

Debt relief and sustainability¹

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I. Introduction

At the Millennium Summit in 2000, Heads of State and Government undertook “to implement the enhanced programme of debt relief for the heavily indebted poor countries without further delay and to agree to cancel all official bilateral debts of those countries in return for their making demonstrable commitments to poverty reduction” and expressed their determination “to deal comprehensively and effectively with the debt problems of low- and middle-income developing countries, through various national and international measures designed to make their debt sustainable in the long term”.² This commitment, and the corresponding target 8.D of the Millennium Development Goals (“Deal comprehensively with the debt problems of developing countries”), was addressed by the open-ended Intergovernmental Working Group on the Right to Development, which recognized “that an unsustainable debt burden is a major obstacle for developing countries in achieving the Millennium Development Goals and in making progress in the realization of the right to development” and was a component of the mandate of its expert mechanism,

the high-level task force on the implementation of the right to development. It is also noteworthy that the Working Group welcomed and encouraged “efforts by donor countries and the international financial institutions to consider additional ways, including appropriate debt swap measures, to promote debt sustainability for both [heavily indebted poor countries (HIPCs)] and non-HIPCs” (E/CN.4/2005/25, para. 54 (a)). Given the importance from the perspective of the right to development of the HIPC Initiative and other forms of debt relief, it is useful to examine the history of debt relief and the range of measures implemented to deal with the issue in the spirit of these policy positions.

The machinery for sovereign debt workouts has been evolving since the United Nations Monetary and Financial Conference, held at Bretton Woods, New Hampshire in 1944. Over the past half-century, 85 developing countries, including 52 low-income countries, have been unable to service their external debt and requested debt relief from their creditors. This chapter provides a retrospective on how debt relief has been granted to low-income countries since Bretton Woods.³ It traces the evolution of debt relief from short-term debt-restructuring operations to outright debt forgiveness, describes the range of debt-relief

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¹ This chapter is adapted from Boris Gamarra, Malvina Pollock and Carlos A. Primo Braga, “Debt relief to low-income countries: a retrospective”, and from the introduction by Carlos A. Primo Braga and Dörte Dömeland to the book they edited entitled *Debt Relief and Beyond: Lessons Learned and Challenges Ahead* (Washington, D.C., World Bank, 2009).

² General Assembly resolution 55/2, paras. 15-16.

³ Debt relief covered in this chapter includes rescheduling of principal and interest payments by Paris Club creditors; forgiveness of official development assistance (ODA) loans by bilateral creditors; debt restructuring and debt forgiveness by non-Paris Club creditors; reduction of commercial debt, including through the International Development Association (IDA) Debt Reduction Facility; special programmes to help debtors meet obligations to multilateral creditors, including the World Bank’s Fifth Dimension programme and the rights accumulation programme of the International Monetary Fund (IMF); debt swaps; the HIPC Initiative; and the Multilateral Debt Relief Initiative (MDRI).

measures adopted by creditors and analyses the extent to which debt relief has alleviated the debt burden of low-income countries.

II. Debt relief: a brief history

During the first 25 years after the Second World War, few countries requested debt relief. By the end of the 1970s, however, serious balance of payments problems and high levels of external debt caused many countries to do so. Since the late 1970s, creditor countries have repeatedly modified debt-relief efforts, making them increasingly generous.

A. Debt relief before 1972

In the years after 1945, most lending to developing countries was provided through new programmes of official development assistance or in the form of insured private credit to support export-related lending. Before the quadrupling of oil prices in 1973, requests for debt relief from developing countries were limited: from the time the World Bank opened its doors in 1946 until 1972, only nine countries (Argentina, Brazil, Chile, Ghana, India, Indonesia, Pakistan, Peru and Turkey) sought relief on their external obligations. Their experiences are instructive, because many of the principles and procedures that still govern debt restructuring were formulated at that time.

Creditors' initial motivation in helping debtor countries over periods of payment difficulties was to increase the likelihood of collecting on the claims they held. That was accompanied by a desire to treat all creditors equally and to see debtor countries make the maximum effort to redress their economic problems. Creditors quickly determined that those objectives could best be met by restructuring their claims on sovereign Governments in a concerted framework. The Paris Club has provided such a framework since the mid-1950s.⁴

Not all of the negotiations for the nine countries took place within the Paris Club forum: restructuring

with Turkey (1955-1970) was conducted under the auspices of the Organisation for Economic Co-operation and Development (OECD)⁵ and debt relief for India (1968-1976) and Pakistan (following the separation of Bangladesh in 1971) was arranged through aid consortium meetings organized and chaired by the World Bank. Since 1971, no debt relief has been arranged through aid consortia. Still, in all cases the negotiations followed the format developed in the Paris Club, in both the nature of the agreement and the rescheduling terms granted.

The debt relief granted was aimed at helping the debtor country avoid "imminent default".⁶ A common guiding principle was that the period of debt relief should be short. One year was the typical consolidation period granted. During this period, creditors could reassess the debtor country's need for further relief; its economic performance, which was subsequently linked to its ability to maintain eligibility for IMF upper-tranche resources; and the debtor country's success in renegotiating debts to other creditors on terms comparable to those extended by Paris Club creditors. The possibility of additional debt relief was often embodied in a goodwill clause—an implicit recognition that the initial debt-relief arrangements might prove inadequate.

For the first nine countries with which agreements were concluded, Paris Club creditors restructured \$6.9 billion of principal and interest in 35 separate agreements.⁷ From the perspective of this chapter, the agreements with Ghana and Indonesia are the most interesting because they were the first instances in which the importance of debt sustainability for low-income countries was addressed in the restructuring process.

Both countries approached their Paris Club creditors in 1966 for debt relief to help restructure their economies, following programmes of vast, unproductive public sector expenditures by recently overthrown Governments. In the first round of negotiations, creditors tried to impose the type of terms established with the Latin American countries to help overcome liquidity crises. In the face of the unsustainable levels of external debt accumulated by both countries, creditors were forced to modify their approach, in the end extending highly concessional terms.

⁴ In 1956, the Treasury of France hosted a group of creditor countries in Paris to renegotiate supplier and buyer credits to Argentina. The assembly, an informal group of official creditors dedicated to finding "coordinated and sustainable solutions to the payment difficulties experienced by debtor countries", came to be known as the Paris Club. It remains a voluntary group of creditor countries that makes decisions by consensus. Since its inception, it has helped 85 debtor countries restructure debt totalling \$513 billion (see www.clubdeparis.org). For analyses of Paris Club activities, see Lex Rieffel, *Restructuring Sovereign Debt: The Case for Ad Hoc Machinery* (Washington, D.C., Brookings Institution Press, 2003) and Enrique Cosío-Pascal, "The emerging of a multilateral forum for debt restructuring: the Paris Club", Discussion Papers No. 192 (UNCTAD/OSG/DP/2008/7) (November 2008).

⁵ See, for example, V. Lavy and H. Rapoport, "External debt and structural adjustment: recent experience in Turkey", *Middle Eastern Studies*, vol. 28, No. 2 (April 1992), pp. 313-332.

⁶ See, for example, Lex Rieffel, "The Paris Club, 1978-1983", *Columbia Journal of Transnational Law*, vol. 23 (1984).

⁷ See www.clubdeparis.org.

Under the agreement concluded with Indonesia in 1970, the entire stock of debt owed to Paris Club creditors was consolidated and paid over 30 years, interest free. There was no grace period, but the agreement had a “bisque” clause (the right to unilaterally suspend or defer payments) which allowed 50 per cent of payments during the first six years to be deferred, at an interest rate of 4 per cent, and repaid at the end of the 30-year term.

After prolonged negotiations, the outcome for Ghana was comparable. Under the agreement concluded in 1974, the entire stock of debt was consolidated and paid over 28 years, with 11 years of grace at an interest rate of 2.5 per cent.

B. Debt relief 1973-1986

The shock of the fourfold rise in petroleum prices at the end of 1973 and the simultaneous rise in the prices of primary commodities generated economic winners and losers in sub-Saharan Africa. But as commodity prices collapsed following a global recession in the mid-1970s and oil prices rose in 1979, many of those countries ran into serious balance of payments problems. Their problems were compounded by high levels of external debt, built up as the result of massive public sector spending during the commodity price boom.⁸

By the end of the 1970s, requests from African countries for debt relief from Paris Club creditors were pouring in. Countries leading the way included the Central African Republic, the Democratic Republic of the Congo, Liberia, Senegal, Sierra Leone, the Sudan, Togo and Uganda, all subsequently classified as HIPCs.

Paris Club creditors responded to this avalanche of requests by building on their earlier experiences with the middle-income countries of Latin America. The accepted wisdom of the day was that the low-income countries were confronting short-term liquidity crises and that rescheduling debt service would provide sufficient breathing space and debt relief to enable them to get back on an even keel and grow out of their debt problems.

The agreements with Ghana and Indonesia were set aside as “exceptional” and the lesson of the impor-

tance of debt sustainability in the restructuring process was lost. This proved to be a costly mistake for debtor countries and creditors alike.

The *modus operandi* adopted by creditors was to determine the minimum amount of relief to be granted to allow debtors to pay their remaining debt service without recourse to further debt relief. Emphasis was put on the need for adjustment by the debtor country. Paris Club agreements in the 1970s and much of the 1980s (as well as those concluded with commercial creditors under the auspices of the London Club, described below) were on non-concessional “classic” terms, with relatively short maturities of 8-10 years. Market-related interest rates were also retained. The creditors’ position was that the interest rate charged on rescheduled debt (the so-called moratorium interest) must be equal to the cost of borrowing for the export credit agencies that had extended or guaranteed the debt.

Despite these efforts, the nature of the debt problem in sub-Saharan Africa (which was magnified by political shocks, such as wars and social strife) and the persistent tendency of creditors to underestimate the amount of debt relief needed led to a continued build-up of debt stocks and repeated debt rescheduling. By the end of 1986, the Paris Club had restructured the debt of 22 sub-Saharan African countries in 55 agreements. Between 1973 and 1986, 14 African countries went to the Paris Club more than once, and nine went three times or more. The principle that debts, once rescheduled, were not to be rescheduled again proved unworkable. In almost half of the 55 agreements signed with African countries during this period, creditors were forced to restructure previously rescheduled claims.

C. Debt relief 1987-1996: a coordinated policy response

The turning point came in 1987, at a time when growth prospects for developing countries continued to be adversely affected by persistent weakness in commodity prices, modest growth in industrial countries and increasing protectionism. It became clear that for the poorest, most indebted countries in sub-Saharan Africa, faced with unsustainable debt burdens and inadequate external financing, something more radical had to be done. The focus of the debt restructuring efforts moved from cash flow considerations to an attempt to deal with the unsustainable build-up of debt stocks.⁹

⁸ For a detailed discussion of the reasons underlying the debt build-up in HIPCs, see Christina Daseking and Robert Powell, “From Toronto terms to the HIPC Initiative: a brief history of debt relief for low-income countries”, IMF Working Paper WP/99/142 (October 1999).

⁹ *Ibid.*

The Strategic Partnership with Africa (SPA) for low-income, debt-distressed countries in Africa was launched in September 1987 at the annual meeting of IMF and the World Bank.¹⁰ The programme was significant because it marked the international community's first coordinated framework to respond to the widespread debt and development crisis on the African continent. Geared towards the resumption of economic growth, SPA was essentially a commitment by donors to provide balance of payments support, including debt relief, to eligible African countries with credible and sustained economic reform programmes in place. Three criteria were established for eligibility for debt relief. Countries had to be low-income countries, defined as eligible for (concessional) loans from IDA, debt distressed defined as having a debt-service-to-export ratio of 30 per cent or more; and engaged in adjustment, defined as implementing a programme supported by IMF and IDA.

The SPA framework identified six channels through which donors' resources could be delivered. Four of them—IDA adjustment credits, the IMF Structural Adjustment Facility and the Enhanced Structural Adjustment Facility, bilateral and other multilateral adjustment financing, and debt relief by bilateral donors—involved adjustment financing. The other two were supplemental financing to offset debt service owed to the International Bank for Reconstruction and Development (IBRD) (known as the Fifth Dimension) and funding for commercial debt reduction through the IDA Debt Reduction Facility (known as the Sixth Dimension).

Between 1988 and 1996, 17 donors, including IDA and IMF, disbursed more than \$27.7 billion in adjustment support. These resources accounted for almost half of total concessional assistance to SPA-eligible countries over this period. Among the 31 countries eligible for SPA assistance, the United Republic of Tanzania (\$1.8 billion), Mozambique (\$1.6 billion) and Zambia (\$1.4 billion) received the most adjustment assistance. They were followed by Côte d'Ivoire, Ghana, Kenya, Senegal and Uganda, each of which received between \$800 million and \$1.1 billion. Over the same period, Paris Club creditors rescheduled or cancelled \$28.2 billion in claims on SPA countries.¹¹

D. From debt relief to debt reduction

The first tentative move towards incorporating an element of debt reduction (or forgiveness) of non-concessional debt by Paris Club creditors followed the summit meeting of the Group of Seven (G7) countries held in Venice, Italy, in June 1987. In their communiqué, leaders of the major industrial countries recommended that for low-income African countries undertaking adjustment efforts, "consideration should be given to the possibility of applying lower interest rates on their existing debt and agreement should be reached, especially in the Paris Club, on longer repayment and grace periods to ease the debt burden".¹² Following this communiqué, the Paris Club quickly declared Mauritania, Mozambique, Somalia and Uganda eligible for special treatment in view of their large debt-service obligations, poor balance of payments prospects and low per capita income. Agreements signed with these countries extended the repayment term for rescheduled non-concessional debt to 20 years, with a 10-year grace period.

A year later, at the economic summit in Toronto, Canada, in June 1988, G7 leaders went a step further.¹³ Consistent with the SPA framework, they agreed that the non-concessional, bilateral official debt and guaranteed commercial debt of low-income (defined as "IDA-only") African countries could be reduced by up to 33 per cent in net present value terms. A menu of restructuring options for creditors was introduced. Creditors could choose to deliver debt reduction through outright cancellation of their claims or by setting the interest rate on restructured claims at below-market rates. The repayment period for restructured claims was also greatly extended (to 23 years). In 1990, Toronto terms were extended to IDA-only countries outside Africa.

Between October 1988 and September 1990, Paris Club creditors restructured their claims on Toronto terms with 19 countries, including two outside sub-Saharan Africa (Bolivia and Guyana), in 26 agreements. These agreements consolidated \$5.8 billion in arrears and debt-service payments falling due and reduced the present value of the debt of the recipient countries by more than \$800 million. Seven African countries (Central African Republic, Madagascar, Mali, Niger, Senegal, Togo and United Republic of Tanzania) concluded more than one agreement on Toronto terms during this period. Although Toronto

¹⁰ From 1987 to 1997 the programme was called Special Programme of Assistance to Africa.

¹¹ For key results of an ex post evaluation of the Special Programme of Assistance for Africa, see <http://lnweb90.worldbank.org/oed/oeddoelib.nsf/DocUNIDViewForJavaSearch/B9308361A99ACB5F852568150051D59F>.

¹² See www.g8.utoronto.ca/summit/1987venice/communique/develop.html.

¹³ See, for example, www.g8.utoronto.ca/summit/1988toronto/communique.html#debt.

terms had some beneficial effect on the debt situation of recipient countries, it did not take long for the international community to recognize that most low-income countries were going to need more far-reaching concessions to achieve a sustained improvement in their external debt situation. Moreover, there was growing recognition that a change in approach was needed: experience had demonstrated that the long-standing practice of Paris Club creditors to restructure only debt service payments falling due during a limited consolidation period was simply setting the stage for a successive round of rescheduling agreements. For example, between 1976 and 1990, nine Paris Club agreements were concluded with the Democratic Republic of the Congo and with Senegal, and seven Paris Club agreements were concluded with Madagascar.

The starting point for discussions on more far-reaching debt relief for low-income countries was the Trinidad terms proposed by the United Kingdom of Great Britain and Northern Ireland in September 1990.¹⁴ In the spring of 1991, political expedience led Paris Club creditors to restructure the entire stock of debt of two middle-income countries (Egypt and Poland) on highly concessional terms. Both agreements reduced the net present value of all future debt-service payments by 50 per cent. Subsequently, some of the innovative features of these two agreements were incorporated into the menu of enhanced concessions for low-income countries (the “enhanced Toronto terms”) that the Paris Club creditors agreed to in December 1991.

The enhanced menu increased the reduction in non-concessional, bilateral official debt and guaranteed commercial debt to 50 per cent in net present value terms. It contained several innovative features. The most important was the two-step approach to debt restructuring, which combined the flexibility of the flow approach (that is, restructuring debt-service payments falling due in a defined consolidation period) with the possibility of a later stock-of-debt operation to allow the debtor country to “exit” the rescheduling process. Another innovation was the introduction of a graduated repayment schedule for debt service due on restructured claims, which rose by an annual rate of about 3 per cent in nominal terms. With exports projected to increase at a faster rate, the debt-service burden on restructured debt was expected to decline over time.

Once again, however, resolution of the debt problems of the poorest countries proved elusive. By the mid-1990s, it became clear that resolving the structural problems inherent in the debt problems of the most severely indebted countries would require even deeper concessions. Following the G7 summit in Naples, Italy, in July 1994, Paris Club creditors agreed that, where necessary, concessionality could be increased to 67 per cent on debt eligible for restructuring.¹⁵

The Naples terms built on the enhanced Toronto terms menu, but extended those terms significantly in several respects. In addition to the increase in the level of concessionality, creditors also agreed that for debtor countries with good track records (under an IMF-supported programme and prior rescheduling agreements), a concessional rescheduling of the entire stock of eligible debt could be implemented. The Naples terms also allowed more flexibility on the coverage of debt to be rescheduled. In particular, debt rescheduled on concessional (Toronto or enhanced Toronto) terms could be rescheduled again and the level of concessionality increased (or topped up) to the new level of 67 per cent.

Uganda was the first country to receive an exit rescheduling agreement on Naples terms. The February 1995 agreement provided a massive reduction in debt contracted before 1 July 1981 (the cut-off date), excluding debt previously rescheduled in February 1992 on enhanced Toronto terms (which had already received a 50 per cent net present value reduction). Debt rescheduled in 1989 on Toronto terms, including arrears and late interest, was increased (topped up) to 67 per cent in net present value (from the 33 per cent net present value reduction granted in the earlier agreement). In the first half of 1995, 10 other low-income countries concluded agreements on Naples terms, consolidating about \$2.7 billion of debt.

Naples terms were heralded as an exit strategy from the rescheduling process. The expectation was that in the context of sound economic policies of adjustment and reform, these terms would bring debt to sustainable levels in most low-income countries and permit a sustainable “exit”. This hope was based on an overestimation of the impact of the reforms on the economies in question. Of the 37 low-income

¹⁴ See Daseking and Powell, “From Toronto terms to the HIPC Initiative” (footnote 8 above).

¹⁵ In their communiqué leaders of the G7 at the Naples summit “encourage[d] the Paris Club to pursue its efforts to improve the debt treatment of the poorest and most indebted countries. Where appropriate, [they] favour[ed] a reduction in the stock of debt and an increase in concessionality for those countries facing special difficulties.” See www.g8.utoronto.ca/summit/1994naples/communique/develop.html.

countries that concluded agreements on Naples terms between 1995 and 2008, only two (Cambodia and Yemen) had their external debt reduced to sustainable levels and exited from the rescheduling process. All of the other countries were declared eligible for debt reduction under the HIPC Initiative, launched in 1996.

As the HIPC Initiative got under way, creditors increased the level of debt forgiveness. In November 1996, they agreed to increase the present value reduction to up to 80 per cent (Lyon terms); in June 1999, they agreed to reduce debt relief to 90 per cent (Cologne terms). Such operations could be in the form of flow restructuring or stock-of-debt reductions.

III. Complementary measures

Some Paris Club creditors took important complementary measures. These measures included forgiveness of ODA loans (using the OECD Development Assistance Committee as a platform to coordinate these efforts), and debt-conversion arrangements under Paris Club auspices and through special initiatives such as the United States Enterprise for the Americas Initiative and the Swiss Debt Reduction Facility.

A. Forgiveness of official development assistance debt

An important component of debt reduction is the forgiveness by bilateral donors of their ODA loans. Many middle-income countries and virtually every low-income country have benefited from the forgiveness of at least part of these loans.

Forgiveness of ODA loans, like forgiveness of aid more generally, has always been considered a strictly bilateral issue between individual donor and debtor countries. Periodically, however, there have been rounds of concerted action by donors, often in the face of global crises. In the late 1970s, in response to the burgeoning debt crisis and the resolution¹⁶ adopted by the Trade and Development Board of the United Nations Conference on Trade and Development (UNCTAD) in 1978, most member countries cancelled all or part of their ODA loans to a group of low-income countries considered less developed. In tandem, they began to provide all new bilateral aid flows to this group of countries in the form of grants. Between 1978 and 1986, 15 Develop-

ment Assistance Committee (DAC) member countries granted about \$3 billion in debt forgiveness under this initiative. More than two thirds of this debt forgiveness related to debt owed by developing countries in sub-Saharan Africa. Beneficiary countries included both those that had rescheduled debt and those that had avoided debt difficulties.

DAC member countries launched a second concerted round of ODA debt forgiveness in 1988, as part of the coordinated programme of assistance to Africa and in parallel with the decision by Governments represented at the Paris Club to provide partial debt reduction on non-concessional claims rescheduled within the Paris Club. In keeping with the SPA framework, ODA debt forgiveness was focused primarily on the HIPCs of sub-Saharan Africa. It was also increasingly linked directly to policy performance by the debtor country. However, some countries that had avoided debt difficulties were again the beneficiaries of debt forgiveness.

In 1989 alone, donors announced ODA debt cancellation of more than \$6 billion. This included cancellations by France of \$3.1 billion in ODA loans contracted by 35 low-income African countries before the end of 1988; by Germany of \$1.4 billion in ODA loans to least developed countries; and by Belgium of \$330 million in ODA loans to several African countries. In July 1989, the United States announced its intention to forgive \$500 million in ODA loans to certain low-income countries of sub-Saharan Africa and to provide future aid to those countries as grants. The forgiveness was delivered in tranches, conditional upon satisfactory implementation of structural adjustment programmes supported by IMF and the World Bank. Later in the year, Canada cancelled \$570 million in ODA loans to 13 sub-Saharan African countries and pledged to provide future aid as grants.

B. Debt swaps and debt conversion

A swap arrangement transforms one type of asset into another with different characteristics. The most common type of swap arrangements are debt for equity, debt for development, debt for investment in environmental conservation projects, debt for debt and debt for local currency. The market for these types of operations evolved in the context of the market-based debt reduction schemes that emerged to deal with the commercial debt crises of the 1980s in middle-income countries. Swap arrangements involving bilateral creditors emerged in the 1990s as

¹⁶ Resolution 165 (S-IX) on debt and development problems of developing countries, adopted by the Trade and Development Board at the third (ministerial) part of its ninth special session (A/33/15, part two, annex I).

another instrument in the ongoing effort to reduce the external debt burden of low-income countries.

The first of these arrangements was the United States Enterprise for the Americas Initiative, announced in June 1990.¹⁷ Its aim was to enhance development prospects through action in the areas of trade, investment and debt. For eligible countries in Central and Latin America, debt owed to the United States could be reduced provided the country was undertaking macroeconomic and structural reforms, was liberalizing its investment regime and had concluded a debt restructuring agreement with its commercial bank creditors. Under the Initiative, bilateral concessional loans extended by the United States Agency for International Development or the Department of Agriculture under the food aid programme governed by Public Law 480 could be reduced and interest payments made in local currency provided those resources were committed to environmental or child development projects. In addition, a portion of non-concessional loans extended by the Export-Import Bank of the United States or the Commodity Credit Corporation could be bought back by the debtor to facilitate debt-for-nature, debt-for-development or debt-for-equity swaps. Bolivia was the only low-income country to qualify for this initiative.

The Swiss Debt Reduction Facility, which became operational in January 1991, was aimed at HIPC.¹⁸ Access was limited to countries with a strong track record of reform, acceptable conditions of governance and adequate debt management systems that were implementing structural reform programmes supported by IMF and the World Bank. The 45 countries eligible for the Facility included low-income countries considered by the United Nations to be least developed (a definition that takes into account per capita income, the stock of human assets and economic vulnerability) and other developing countries that had either rescheduled with Paris Club creditors on enhanced concessional terms or were recipients of Swiss ODA. The resources of the Facility could be used for a wide range of measures, including buy-back of officially insured Swiss export credits and commercial non-insured debt and contributions to clearing arrears and financing debt-service payments owed to multilateral institutions. Debt cancellation could also be linked to creation by the debtor Government of a local currency

counterpart fund to be used to finance development projects. An estimated \$1.8 billion in outstanding claims were eliminated through the Facility.

Other bilateral initiatives for debt forgiveness included the Libreville Debt Initiative, announced by France at the Franco-African summit in 1992¹⁹ and the United States Tropical Forest Conservation Act of 1998.²⁰ Under the Libreville Debt Initiative, France committed to set up a 4 billion franc (about \$800 million) fund to cancel or convert ODA loans to four African countries (Cameroon, the Republic of the Congo, Côte d'Ivoire and Gabon) in conjunction with specific development projects approved by the Agence française de développement.

The Tropical Forest Conservation Act established a facility that allowed low- and middle-income countries with tropical forests to finance debt buy-backs with concessional debt owed to the United States provided that the debtor country had a bilateral investment treaty with the United States and an ongoing investment reform programme supported by the World Bank or the Inter-American Development Bank. Five low-income countries (Bolivia, Côte d'Ivoire, Guyana, Liberia and Madagascar) were eligible for this facility.

Debt conversions for lower-middle-income countries under Paris Club agreements were first introduced in September 1990. A provision allowed creditors to swap a limited amount of their ODA claims and 10 per cent of their guaranteed commercial claims (on a purely voluntary and bilateral basis) in the form of debt for aid, debt for equity, debt for nature and debt for local currency. In December 1991, these provisions were extended to low-income countries.

Between 2002 and 2007, Paris Club creditors concluded more than 376 operations that extinguished \$8.3 billion in claims. Sixty per cent of the total amount swapped was in the form of debt for aid; 31 per cent was in the form of debt-for-equity swaps. Five creditors (France, Germany, Italy, Spain and Switzerland) accounted for 80 per cent of the total volume of debt swapped. The largest beneficiaries of debt swaps were Côte d'Ivoire, Egypt, Honduras, Jordan, Morocco and Peru, which together accounted for 60 per cent of all debt swapped by Paris Club creditors.

¹⁷ See, for example, R. Porter, "The Enterprise for the Americas Initiative: a new approach to economic growth", *Journal of Interamerican Studies and World Affairs*, vol. 32, No. 4 (Winter 1990).

¹⁸ See, for example, "The Swiss debt-reduction program 1991-2001: achievements, perspectives", available at www.alliancesud.ch/en/policy/expertise/downloads/swiss_debt_reduct1.pdf.

¹⁹ See www.diplomatie.gouv.fr/fr/pays-zones-geo/afrique/sommets-afrique-france/article/la-rigueur-economique-17eme-sommet.

²⁰ For more information on the Act, see www.usaid.gov/our_work/environment/forestry/tfca.html.

Twenty HIPC countries have concluded debt-swap operations with Paris Club creditors, primarily in the form of debt-for-aid swaps. These operations have extinguished almost \$2 billion of these countries' external debt.

C. Debt relief by non-Paris Club creditors

Many countries have debt-service obligations to official bilateral creditors that do not participate in Paris Club rescheduling or other established institutional forums for negotiation. Individual creditor countries not participating in the Paris Club have developed various approaches, which have been adapted to the individual circumstances of each debtor country. Most non-Paris Club bilateral creditors have agreed to a rescheduling of obligations, although in some cases debt buy-backs involving substantial discounts have been implemented. In some instances, claims have been forgiven: in 1991, the Gulf countries (principally Kuwait and Saudi Arabia) forgave \$6 billion of their claims on Egypt and more than \$2 billion of their claims on Morocco.

As a condition of debt rescheduling, Paris Club creditors require that debtor countries seek debt relief on terms comparable to those of other creditors. Because of the ad hoc and bilateral nature of negotiations with non-Paris Club bilateral creditors, comprehensive information on the terms of agreements concluded and the volume of claims restructured is not generally available. However, in the context of the HIPC Initiative, debt relief by non-Paris Club bilateral creditors is monitored in parallel with debt relief provided by all other categories of creditor.

About 13 per cent of total debt is owed by HIPC countries to non-Paris Club bilateral creditors. Of the 51 non-Paris Club bilateral creditors with claims on those countries, only eight (Egypt, Hungary, Jamaica, Morocco, Republic of Korea, Rwanda, South Africa and Trinidad and Tobago) had provided full relief and another 22 creditors partial debt relief by June 2008.²¹

Twenty-one creditors have not yet delivered any HIPC Initiative debt relief, although some, including Colombia and Kuwait, are making efforts to modify their national laws so that they no longer hinder their

delivery of such relief. For individual HIPC countries, the relief delivered by non-Paris Club bilateral creditors varies significantly. Four such countries (Honduras, Madagascar, Sao Tome and Principe and Zambia) have received less than 15 per cent of their expected debt relief from non-Paris club creditors. Others (Benin, Cameroon, Ghana and Sierra Leone) have received more than 75 per cent of the expected debt relief.

D. Debt relief by commercial creditors

The debt crisis that engulfed low-income countries in the 1970s and 1980s also led to restructuring with commercial creditors. These agreements evolved from ad hoc arrangements by individual creditors to a more coordinated restructuring through commercial bank advisory committees, often referred to as the London Club.

Unlike the Paris Club, the London Club held no regular group meetings with debtors: a special advisory committee, representing the major creditor banks, was formed for each negotiation (meetings did not always take place in London). Membership in the advisory committee was based on the size of an individual bank's exposure and the need to spread representation among key creditor countries. Normally, only principal payments were rescheduled, and arrears were expected to be paid at the time the restructuring agreement went into effect. In addition to restructuring outstanding loan maturities, commercial bank creditors sometimes provided new money (normally extended in proportion to existing exposure) and maintained or extended short-term credit facilities.

The process followed by the London Club required the advisory committee and the debtor Government to first reach an agreement in principle for a restructuring. That agreement was then signed by all creditor banks. The agreement became effective when a specified proportion of creditors signed the agreement and other conditions (such as payment of arrears) were met.

In an effort to eliminate uncertainties, in some cases commercial banks concluded multi-year agreements that consolidated principal payments over a three- to five-year period. Formal arrangements to monitor economic performance were an essential element of multi-year agreements, for which the debtor country was required to have an upper-credit tranche agreement in place with IMF.

²¹ IDA and IMF, "Heavily Indebted Poor Countries (HIPC) Initiative and Multilateral Debt Relief Initiative (MDRI)—Status of implementation" (12 September 2008).

Between 1980 and the end of 1988, 20 low-income countries restructured their commercial bank debt one or more times.²² During this period, \$18.7 billion in commercial bank debt owed by low-income countries was restructured. Five countries (Côte d'Ivoire, Democratic Republic of the Congo, Nicaragua, Nigeria and the Sudan) accounted for 85 per cent of this amount.

By the mid-1980s, it had become evident that the debt crisis in low-income countries was too deep-rooted to be resolved through rescheduling of principal payments owed to commercial creditors, and participation in concerted lending was becoming increasingly difficult to arrange. Creditor banks began to recognize that some form of debt cancellation was essential to a viable debt-relief package.

In March 1989, the creditor community established a mechanism to support voluntary debt and debt-service reduction operations based on a plan by Nicholas Brady, then Secretary of the Treasury of the United States. The Brady Plan was designed to provide the debtor country with a reduction in the stock of debt or future debt service as well as new money, with support from international financial institutions and bilateral donors, notably Japan. Commercial lenders found the plan attractive because it provided a menu of instruments from which they could choose depending on their balance-sheet needs. The main instruments were buy-backs and discounted exchanges for debt-stock reduction, par exchanges at reduced interest rates for debt-service reduction and a new money option for debt not subject to debt or debt-service reduction.²³

The Brady Plan was aimed primarily at middle-income countries. Operations under the Plan were concluded with only two low-income countries: Nigeria in 1992 and Côte d'Ivoire in 1997. The agreement with Nigeria restructured \$5.4 billion through a cash buy-back of \$3.3 billion at 40 cents per dollar and an exchange of \$2.1 billion for collateralized 30-year bullet maturity par bonds with reduced interest rates. A recovery value provision allowed bondholders to recapture part of the discount if the international price of oil rose above an agreed reference price. The total

cost of the operation (\$1.7 billion) was paid from Nigeria's own resources.

The agreement with Côte d'Ivoire was something of a hybrid: in essence a Brady Plan operation but with a portion of the costs provided by the Debt Reduction Facility for IDA-only countries (described below). In total, \$6.5 billion were restructured and debt owed to commercial creditors was reduced by \$4.1 billion in nominal terms, equivalent to a reduction of just under 80 per cent in net present value terms. Of the \$2.3 billion of eligible principal, \$700 million were bought back at 24 cents per dollar, \$200 million were exchanged for 50 per cent discount bonds and \$1.4 billion were exchanged for front-loaded interest reduction bonds. Of the \$4.2 billion of past-due interest, \$900 million were exchanged for past-due interest bonds, \$30 million were paid in cash at closing and \$3.3 billion were written off. The principal component of the discount bond was collateralized with 30-year United States Treasury or French Treasury zero-coupon bonds, delivered at closing. The total cost of the operation was \$226 million, of which \$19 million came from Côte d'Ivoire's own resources and \$207 million were funded with external loans and grants (\$70 million from IMF, \$52 million from France, \$50 million from IDA and \$35 million from the Debt Reduction Facility, supported by \$15 million in grants from the Netherlands and Switzerland).

E. Debt Reduction Facility

Created in July 1989, the IDA Debt Reduction Facility (DRF) was designed to address the commercial debt problems of low-income countries. Its objective is to help reforming, heavily indebted, IDA-only countries reduce their sovereign commercial external debt as part of a broader debt-resolution programme, and thereby to contribute to growth, poverty reduction and debt sustainability.

Under a typical DRF-supported operation, a Government buys back its public and publicly guaranteed debts from external commercial creditors for cash at a deep discount.²⁴ DRF provides grants for both the preparation and the implementation of commercial debt-reduction operations. The preparation grants support eligible Governments in retaining the services needed to prepare such operations. The implementa-

²² The low-income countries involved were: Bolivia, Congo, Côte d'Ivoire, Democratic Republic of the Congo, Gambia, Guinea, Guyana, Honduras, Liberia, Madagascar, Malawi, Mozambique, Nicaragua, Niger, Nigeria, Senegal, Sierra Leone, Sudan, Togo and Zambia.

²³ For a discussion of the Brady Plan, see, for example, Ian Vásquez, "The Brady Plan and market-based solutions to the debt crises", *The Cato Journal*, vol. 16, No. 2 (Fall 1996).

²⁴ Other modalities have also occasionally been used. They include debt swaps (which have been part of operations in Albania, Bolivia, Niger, Senegal, the United Republic of Tanzania and Zambia) and debt restructurings (used in Viet Nam and for a substantial part of the debt reduction in Côte d'Ivoire).

tion grants finance the costs of debt buy-backs as part of the implementation of commercial debt-reduction operations. In April 2008, the policies and practices of DRF were modified to enhance its effectiveness (by, for example, allowing it to provide more rapid support for the preparation of commercial debt-reduction operations) and better align it with the HIPC Initiative framework.

Since its inception, DRF has helped extinguish about \$10 billion of external commercial debt and become one of the key instruments used to promote commercial creditor participation under the HIPC Initiative. As such, it helps reduce the risk of these creditors taking advantage of debt relief provided by other creditors. By settling commercial claims, which are generally in arrears, DRF may also help improve the climate for foreign direct investment and trade. In addition, DRF enables countries to manage their debts and reserves in a more cost-effective way, by reducing the likelihood that their debts will be sold to aggressive distressed debt funds and by avoiding litigation and attempted attachment of assets. In some cases, DRF can help HIPCs extinguish court judgements, even after awards have been distributed.²⁵

DRF is financed mainly from transfers from IBRD, grant contributions from other donors and investment income earned on such contributions. As of March 2009, DRF had received \$350 million in transfers from IBRD net income. In addition, bilateral donors, including Canada, Finland, France, Germany, Norway, the Netherlands, the Russian Federation, Sweden, Switzerland, the United Kingdom and the United States, had contributed grants to support commercial debt-reduction operations. The European Commission, France, Germany, Japan, Switzerland and the United States have made grants directly to debtor Governments in support of DRF-sponsored operations. Debtor Governments' own financing has also been contributed to DRF-supported operations.

F. Debt-relief initiatives by multilateral creditors

Three initiatives—the Fifth Dimension of the Strategic Partnership with Africa, the HIPC Initiative and the Multilateral Debt Relief Initiative—provide debt relief. Each is described below.

1. Fifth Dimension

The Fifth Dimension of the Strategic Partnership with Africa was aimed explicitly at IDA-only countries with outstanding obligations on IBRD loans. These loans were contracted when the debtor country had access to IBRD and other market-based financing. Initially, concessional bilateral assistance, mainly from the Nordic countries, was provided to help finance debt-service payments to IBRD. Subsequently, IDA introduced supplemental (Fifth Dimension) credits to offset interest payments to IBRD.

Financed with IDA reflows, the supplemental credits were allocated to eligible countries on an annual basis, in proportion to the interest payments due on their IBRD loans. In order to receive supplemental IDA credits, the debtor country had to be current with its debt-service payments to IBRD and IDA and have an ongoing adjustment programme supported by IDA. In total, IDA provided about \$1 billion in supplemental IDA credits to SPA countries to offset debt-service payments to IBRD; donors contributed another \$200 million.

2. Heavily Indebted Poor Countries Initiative

After a difficult period at the onset of the debt crisis of the 1980s, the debt situation of most middle-income countries improved substantially, thanks to the support provided by the international financial community and the implementation of structural adjustment. However, a number of low-income countries, most of them in sub-Saharan Africa, continued to bear heavy external debt burdens. These burdens reflected several factors, including imprudent external debt management, deficiencies in macroeconomic management, adverse developments in the terms of trade and poor governance. By the mid-1990s, with an increasing share of debt owed to multilateral creditors, it became clear that further action from the international community was needed to help those countries overcome their external debt difficulties. During the debt crisis, most low-income countries continued to receive positive net transfers from the international community. This contrasts with the negative net transfers to the HIPCs in the mid-1980s. The positive net transfers resulted mainly from increased grants from official bilateral creditors, bilateral debt forgiveness/restructuring and increased loans from multilateral institutions, mostly on highly concessional terms.

In February 1996, the Executive Boards of the World Bank and IMF discussed two papers that set

²⁵ A significant number of litigating creditors participated in the recent DRF-supported buy-back operations in Liberia and Nicaragua. These arrangements extinguished almost half of the overall value of reported court judgements against post-decision point HIPCs.

out the scope and nature of the debt problems of the HIPC's.²⁶ The analyses concluded that the debt burden of about half of the countries studied was likely to remain above manageable levels in the medium to long term, even with strong policy performance and full use of existing debt-relief mechanisms. During the discussion, there was a widespread sense that the initiatives to assist such countries in dealing with their debt problems needed to be supplemented with new strategies and instruments. As a result, a new debt-relief initiative was called for at the G7 summit in Lyon, France.

In response to that call, in September 1996 the World Bank and IMF launched the HIPC Initiative.²⁷ The key objective of the Initiative was to ensure that adjustment and reform efforts were not put at risk by continued high debt and debt-service burdens. The Initiative aimed to reduce the debt burden of eligible countries to predetermined levels, provided they adopted and carried out strong programmes of macroeconomic adjustment and structural reforms. Its launch represented a major departure from past practice in that, for the first time, debt relief was offered on multilateral debt.

Key features of the Heavily Indebted Poor Country Initiative

To be considered for HIPC Initiative debt relief, a country must be IDA-only and eligible for a Poverty Reduction and Growth Facility;²⁸ have debt burden indicators above the HIPC Initiative thresholds after full use of traditional debt-relief mechanisms; establish a track record of policies and reform through IMF- and IDA-supported programmes; and have developed a poverty reduction strategy paper through a broad-based participatory process.

Once a country has met or made sufficient progress in meeting these criteria, the World Bank and IMF decide on its eligibility for debt relief. This decision is called the HIPC Initiative decision point. At the decision point, the World Bank and IMF decide how much debt reduction a country will receive in the context of the HIPC Initiative. The World Bank and IMF also come to agreement with authorities from debtor countries on the requirements that need to be fulfilled

(the so-called completion point triggers) for the country to receive irrevocable debt relief. Once a country reaches its decision point, it may immediately begin receiving interim relief from some creditors upon its debt service falling due.²⁹

In order to receive irrevocable debt relief under the HIPC Initiative, a country must meet the completion point triggers. Once it does, it can reach the HIPC Initiative completion point, at which time lenders are expected to provide the full debt relief committed at the decision point. This amount is equal to the reduction needed to bring down the country's debt to the relevant HIPC Initiative threshold (150 per cent of the net present value of the debt-to-exports ratio or 250 per cent of the net present value of the debt-to-revenue ratio). The Initiative was based on six guiding principles:

- (a) Overall debt sustainability should be assessed on a case-by-case basis that focuses on the totality of a country's debt;
- (b) Action should be taken only when a debtor has shown the ability to put the debt relief provided to good use;
- (c) Existing debt-relief mechanisms should be built upon;
- (d) The provision of debt relief should be coordinated by all creditors, with broad and equitable participation;
- (e) The delivery of debt relief by multilateral creditors should preserve the financial integrity of the institutions and their preferred creditor status;
- (f) New external financing to beneficiary countries should be provided on appropriate concessional terms.

At the onset of the Initiative, a two-year limit was established, at the end of which a comprehensive review would be conducted to decide whether to continue the programme. The 1998 review of the Initiative acknowledged that, while the Initiative had accomplished significant results over its first two years, more needed to be done.³⁰

²⁶ World Bank and IMF, "Analytical aspects of the debt problems of heavily indebted poor countries" and "Debt sustainability analysis for the heavily indebted poor countries".

²⁷ "A programme for action to resolve the debt problems of the heavily indebted poor countries: report of the Managing Director of IMF and the President of the World Bank to the Interim and Development Committees" (September 1996).

²⁸ Superseded in 2010 by the Extended Credit Facility.

²⁹ For a list of countries that have reached the decision point, see <http://go.worldbank.org/4IMVXTQ090>.

³⁰ World Bank and IMF, "The initiative for heavily indebted poor countries: review and outlook", document DC/98-15 (22 September 1998).

To make the Initiative as effective as possible, the Executive Boards of the World Bank and IMF called for a comprehensive review of its framework. The review was informed by a two-stage consultation process.³¹ The first phase, finalized in mid-March 1999, addressed concerns about, and possible modifications to, the Initiative's framework, including debt-relief targets, timing of decision and completion points and performance under economic and social reform programmes.³² The second phase, finalized in mid-June 1999, focused on the link between debt relief and social development. Three clear messages emerged from the consultation process. First, there was general acknowledgment that the Initiative was a positive step forward towards solving the debt problems of HIPC's. Second, there was disappointment with the depth of debt relief and the pace of implementation (often expressed as "too little, too late"). Third, there was a clear desire for a more direct link between debt-relief and poverty-reduction measures. Proposals for modifying the HIPC Initiative framework ranged from building on the existing framework (by, for example, making changes to timing, conditionality, debt ratios and targets) to adopting a completely different approach to debt relief (for example, adopting the human development approach or introducing international insolvency procedures).³³

In April 1999, the President of the World Bank and the Managing Director of IMF outlined a set of guiding principles for modifying the HIPC Initiative framework. The proposed principles stated that debt relief should

- Reinforce the wider tools of the international community to promote sustainable development and poverty reduction
- Strengthen the incentives for debtor countries to adopt strong programmes of adjustment and reform
- Focus on the poorer countries, for which excessive debt can be an obstacle to development that is particularly difficult to overcome

- Remove the debt overhang and provide an appropriate cushion against exogenous shocks
- Be provided to all countries, including those that have already reached decision and completion points under the Initiative, provided that they qualify under any revised thresholds
- Be provided in a simplified framework
- Be accompanied by proposals for financing the cost to multilateral institutions

In line with these principles, the President and the Managing Director proposed a number of specific modifications. They included more debt relief to a broader group of countries by a reduction in the Initiative's debt-burden thresholds and the calculation of assistance based on actual data at the decision point rather than projected data for the completion point (as under the original framework). They also proposed providing faster debt relief, by delivering interim debt relief on a voluntary basis and front-loading debt relief after the completion point. In addition, they proposed the introduction of "floating" completion points, contingent on an outcome-based assessment of country performance rather than a fixed track record (as under the original framework). These changes aimed to provide incentives to implement reforms quickly, speed up the delivery of debt relief and develop country ownership of reforms. At the G7 summit in Cologne, Germany, in June 1999, Government leaders endorsed a number of specific suggestions by their finance ministers to provide "faster, deeper and broader debt relief for the poorest countries that demonstrate a commitment to reform and poverty alleviation".³⁴ In response, the World Bank and IMF enhanced the HIPC Initiative framework in accordance with the approach proposed in April 1999.³⁵

At the same time, the HIPC Initiative process was linked to progress in preparing and implementing poverty reduction strategies, which were designed to be country driven and developed with the broad participation of civil society. The framework was adapted to provide an adequate cushion against exogenous shocks: under the revised framework, additional debt relief ("topping up") can be provided if, by the time a heavily indebted poor country reaches the completion point, its debt burden indicators have deteriorated owing to factors beyond its control.

³¹ A request for comments and proposals was posted on the World Bank and IMF websites, and staff from both institutions attended seminars and conferences in Africa, Europe, Latin America and the United States. As of the end of March 1999, 65 written comments and proposals for improvement of the HIPC Initiative framework had been received.

³² See World Bank and IMF, "Heavily Indebted Poor Countries (HIPC) Initiative: perspectives on the current framework and options for change" (2 April 1999).

³³ For sceptical views on the HIPC Initiative, see, for example, L. Rieffel, *Restructuring Sovereign Debt: The Case for Ad Hoc Machinery* (Washington, D.C., Brooking Institutions Press, 2003) or B. Gunter, "What's wrong with the HIPC Initiative and what's next?", *Development Policy Review*, vol. 20, Issue 1 (March 2002), pp. 5-24.

³⁴ Report of the G7 Finance Ministers on the Köln Debt Initiative to the Köln Economic Summit, Cologne, Germany (18-20 June 1999), para. 2.

³⁵ World Bank and IMF, "Modifications to the Heavily Indebted Poor Countries (HIPC) Initiative" (23 July 1999).

The flexibility of the enhanced framework has facilitated access by HIPCs to debt relief while preserving the Initiative's principles.³⁶ In particular, as the universe of countries in need of debt relief changed, operational modalities were adapted to better fit their challenging circumstances. Flexibility has been exercised with respect to three features:

- The eligibility criteria, which were reviewed to ensure that no country with debt burdens in excess of the HIPC Initiative's thresholds would be left without a comprehensive framework to address its debt problems
- The definition of a satisfactory track record of policy performance
- The preparation and implementation of poverty reduction strategies

3. Multilateral Debt Relief Initiative.

The HIPC Initiative was supplemented in 2005 by MDRI. This initiative, called for at the Group of Eight (G8) Summit at Gleneagles, Scotland, United Kingdom, seeks to achieve two objectives: (a) deepen debt relief to HIPCs to support their progress towards the Millennium Development Goals while safeguarding the long-term financial capacity of the international financial institutions; and (b) encourage the best use of additional donor resources for development by allocating them to low-income countries on the basis of policy performance.

Key features of the Multilateral Debt Relief Initiative

Unlike the HIPC Initiative, MDRI is not comprehensive in its creditor coverage; it does not involve participation by official bilateral or commercial creditors or multilateral creditors other than IDA, IMF, the African Development Fund (administered by the African Development Bank) and the Inter-American Development Bank (IDB). While MDRI is an initiative common to the four institutions, their implementation modalities vary. The Initiative covers all countries that reached the HIPC completion point. Debt relief covers all debt disbursed by IMF, the African Development Fund and IDB by the end of December 2004 and all debt disbursed by IDA by the end of December 2003

³⁶ For a detailed discussion of the flexibility of the Framework, see IDA and IMF, "Heavily Indebted Poor Countries (HIPC) Initiative and Multilateral Debt Relief Initiative (MDRI): Status of implementation" (12 September 2008).

and still outstanding at the time of qualification (after HIPC Initiative debt relief). MDRI entails the cancellation of all eligible debts owed to IDA, IMF and the African Development Fund for countries reaching the HIPC completion point. In 2007, the Inter-American Development Bank agreed to cancel eligible debts to HIPCs through an initiative similar to MDRI.

Substantial progress has been made in implementing the HIPC Initiative and MDRI. As of December 2011, 32 HIPCs that had received debt relief under both the HIPC Initiative and MDRI had reached the completion point (when debt relief becomes irrevocable); another four were receiving interim assistance after having reached the decision point (when they qualify for HIPC). The debt relief already committed to the 36 post-decision point countries represents almost 35 per cent of the 2010 gross domestic product (GDP) of the countries concerned.³⁷ If all potentially eligible countries reach completion point, total debt relief provided is estimated at about \$76 billion (under HIPC) and \$33.8 billion (under MDRI) in end-2010 present value terms, with IDA providing \$14.9 billion under HIPC and \$21.9 billion under MDRI in end-2010 present value terms. Furthermore, debt-service payments have declined as a result of the initiatives in the 36 post-decision point HIPCs, for which the average debt-service payment relative to exports has dropped from 13 per cent in 2001 to 2.9 per cent in 2011 (debt service/GDP, in turn, decreased from 3.1 per cent in 2001 to 0.9 per cent in 2011). Moreover, on average, poverty reduction-related expenditures increased by more than 3 per cent of GDP between 2010 and 2011 in the 36 post-decision point countries.³⁸

IV. The road ahead³⁹

Debt relief has provided low-income countries with new opportunities, but formidable challenges remain. Broadening the production and export bases of these economies remains a challenge, particularly given the impact of the "great recession", which is likely to put additional pressure on debt-burden indi-

³⁷ See IDA and IMF, "Heavily Indebted Poor Countries (HIPC) Initiative and Multilateral Debt Relief Initiative (MDRI): Status of implementation and proposals for the future of the HIPC Initiative" (8 November 2011). It is worth noting that in reviewing this document the Boards of IMF and IDA approved further ring-fencing of countries eligible for the HIPC Initiative. Accordingly, taking into account eligibility criteria and reported willingness to avail themselves of the Initiative, the number of pre-decision countries declined from four to three (since Kyrgyzstan did not meet the HIPC thresholds at the end of 2010) and the total number of HIPC Initiative countries from 40 to 39.

³⁸ *Ibid.*, p. 4.

³⁹ From the introduction to Carlos A. Primo Braga and Dörte Dömeland, eds., *Debt Relief and Beyond: Lessons Learned and Challenges Ahead* (Washington, D.C., World Bank, 2009).

cators in many low-income countries. Declines in commodity prices and plummeting capital inflows, combined with limited tools with which to address the economic downturn, are fostering liquidity problems and are likely to raise the probability of debt distress in many of these countries if the effects of the financial crisis persist. What can be done to dampen the impact of the financial crisis on low-income countries and ensure that the benefits from HIPC Initiative and MDRI debt relief are not reversed in the years to come?

Most low-income countries and emerging economies perform better now than in the past on key dimensions the literature identifies as relevant to the risk of sovereign defaults. On average, for example, Latin American countries and emerging markets in Asia have significantly reduced the ratio of external debt to GDP in recent years. Only Eastern European countries had higher external debt levels in 2008 than they did in 2000 (the result of increases in private sector external debt). Accordingly, a wave of sovereign defaults seems less likely than in previous global economic crises.

That said, the impact of the current crisis is just beginning to reach low-income countries, as the spillover of the slowdown in richer economies and the resulting decline in external demand for commodity exporters affects their trade flows. A reversal in financial flows, particularly private capital flows, could lead to a strong decline in capital formation and eventually to liquidity problems. Before the boom in private sector flows, low-income countries had limited or no access to private foreign capital, even in good times. As global credit conditions tighten and investors' risk aversion increases, credit has once again become more limited. As a result, investment flows are moving to higher-quality and more liquid assets. After peaking in the second quarter of 2007, for example, portfolio flows to African markets decreased substantially, leaving countries that had begun to integrate into global financial markets particularly vulnerable.

Given the dependence of many low-income countries, especially African countries, on primary

exports and the bleak near-term prospects of substantial private capital inflows, a shortfall in aid could be an additional harmful side effect of the global crisis.

Implementation of the joint World Bank-IMF Debt Sustainability Framework (DSF) can play a role in helping countries manage the impact of the financial crisis. By enabling better monitoring of the debt sustainability outlook, increasing coordination among creditors and raising the amount of grant financing, especially to countries with elevated levels of risk distress, DSF partly offsets the negative impact of the financial crisis on debt sustainability prospects. DSF suffers, however, from the still limited understanding of the complex link between debt and economic growth, especially in low-income countries, which lies at the heart of debt sustainability. More analytical work in this area is therefore needed.

The global financial crisis also underscores the importance of strengthening public debt-management capacity and institutions.⁴⁰ Better debt management not only can improve the quality and comprehensiveness of debt data and information systems and increase the coordination with fiscal policies, but also may enable low-income countries to develop a sound and efficient domestic debt market, which could provide Governments with a stable alternative source of financing. These efforts take time to bear fruit, however; in the interim, continuing donor support and creditor coordination will be essential to maintain the momentum gained to date.

The road ahead remains extremely challenging. Translating debt relief into sustainable growth requires low-income countries to invest in building strong and accountable institutions and avoiding the temptation to over-borrow. In the absence of such efforts, debt relief is unlikely to have a lasting impact on the realization of the right to development.

⁴⁰ See, for example, S. Gooptu and C. A. Primo Braga, "Debt management and the financial crisis", in *The Day After Tomorrow: A Handbook on the Future of Economic Policy in the Developing World*, O. Canuto and M. Giugali, eds. (Washington, D.C., World Bank, 2010).