bank and the Fund, together with the international community, have taken substantial steps to meet the Monterrey Consensus commitments on debt relief, and as a result debt burdens have been reduced markedly for many HIPCs**. Progress was made on each of the recommendations. Together, the Bank and the Fund have already committed debt relief amounting to US$16.3 billion (in end-2007 NPV terms) to the 33 post-decision-point countries under the HIPC Initiative and an additional ~~US$17.8~~ US$17.9 billion has been delivered to the 23 post-completion-point countries under the MDRI.

11. **Completing the implementation of the HIPC Initiative will require sustained efforts from the international community—creditor and pre-completion-point countries**. Despite the achievements described above, a number of challenges remain to be addressed for a full implementation of the Initiative, such as: (i) full financing of the HIPC initiative and MDRI; (ii) full participation of official and commercial creditors to the Initiative; and (iii) support to the remaining countries to reach completion point.

12. **Debt relief, while welcome, addresses only a relatively small part of HIPCs' financing needs and cannot ensure debt sustainability permanently**. Debt relief savings accrue through time and generally constitute only a fraction of net aid inflows to HIPCs.[13] Addressing HIPCs', and more generally LICs', development needs therefore requires higher new aid flows in addition to debt relief. New flows also allow for a quick and targeted response to address any emerging issues, such as the recent surge in food and fuel prices.[14] These new flows need to be on appropriate terms to make sure that debt sustainability, which has been restored through debt relief, is maintained in the future.[15]

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[13] See Chapter 3 of the IMF-World Bank 2008 Global Monitoring Report.

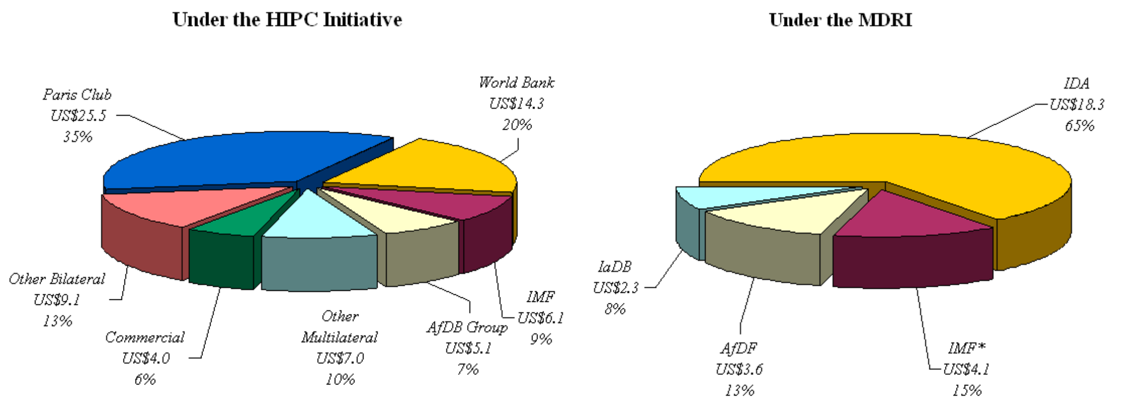
[14] Simulations suggest that the reserve position of eight pre-completion point countries may substantially deteriorate if commodity prices increase further. Most of these countries are also highly fiscally vulnerable (with a CPIA rating on the criteria for fiscal and debt management policies below 3), with limited capacity to help absorb these kinds of shocks. See "Food and Fuel Price—Recent Developments, Macroeconomic Impact and Policy Responses", IMF, June 2008. Simulations assume a 20 percent increase in oil and food prices compared to baseline projection of the Spring 2008 WEO and do not assume policy or behavioral responses to the increase in prices. For this analysis on HIPCs, a reserve deterioration is considered as "substantial" if reserves coverage drops to less than 3 months of next year's imports of goods and services as a consequence of the increase in food or oil prices or a combined shock.

[15] The IMF and the World Bank stand ready to provide policy advice and balance of payment and budget support to the affected countries. The IMF provides financing through augmentations of PRGF arrangements. The Exogenous Shocks Facility is also being streamlined to ease access. The World Bank has launched the Global Food Crisis Response Program in May 2008 targeted at vulnerable IDA countries with priority to the most fragile states. To June 2008, seven HIPCs, including two pre-completion point countries have benefited from augmentations of PRGF arrangements. As of end of July 2008, the World Bank has already approved US$64 million in grants to six countries, including three pre-completion point HIPCs. The Bank and the Fund

(continued)

15. **Multilateral and Paris Club creditors shoulder most of the total HIPC Initiative cost** (46 percent and 36 percent respectively; Figure 2). Among multilateral creditors, the heaviest burdens are borne by IDA (20 percent), the IMF (9 percent) and the AfDB Group (7 percent). The share of total cost borne by multilateral creditors is higher for post-completion-point countries (at 54 percent) than for interim countries (43 percent) or pre-decision-point countries (33 percent). The share of Paris Club creditors is about one third for post-completion-point and pre-decision-point countries, but much higher (44 percent) for interim countries.

Figure 2. Distribution of Potential Costs under the HIPC Initiative and MDRI by Creditor



Sources: HIPCs decision and completion point documents.
Note: * Excludes non-HIPCs.

16. **With respect to MDRI, the total cost to the four participating creditors is estimated at US$28 billion in end-2007 NPV terms** (Table 3)**.** About two thirds has already been delivered to the 23 post-completion-point countries. Two thirds of the total estimated MDRI cost will be borne by IDA, with the share of the IMF, AfDF and IaDB amounting to 14, 13, and 8 percent, respectively.

Table 3. MDRI Costs by Creditor and Country Group
(In billions of U.S. dollars and in end-2007 NPV terms)

	Assistance in Nominal Terms 2/			Assistance in end-2007 NPV Terms
	Principal	**Foregone Interest**	**Total**	**Principal and Foregone Interest**
Post-Completion-Point HIPCs 1/	**38.9**	**4.4**	**43.3**	**22.7**
IDA	26.9	2.7	29.6	14.5
IMF 3/	3.2	…	3.2	3.5
AfDF	5.9	0.8	6.7	2.8
IaDB	3.0	0.9	3.9	2.0
Interim and Pre-Decision-Point HIPCs 2/	**10.0**	**0.9**	**10.9**	**5.6**
IDA	7.2	0.6	7.8	3.8
IMF 3/	0.8	…	0.8	0.7
AfDF	1.5	0.2	1.7	0.8
IaDB	0.4	0.1	0.5	0.3
All HIPCs	**48.9**	**5.3**	**54.2**	**28.3**
IDA	34.1	3.3	37.4	18.3
IMF 3/	4.0	…	4.0	4.1
AfDF	7.4	1.0	8.4	3.6
IaDB	3.4	1.0	4.4	2.3
Non-HIPCs 4/	**0.2**	**0.2**	**0.2**	**0.2**

Sources: Country authorities, and World Bank, IMF, AfDB and IaDB staff estimates.

1/ These countries have qualified for MDRI relief. Figures are based on actual disbursements and commitments.

2/ Estimates are preliminary and subject to a number of assumptions, including the timing of HIPC decision and completion points, and, where applicable, of arrears clearance.

3/ The estimated costs for IMF reflect the stock of debt eligible for MDRI relief, which is the debt outstanding (principal only) as of end-2004 and that has not been repaid by the member and is not covered by HIPC assistance (EBS/05/158 Revision 1, 12/15/2005).
4/ IMF MDRI assistance to Cambodia and Tajikistan.

IV. Remaining Challenges

17. Completing the implementation of the HIPC Initiative will entail addressing three main challenges: (i) taking the remaining 18 pre-completion-point countries to the completion point; (ii) ensuring full participation of all creditors; and (iii) mobilizing additional resources to finance debt relief to all remaining HIPCs.

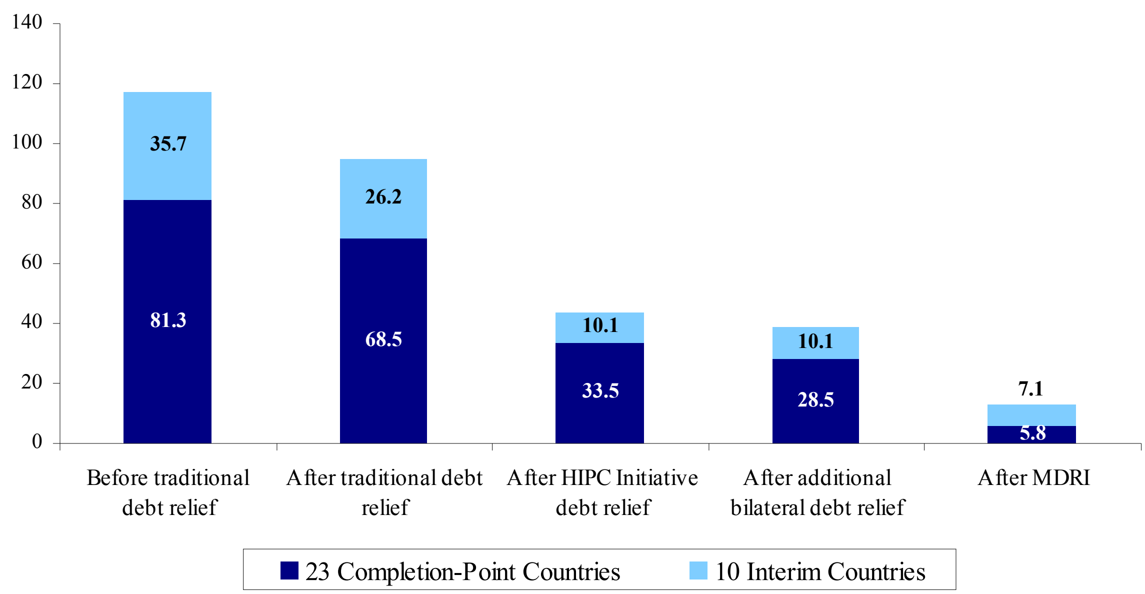
V. Debt Outlook in Post-Completion-Point Countries

A. Overview

44. **Debt relief provided to post-completion-point countries is expected to reduce their external debt stock by more than 90 percent in end-2007 NPV terms** (Figure 5). Most of this reduction (~~76~~ 77 percent) would be delivered in the context of the HIPC Initiative and the MDRI. The remainder is attributable to traditional debt relief and voluntary bilateral debt relief beyond HIPC. Debt stocks in the 10 interim period countries are expected to decline by a similar factor.

Figure 5. Post-Decision Point HIPCs' Debt Stock under Different Debt Relief Stages

(In billions of U.S. dollars, in end-2007 NPV terms)



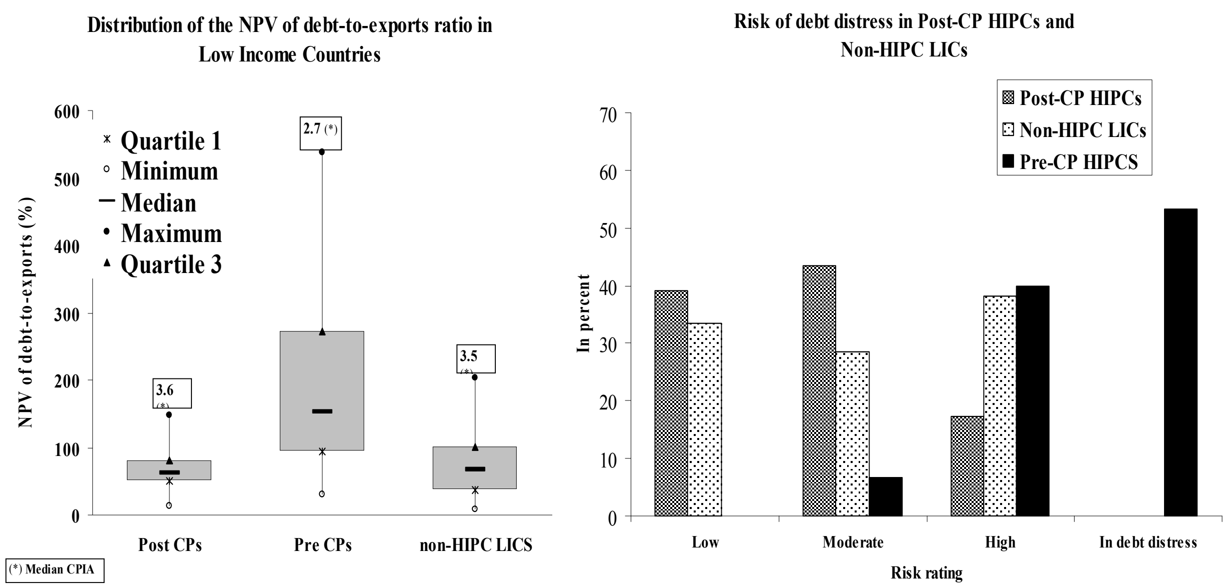
Sources: HIPC Initiative country documents, and IDA and IMF staff estimates.
Note: Estimates based on decision point debt stocks.

45. **Debt sustainability analyses (DSAs) performed under the Debt Sustainability Framework (DSF) provide a comprehensive view of the debt outlook of post-completion-point countries**. Their forward-looking nature allows for a nuanced assessment of risks that goes beyond the consideration of current debt ratios. The remainder of this section analyzes the information contained in DSAs conducted so far on these countries.

46. **DSAs confirm that post-completion-point countries are in a better debt situation than other HIPCs, and also than non-HIPCs.** At end-2007, the NPV of the debt-to-export ratio for post-completion-point HIPCs averaged 63 percent. This contrasts with an average of

200 percent for pre-completion-point HIPCs.[42] Reflecting their heavier debt burden, all but one pre-completion-point HIPC have been assessed either to be in debt distress or to have a high risk of debt distress, while most post-completion-point countries have a low or moderate risk rating (Figure 6). The distribution of risk ratings is also better for post-completion-point countries than for non-HIPC LICs. The better rating distribution reflects both lower debt ratios—a direct outcome of debt relief—and the fact that post-completion-point countries tend to have, on average, better policies and institutions than other HIPCs and, to a lesser extent, non-HIPCs, as measured by the CPIA rating. Better policies and institutions lead to a higher capacity to carry debt and translates, in the DSF, in higher indicative thresholds.

Figure 6. Dispersion of the NPV of Debt-to-Exports Ratio and Risk of Debt Distress in Low Income Countries



Sources: Latest joint Bank/Fund DSAs available for LICs.
Note: Based on the actual/projected NPV of debt-to-exports ratio under the baseline scenario.

47. **However, long-term debt sustainability remains a challenge in many post-completion-point countries.** Despite the significant decline of debt burdens thanks to debt relief, only nine post-completion-point HIPCs (or about 40 percent) have a low risk of debt distress according to the most recent DSAs. In addition, the distribution of ratings has deteriorated since last year (Figure 7), with the number of countries with a high risk rating increasing from one to four. A new DSA for Rwanda confirmed the high risk rating of the previous DSA. New DSAs for Burkina Faso and São Tomé and Principe changed these

[42] For HIPCs in the interim period, debt ratios incorporate only the impact of interim debt relief.