Debt Relief for Poverty Reduction:

The Role of the Enhanced HIPC Initiative

Prepared by the
International Monetary Fund and the World Bank

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Debt Relief for Poverty Reduction: The Role of the Enhanced HIPC Initiative

Why Is There a HIPC Initiative?

Many factors contribute to poverty. War, corruption, and destructive economic management are among the most pervasive. Others worsen poverty's impact. Unsustainable debt is one such factor. Half of the 600 million people living in the 40 poorest, most debt-burdened countries struggle to survive on less than one dollar a day. They die earlier, have access to fewer schools and teachers, and are hungrier and sicker than their counterparts in other developing countries.

Development credits extended to these countries have been provided on highly concessional terms[1] and creditor countries have been working together to further ease repayment terms. The Paris Club, a group of official bilateral creditors mostly from developed countries, devised new and increasingly concessional mechanisms since the late 1980s for debt relief; by 1995 the Paris Club offered to low-income countries "Naples terms" for rescheduling, under which up to two-thirds of the eligible debt is canceled. Still, the poorest countries' debt burdens remained high.

Over the past few decades, weak policies, adverse environmental and other external factors—often combined with protracted armed conflicts—and sometimes misguided borrowing and lending decisions have increasingly impeded progress toward sustainable economic and social development. This, in turn, made the debt burdens of the poorest countries ever more unmanageable. As it had become increasingly clear that much more needed to be done to help countries break the poverty-debt

[1]Often at interest rates of 1 percent or less and maturities of more than 30 years.

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cycle, a global consensus emerged on the need to confront high poverty and crushing debt levels head-on.

Launched in 1996, the original Initiative for Heavily Indebted Poor Countries (HIPCs) marked the first time that multilateral, Paris Club, and other official bilateral and commercial creditors united in a joint effort to reduce the external debt of the world's most debt-laden poor countries to "sustainable levels"—that is, levels that allow these countries to service their debt through export earnings, aid, and private capital inflows without compromising long-term, poverty-reducing growth. Assistance under the HIPC Initiative is limited to countries that have per capita incomes low enough to qualify for World Bank and IMF concessional lending facilities, and that face unsustainable debt burdens even after traditional debt relief (i.e., that provided under the Paris Club's Naples terms). The vast majority of beneficiary countries are in Africa.

How Does the Enhanced HIPC Initiative Work?

The sustainability targets under the original HIPC framework were set in light of the empirical work that had examined largely middle-income countries, and many—in particular civil society organizations—felt that low-income countries had less capacity to sustain external debt. Thus, in 1999, a review of the HIPC Initiative was carried out by the World Bank and the IMF in broad consultation with civil society organizations and public officials. As a result of this review, the international community agreed to enhance the Initiative and committed to providing faster, broader, and deeper debt relief: more debt relief is delivered more quickly and to more countries once they have demonstrated a commitment to put the freed-up funds to work for the poor. This approach is also innovative because it delivers debt relief within a transparent framework that invites the governments of these countries—in consultation with civil society, including the poor themselves—to take the lead in formulating comprehensive national strategies for reducing poverty. And because the qualifying thresholds have been lowered under the enhanced Initiative, more countries have become eligible for debt relief and some previously eligible countries are able to seek greater relief:

- The debt-to-exports target is now 150 percent (down from 200–250 percent) for countries qualifying under the exports window; and

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- The debt-to-fiscal revenue target is now 250 percent (down from 280 percent) for countries qualifying under the fiscal window, with the eligibility thresholds reduced as follows:
  - The exports-to-GDP ratio is now 30 percent (down from 40 percent); and
  - The fiscal revenue-to-GDP ratio is now 15 percent (down from 20 percent).

Once a heavily indebted poor country has shown a commitment to put in place sound macroeconomic policies with a focus on poverty reduction—normally over a three-year period, though this can be shorter under the enhanced Initiative—the country is considered to have reached its "decision point" (see Figure 1). At this point, an external debt sustainabilty analysis is carried out in cooperation with the country authorities, and a country's eligibility and the amount of debt relief are determined by the IMF and World Bank Boards (based on the qualifying thresholds and targets discussed above). Debt relief and other assistance now begin flowing as soon as the decision point is reached, with the amount based on the country's immediate needs and capacity for channeling the funds to poverty-reducing purposes. This also marks the point at which the international community commits to provide sufficient assistance by a particular date (the "completion point") in an amount that would enable the country to achieve debt sustainability. At the "completion point," the remainder of the full stock-of-debt reduction pledged is delivered.

Assuming a country remains committed to sound, poverty-reducing policies throughout the period between its decision point and completion point, assistance during this period (interim relief) will continue flowing. And the enhanced Initiative aims to deliver debt relief more quickly by introducing "floating" completion points not linked to a rigid timeframe, but rather determined by progress toward implementing measures that will reduce poverty in a sustainable manner.

So the actual time period between a country's decision and completion points is flexible. It depends on how quickly the country can formulate and implement its own poverty reduction strategy, sustain macroeconomic stability, and put in place mechanisms to safeguard and track the use of funds freed by debt relief. Therefore, good performers can benefit from faster debt relief.

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Figure 1. Enhanced HIPC Initiative Flow Chart

First Stage

- Country establishes three-year track record of good performance and develops together with civil society a Poverty Reduction Strategy Paper (PRSP); in early cases, an interim PRSP may be sufficient to reach the decision point.
- Paris Club provides flow rescheduling on Naples terms; i.e., rescheduling of debt service on eligible debt falling due (up to 67 percent reduction on a net present value basis).
- Other bilateral and commercial creditors provide at least comparable treatment.[1]
- Multilateral institutions continue to provide adjustment support in the framework of World Bank- and IMF-supported adjustment programs.

Decision Point

EITHER

Paris Club stock-of-debt operation under Naples terms and comparable treatment by other bilateral and commercial creditors
is adequate
for the country to reach external debt sustainability.
========> **Exit**
(Country does not qualify for HIPC Initiative assistance)

OR

Paris Club stock-of-debt operation under Naples terms and comparable treatment by other bilateral and commercial creditors
is not sufficient
for the country to reach external debt sustainability.
========> World Bank and IMF Boards determine eligibility for assistance.

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

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Second Stage

- Country establishes a second track record by implementing the policies determined at the decision point (which are triggers to reaching the floating completion point) and linked to the (Interim) PRSP.
- World Bank and IMF provide interim assistance.
- Paris Club provides flow rescheduling on Cologne Terms (90 percent debt reduction on NPV basis or higher if needed)
- Other bilateral and commercial creditors provide debt relief on comparable terms.[1]
- Other multilateral creditors provide interim debt relief at their descretion.
- All creditors continue to provide support within the framework of a comprehensive poverty reduction strategy designed by governments, with broad participation of civil society and the donor community.

"Floating Completion Point"

- Timing of completion point is tied to the implementation of a comprehensive poverty reduction strategy, including macroeconomic stabilization policies and structural adjustment.
- All creditors provide the assistance determined at the decision point; interim debt relief provided between decision and completion points counts toward this assistance.
- All groups of creditors provide equal reduction (in NPV terms) on their claims as determined by the sustainability target. This debt relief is provided with no further policy conditionality.
  – Paris Club provides stock of debt reduction on Cologne terms (90 percent NPV reduction or higher if needed) on eligible debt.
  – Other bilateral and commercial creditors provide at least comparable treatment on stock of debt.[1]
  – Multilateral institutions provide debt relief, each choosing from a menu of options and ensuring broad and equitable participation by all creditors involved.

[1]Recognizing the need for flexibility in exceptional cases.

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Debt relief clearly is a key part of a comprehensive strategy for reducing poverty, but it is no panacea. Debt relief—no matter how generous—is only the first step toward economic recovery for heavily indebted poor countries. These countries can achieve long-term debt sustainability only if they directly address the underlying causes that triggered the debt problem in the first place. To avoid slipping back into a situation where poverty-reducing investments are sacrificed to mounting external debt repayments, these countries must use the debt relief proceeds to create the basis for sustained growth and poverty reduction.

What Has Been Done So Far?

Debt Relief

Of the 41 countries identified by creditors as potentially eligible for debt relief under the HIPC Initiative, 23 now have debt relief agreements in place—with relief already flowing (see Table 1). Two countries (Bolivia and Uganda) have already reached their completion points under the enhanced Initiative. The HIPC Initiative agreements together with other debt relief sources cut the total external debt stock of the 23 beneficiary countries by as much as two-thirds—to a level that is below the average for all developing countries. That is, the total external debt stock of these countries will be reduced to around $20 billion in net present value terms, down from $54 billion (see Figure 2). The corresponding savings in total future debt service payments (in nominal terms) is estimated at US$53 billion.

Expressing the external debt[2] of these countries as a percent of GDP, the ratio falls from 57 percent before relief under the HIPC Initiative (as of 1999) to a projected 29 percent by 2003—a level that is lower than the average of 36 percent for non-HIPC developing countries (see Table 2).

Actual debt service savings in these 23 countries in the near term are also substantial: on an annual basis, they will pay about $0.8 billion less in 2001–03 compared with 1998–99.[3] In other words, while these coun-

[2]In net present value terms.

[3]Taking into account the debt relief provided under the original HIPC Initiative, which reduced debt service payments in a number of countries in 1989–99, the debt service savings in these 23 countries amount to some $1.1 billion each year in 2001–03.

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Table 1. Grouping of the Heavily Indebted Poor Countries

Status as of May 2001

41 HIPCs					
Angola*	Chad	Guinea	Madagascar	Niger	Tanzania
Benin	Congo, Dem. Rep.*	Guinea-Bissau*	Malawi	Rwanda*	Togo
Bolivia	Congo, Rep. of*	Guyana	Mali	Sierra Leone	Uganda
Burkina Faso	Côte d'Ivoire	Honduras	Mauritania	São Tomé and Príncipe	Vietnam
Burundi*	Ethiopia*	Kenya	Mozambique	Senegal	Yemen, Rep. of
Cameroon	The Gambia	Lao P.D.R.	Myanmar*	Somalia*	Zambia
Central African Republic	Ghana	Liberia*	Nicaragua	Sudan*	

Approved (23)		Yet to be Approved (14)		Sustainable Cases (4)[1]
Benin	Mali	Burundi	Lao P.D.R.	Angola
Bolivia	Mauritania	Central African Republic	Liberia	Kenya
Burkina Faso	Mozambique	Congo, Dem. Rep. of	Myanmar	Vietnam
Cameroon	Nicaragua	Congo, Rep. of	Sierra Leone	Yemen, Rep. of
Chad	Niger	Côte d'Ivoire	Somalia	
The Gambia	Rwanda	Ethiopia	Sudan	
Guinea	Senegal	Ghana	Togo	
Guinea-Bissau	São Tomé and Príncipe			
Guyana	Tanzania			
Honduras	Uganda			
Madagascar	Zambia			
Malawi				

*Conflict affected.

[1]These countries are expected to achieve debt sustainability after receiving debt relief under traditional mechanisms.

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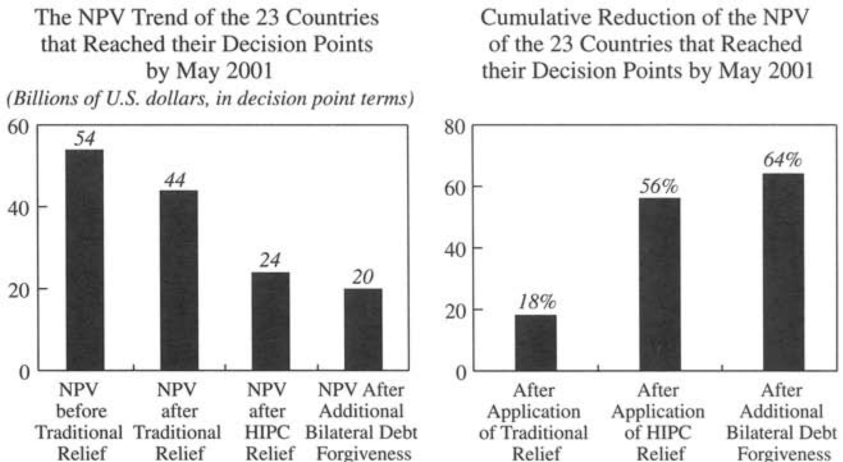
Figure 2. Reduction of Debt Stocks for 23 Decision Point Countries Status as of May 2001



Source: HIPC Documents.

tries paid on average $2.7 billion in debt service a year in 1998–99, their debt service obligations are projected to fall to $1.9 billion a year on average during 2001–03. This amount probably underestimates the full effects of debt relief: several creditor governments have indicated that they will provide additional relief through further and sometimes complete debt cancellation. HIPC relief is projected to nearly halve debt service levels as a percent of GDP for this period—to 2.1 percent of GDP, down from 4 percent of GDP otherwise. More important, the share of government revenue going to debt service is slated to fall from an annual average of 27 percent at the end of the last decade to 12 percent in 2001–03, and then to less than 10 percent by 2005.

Debt relief is now flowing to all 23 countries that have reached their decision points under the enhanced Initiative. Debt relief through interim assistance provides the HIPCs with resources comparable on average to those they will obtain after their completion points (see Figure 3). This eases their debt burdens considerably and enables them to begin channeling funds into poverty-reducing social programs and investments. Moreover, these economies can begin to benefit from the added funds available for the productivity-enhancing and capacity-building in-

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Table 2. Debt Indicators in Developing Countries and HIPCs, 1999[1]
(Weighted averages, in percent)

Ratio	Developing Country Average	Non-HIPC Developing Countries	All HIPCs, Before HIPC Relief	23 Decision Point HIPCs Before HIPC Relief (1999)	23 Decision Point HIPCs After HIPC Relief (2003)
NPV of debt-to-exports	133	128	249	259	127
NPV of debt-to-GDP	38	36	84	57	29
Debt service-to-exports	20	21	14	17[2]	8[3]

Sources: World Bank *Global Development Finance*; and HIPC documents.
[1]Excludes Liberia and Somalia due to incomplete data. Figures for 1999 are based on data in *Global Development Finance*.
[2]Average for 1998–99 based on debt service paid.
[3]Average for 2001–03.

vestment needed to help improve their global competitiveness. As their productivity increases, these economies will become better able to attract more long-term private investment flows. This, in turn, will give a further spur to the growth of exports and fiscal revenues and boost economic growth prospects.

What Does Debt Relief Mean for Social Spending?

So far, social spending in the 23 HIPCs is projected to increase to an annual average of $6.1 billion during 2001–02—up from an average social expenditure of $4.3 billion in 1999 (see Table 3). As a share of government revenue, social spending will rise from 35 percent to 40 percent over the same period. And debt relief will allow HIPCs to spend on average much more on priority social investments (7 percent of GDP) than on external debt service obligations (2 percent of GDP).

The vast majority of the funds freed by debt relief will go to improving health (particularly HIV-AIDS treatment and prevention), education, basic infrastructure, and social safety nets. Early indications from the 23 countries suggest that they will spend, on average, just under 40 percent of their annual interim debt relief on education and about 25 percent on health care.

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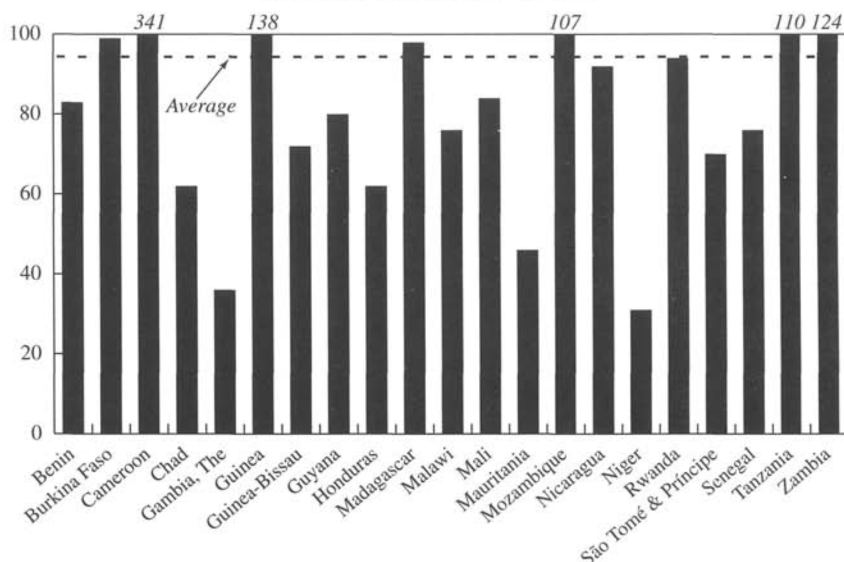
Figure 3. HIPC Initiative: Comparison of Interim Relief and Relief after Completion Point[1]

(Ratio of HIPC debt relief during interim period to relief one year after completion point, in percent)



[1]For the purposes of this chart, interim relief refers to debt relief received by each country above in 2001. For each country, debt relief in 2001 is compared to projected debt relief in the year after the completion point (when full debt relief is to be delivered by all creditors). This chart excludes Bolivia (which did not receive interim relief due to substantial relief already received at completion point under the original HIPC Initiative) and Uganda (which reached its completion point under the enhanced Initiative after a short interim period of three months).

This has the potential to make a real difference to the lives of poor people in HIPCs. In Malawi, for example, $25 million of the total of about $100 million in extra resources from debt relief over the next three years has been earmarked for education (teacher training and teaching materials). Presently, more than half of all women and more than one quarter of all men are illiterate[4] in Malawi and some 5,000 teachers are lost each year to the AIDS epidemic and attrition. In Madagascar, a $30 million portion of the projected total $120 million in extra resources from debt relief in 2001–03 is slated for education, while $25 million will go to improving

[4]Adult illiteracy rates in 1998, according to the World Bank's *World Development Indicators, 2000*.

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Table 3. Average Annual Social Expenditure in 23 HIPCs[1]

	Africa (19 countries)	Latin America (4 countries)	Total (23 countries)
		(In billions of U.S. dollars)	
Before HIPC relief (1999)	2.5	1.8	4.3
After HIPC relief (2001–02)	3.5	2.6	6.1
		(In percent of GDP)	
Before HIPC relief (1999)	4.4	10.8	5.8
After HIPC relief (2001–02)	5.1	13.5	7.0
		(In percent of government revenue)	
Before HIPC relief (1999)	29.9	48.0	35.6
After HIPC relief (2001–02)	32.7	56.4	39.9

Sources: HIPC documents; and IMF and World Bank staff estimates.
[1]Weighted averages.

healthcare. For many people living in this country's rural areas, the nearest healthcare center is now a two-hour walk away, and the majority of these centers lack medicines and basic medical equipment.

The enhanced HIPC Initiative's aim of freeing up more funds more quickly to be reallocated to poverty reduction has lent increased urgency to the need for the beneficiary countries to put in place systems that track their public spending on poverty-related programs. The World Bank, the IMF, and others are providing technical and other assistance to help these countries develop and strengthen their national public spending management systems to ensure that budgetary savings from HIPC assistance are properly accounted for and are effectively used for their intended, poverty-related purposes.

Funding the HIPC Initiative

The total cost of assistance under the HIPC Initiative is estimated at \$29.3 billion[5] in 1999 net present value terms, divided roughly evenly be-

[5]This is the total cost for 32 HIPCs. The figure excludes costs for Liberia, Somalia, and Sudan due to insufficient debt data and protracted arrears. Also, other countries that have not yet been identified may meet the criteria and qualify for relief under the HIPC Initiative.

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Net Present Value of Debt

The net present value (NPV) of debt measures the actual financial burden on a country of various kinds of debt and allows a more meaningful comparison of debt burdens across low-income countries than the face value of debt. This is because the face value of the external debt stock does not reflect the fact that low-income countries contract a significant part of the external debt on concessional terms (i.e., with an interest rate below the prevailing market rate and often long repayment periods). The NPV of debt is a measure that takes into account the degree of concessionality. It is defined as the sum of all future debt-service obligations (interest and principal) on existing debt, discounted at the market interest rate. Whenever the interest rate on a loan is lower than the market rate, the resulting NPV of debt is smaller than its face value, with the difference reflecting the grant element.

tween bilateral and multilateral creditors. Two-thirds of the total amount—$19.5 billion—has been committed to the 23 countries that already have reached their decision points (see Table 4).

Virtually all of the world's multilateral creditors have pledged to participate in the Initiative. The World Bank, IMF, and African Development Bank are among the several multilateral lenders that have committed to funding the interim debt relief now made available as soon as countries reach their decision points under the enhanced Initiative.

At an estimated cost of $14.2 billion—nearly half the total cost—the participation of multilateral creditors in the Initiative depends on the support of their member countries. Taxpayers in member countries are the ultimate source of the debt relief these institutions are able to provide.

The World Bank is financing its estimated $6.3 billion participation in the Initiative partly out of earnings on its loans to middle-income countries. Part of the IMF's estimated $2.3 billion share of the cost of funding debt relief comes from investment income related to the IMF's gold holdings. But both the Bank and the IMF will also rely directly on pledged member country contributions to fund their participation in the Initiative.

The IMF's gold holdings reflect part of the capital contributed by its members. After long and difficult discussions, the IMF Executive Board authorized on a one-time basis the sale and subsequent reacquisition of some of the gold holdings. (These transactions do not actually release gold to the market and so the balance of supply and demand in the market re-

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Table 4. HIPC Initiative: Timeline of Cost Commitments by Main Creditors

(In billions of U.S. dollars, in end-1999 NPV terms)[1]

		Decision Point Cases (23)			Post-2000
	Total (32 countries)	Retroactive[2] (8 countries)	New cases[3] (15 countries)	Total (23 countries)	Others[4] (9 countries)
Total costs	**29.3**	**6.4**	**13.2**	**19.5**	**9.8**
Bilateral and commercial creditors	**15.1**	**2.5**	**6.7**	**9.3**	**5.9**
Multilateral creditors	**14.2**	**3.8**	**6.4**	**10.3**	**3.9**
World Bank	6.3	1.7	2.9	4.6	1.7
Of which: IDA	5.6	1.7	2.7	4.3	1.3
IBRD	0.7	0.0	0.3	0.3	0.4
IMF	2.3	0.6	1.0	1.6	0.6
African Development Bank/ African Development Fund	2.4	0.4	0.8	1.3	1.1
Inter-American Development Bank	1.1	0.6	0.5	1.1	0.0
Other	2.2	0.5	1.2	1.7	0.5
Memorandum item:					
In percent of total cost	100	22	45	67	33

Sources: Country authorities; and IMF and World Bank staff estimates.

[1]Excluding Liberia, Somalia, and Sudan, as well as Angola, Ghana, Kenya, Lao P.D.R., Vietnam, and Yemen.

[2]Benin, Bolivia, Burkina Faso, Guyana, Mali, Mozambique, Senegal, and Uganda. Côte d'Ivoire is a retroactive case but has not reached its enhanced decision point.

[3]Cameroon, Chad, The Gambia, Guinea, Guinea-Bissau, Honduras, Madagascar, Malawi, Mauritania, Nicaragua, Niger, Rwanda, São Tomé and Príncipe, Tanzania, and Zambia.

[4]Burundi, Central African Republic, Democratic Republic of Congo, Republic of Congo, Côte d'Ivoire, Ethiopia, Myanmar, Sierra Leone, and Togo.

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mains unchanged.) The interest earnings on the related revaluation profits help fund the IMF's HIPC relief. There has been strong opposition in the IMF's membership to further gold transactions, including from non-HIPC developing countries.

A number of bilateral creditors—notably the G–7 countries but also others—have announced their intention to provide debt forgiveness over and above HIPC Initiative assistance, in some cases up to total cancellation of bilateral debt. The onus is now on bilateral creditors to fulfill their pledges both to multilateral agencies as well as directly to HIPCs. Most important, donors and lenders must contribute their share to funding debt relief without cutting back on other forms of aid. These other aid flows provide the support many HIPCs need to implement their poverty reduction strategies, a task that is supported by, but goes beyond, the prudent use of debt relief.

The Challenges Ahead

Keeping HIPCs on Track to Reach Their Completion Points

Relief from many, but not all, creditors is already flowing to the 23 countries that have reached their decision points. Creditors have the responsibility to ensure that these countries continue to receive the full relief required. Delays in the commitment and delivery of assistance run the risk of derailing a country's progress to the completion point—and the full benefits of debt relief—and thereby may seriously thwart a country's ability to achieve longer-term debt sustainability. This points to the need for stronger donor/creditor coordination.

In turn, one of the main challenges ahead for the 23 decision-point countries is to stay on track with growth-oriented macroeconomic policies that integrate poverty-reducing measures. Each of these countries must develop a nationally owned action plan for policy reform, set forth in a poverty reduction strategy paper (PRSP) endorsed by the IMF and the World Bank Boards. Each country's PRSP should emerge out of a local, broad-based participatory process. To reach its completion point, each HIPC must have made progress in implementing its PRSP.

There is no single blueprint for poverty reduction strategies: each PRSP is expected to reflect individual country circumstances. But each country's paper will describe the main characteristics of poverty and outline the ap-

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propriate antipoverty strategies over the medium and long term. These strategies are meant to focus the country's policy agenda on shared economic growth and poverty reduction, promote government accountability by encouraging a national dialogue on economic and social policies, and lead to programs that command more public support than in the past. As part of the preparation process, a country must identify key obstacles to faster growth and poverty reduction, specify realistic and trackable poverty reduction goals, and set out macroeconomic, structural, and social policies for reaching those goals. To make it easier to track programs in the short term, countries will have to set annual targets to correspond to their longer-term poverty reduction goals. The PRSP also provides a means of identifying the financing needs associated with various poverty reduction programs and incorporating them in a sustainable fiscal and macroeconomic framework.

Unfortunately, other obstacles—beyond crushing debt burdens—can obstruct progress toward poverty reduction and growth in HIPCs. In many African countries, armed conflict and the HIV/AIDS pandemic have depleted essential capacities for macroeconomic management and have taken an enormous human toll. This underscores the importance of and need for more help from donor countries.

Maintaining External Debt Sustainability

The HIPC Initiative is meant to provide heavily indebted poor countries with a way to permanently escape unsustainable debt burdens and transition smoothly to more normal relationships with external creditors. These are essential conditions for securing the necessary financing for sustainable growth and development, and enduring poverty reduction in these countries.

A country is considered to have achieved external debt sustainability when it is able to make good on all of its external debt service payments—current and future—in full and without sacrificing economic growth. That is, a country that has reduced its debt burden to sustainable levels should not have to resort to rescheduling its debt or accumulating arrears.

Three key determinants of a country's external debt sustainability can be identified:

- the existing stock of external debt and its repayment terms;
- the country's ability to repay its foreign debt, based on growth of income, exports, and fiscal revenues; and

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- the characteristics of new external financing available to the country—the amount of financing, mix of grants and loans, and the terms on which the financing is available.

These three determinants are closely interrelated and are themselves influenced by past domestic and external economic policies and have an influence on future policies. For example, a country's debt stock and associated debt repayment terms today are often to some degree by-products of past policies. In turn, today's debt burden influences future economic polices—often in the form of taxes borne by a country's inhabitants. A heavy debt burden today can worsen poverty in the future by discouraging investment flows and reducing funds available for development spending. And a country's ability to repay its debt based on growth of national income and exports together with new external finance depends largely on both current and future policies. The relationship here is clear: when export revenues grow strongly, they give a positive boost to GDP, which can increase government revenues available to pay back debt—so long as the country has an adequately functioning system for collecting these revenues. Similarly, the terms of agreements for new external loans will have implications for the returns to investment from these fresh funds and will help shape tax policies, thereby indirectly influencing the country's future growth prospects.

The real progress made in lowering the debt stocks and debt service obligations of the 23 HIPCs now receiving relief under the Initiative helps put these countries firmly on the path to longer-term debt sustainability. But debt reduction, no matter how generous, provides only temporary relief. Countries must still take steps to build on the foundations of debt relief by improving the underlying conditions that caused past debt problems and by responding to unforeseen events beyond their control.

A comprehensive approach is needed to stimulate durable, rapid growth and poverty reduction. More specifically, this requires a "twin pillar" strategy—involving HIPCs' own efforts through policy reform, on the one hand, and actions by the rest of the world, on the other.

The Role of HIPCs Themselves

Sticking to sound policies

HIPCs themselves must do their part to break the vicious cycle of poor policies and weak governance that, in many cases, contributes to a buildup of unsustainable debt. Sound polices and structural reforms that lay the

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groundwork for lasting economic growth and poverty reduction are crucial to ensuring debt sustainability for the longer term.

Unsound policies and corrupt practices and institutions mean that funds released by debt relief do not reach and benefit the poor people for which the funds are intended. And this tends to jeopardize new debt relief and financing flows from donors concerned that future assistance would be squandered as well.

From the start, the HIPC Initiative has been embedded in an overall framework of economic and social reform. Five aspects of this policy framework deserve special attention:

- macroeconomic policies, including fiscal, monetary, and exchange rate policies that, when adjusted in an appropriate and timely way in the face of economic shocks, can provide a stable environment for economic activity;
- structural policies, including trade, tax, regulatory, and industry and agriculture sector policies that positively affect incentives for private investment and production;
- public sector management, whereby public sector institutions provide infrastructure, social, and other services in an effective, accountable, and transparent way;
- governance and market institutions, including the rule of law (the judiciary and police) and reduction of corruption; and
- social inclusion, which embraces the full participation of society through social services that reach the poor and disadvantaged, including women and minorities.

Improving the investment environment

An easing of HIPCs' debt burdens to sustainable levels is an important step toward a more favorable climate for private investment—both domestic and foreign-financed. Foreign investment capital—put to effective use—is critical for HIPCs' development prospects. So far, these countries have remained marginalized in the global competition for foreign direct investment, however. Policies that produce stable socio-economic environments so vital to attracting investors both locally and from overseas could help reverse this trend. To this end, the business operating environment must be improved, particularly by strengthening the rule of law and

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eliminating excessive and discriminatory regulations, so that investors become more willing to choose these countries as destinations for job-creating capital and technological know-how.

Diversifying exports

Typically, these countries are heavily dependent on a narrow range of exports, which exposes them more than industrialized countries to external shocks such as fluctuations in commodities prices and bad weather conditions. The 23 HIPCs that already have reached their decision points rely on just three main export items for more than half of their total exports. Moreover, these exports tend to be commodity goods, subject to low and widely fluctuating prices. The narrow export base of most HIPCs and their exceptional vulnerability to external shocks was one main reason for lowering the Initiative's qualifying thresholds in 1999 (see above).

But a diversified export base remains the best protection against external shocks to the fragile HIPC economies and holds out much better prospects for export-driven growth. In this regard, public policy must actively promote private-sector development, strengthen infrastructure, step up public investment in education and training to boost human capital, and cultivate new export sectors and add value to existing ones. Countries must adopt trade policies that provide strong incentives for export-oriented growth and do away with trade policies that promote a weak manufacturing base geared mostly to import substitution. Finally, HIPCs can only succeed in diversifying their exports and increasing export revenues if developed countries do more to open their markets and remove trade barriers (see below).

Prudent policies on new borrowing

Poor debt management and imprudent borrowing practices play a major role in the build-up of unsustainable debt levels. This typically happens when governments do not carefully manage the amounts and terms of their foreign borrowing and borrow excessively for consumption—rather than using borrowed funds with adequate regard to future economic returns and debt repayment obligations. The picture becomes bleaker still if macroeconomic policies are not adjusted in an appropriate and timely way in the face of economic shocks, thereby only worsening debt problems.

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Because the ability of HIPCs to repay their external debt is expected to strengthen only gradually even following debt relief, both HIPCs and donors agree that new external borrowing on terms that are not concessional should be strictly limited. While debt relief should not preclude new external financing on adequately *concessional* terms, each beneficiary HIPC has a responsibility to make its debt management structure and practices more effective, to provide a framework for prudent future borrowing policies while enabling timely servicing of obligations. In particular, this means strengthening the transparency and accountability of the national structure for managing debt by improving information disclosure and public oversight.

Fiscal and monetary policies must be coordinated with debt management, especially when economic shocks occur and policies must adjust quickly for speedy recovery. An effective debt management strategy also requires good monitoring, analytical, and negotiation capabilities. In these areas, the poverty reduction strategy paper is a useful vehicle for clearly communicating to the international community the country's financing needs and goals as part of a comprehensive strategy for growth and poverty reduction.

The Role of Creditors and Donors

More aid: grants and low-cost loans

For the foreseeable future, HIPCs will continue to depend on substantial inflows of grants and low-cost loans from international financial institutions and bilateral donors/creditors to reach levels of investment needed to spur economic growth and reduce poverty.

While creditor governments are clearly making real progress in easing the crushing debt burdens of the world's poorest countries, it is essential that this relief not be offset by reductions in aid flows. A decline of just 10 percent in new aid flows would wipe out the benefits of HIPC debt relief. In order for debt relief to make any meaningful difference in the fight against poverty, developed countries must reverse the trend of declining aid flows and honor their pledge to boost their official development assistance levels to at least the UN target of 0.7 percent of GNP. At an annual average 0.24 percent of national output, current levels of foreign aid fall short of this promise by some $100 billion a year.

Creditor governments also must continue to make available low-cost loans and ensure that the mix of concessional finance is in line with the

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debt servicing ability of the particular country. When warranted by unforeseen, adverse events such as natural disaster or a sudden decline in terms of trade, creditors must be flexible in their assistance to struggling economies by providing further financing, additional grants, and/or a temporary moratorium on debt service.

More open rich country markets

Export growth is directly related to a country's ability to repay its domestic and foreign debts—one of the key determinants of the country's debt sustainability. For this reason, more generous official development assistance must be complemented by more open developed country markets to poor countries' exports.

Over the past three decades, the HIPCs' share of world exports eroded to a meager 0.7 percent by 1997, down from already low levels of 2.2 percent in 1970. And industrial countries now spend some $360 billion a year on subsidies to protect their own agricultural sectors, while poverty rates climb in poor countries, especially in rural areas. These subsidies together with direct limitations on market access for developing countries' products inhibit the diversification of these countries' exports toward higher value-added products. Clearly, developed country trade restrictions are a direct blow to the efforts of the poorest countries to earn their own way through trade.

To have any meaningful effect, rich countries must open their markets to products from poor countries, particularly their agricultural sectors—upon which most HIPC economies depend. Just as important, free access must also provide better opportunities for exports of manufactured goods by poor countries, as they diversify and develop their economies. A lowering of barriers to rich countries' export markets would help HIPCs attract the vital long-term private investment flows needed to build and diversify their export sectors.

Recent World Bank studies show that if the United States, the European Union, Canada, and Japan were to give unrestricted market access to the 49 least developed countries (as identified by the United Nations General Assembly), their net exports would increase by about 11 percent, with non-oil exports from Africa expanding by 14 percent. Recent market-opening actions by the EU and some other industrial countries are welcome initiatives, but it is important for all countries to remove remaining barriers to the exports of the poorest countries and find common ground for launching new multilateral trade negotiations.

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The Special Case of Conflict-Affected Countries

The HIPC Initiative's top challenge in the year ahead is to bring the remaining eligible countries to their decision points as fast as realistically possible so that they can begin to receive debt relief. This challenge presents special difficulties since most of these countries have recently emerged from, or are still engaged in, conflict, and many of them are struggling with severe governance problems. Several of these conflict-affected countries have built up large arrears to international financial institutions, further obstructing progress to their decision point. At the same time, these countries have a particularly acute need for debt relief, because of their major reconstruction requirements and the urgent need for speedy and effective action to help break the cycle of violence, low growth, and severe poverty.

To take into account the extreme difficulties faced by these countries and deliver debt relief to them as quickly as practicable, the World Bank and IMF intend to link these countries at an early stage to the HIPC process. These countries would be able to reach decision point—and begin receiving debt relief—as early as feasible, assuming they could show progress in pursuing sound policies with a commitment to alleviating poverty and an emphasis on rebuilding institutional and administrative capacity and improving overall governance. The HIPC Initiative framework has the flexibility to "front-load" assistance to conflict-affected countries. That is, the Initiative can make a larger amount of debt relief available at as early a point as possible, taking into account the countries' debt service profiles and capacity to put the proceeds to poverty-reducing uses.

The move to put debt relief agreements in place as swiftly as practicable would normally be combined with a longer period to completion point. This would allow these countries the time to prepare and implement national strategies for poverty-reducing uses of the funds freed by debt relief (set forth in a poverty reduction strategy paper), sustain macroeconomic stability, and put in place good mechanisms for tracking the use of debt relief proceeds. The authorities in postconflict countries would be encouraged to start preparing an *interim* poverty reduction strategy paper as soon as political and security conditions permit, specifying measures to help stabilize the political and security situation and help restart economic activity. As is the case under the usual HIPC debt relief mechanism, the actual length of the period between decision and completion points would be

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flexible, depending on how quickly a country can make progress in implementing reforms for sustainable, pro-poor growth.

Under the usual two-stage qualification period, debt relief would begin to flow to a postconflict HIPC from an early decision point and throughout the period during which the country works to arrive at its completion point. During this period, the World Bank also would provide support to the country through grants and/or low-cost credits under its International Development Association (IDA) concessional window, while the IMF would provide support through its concessional lending facility, the Poverty Reduction and Growth Facility (PRGF).

Moreover, the World Bank and IMF have proposed that plans to clear the (in some cases large) arrears of postconflict HIPCs to international financial institutions be worked out jointly with the countries themselves, in consultation with other creditors. Such a plan would typically include agreement on the length and content of the track record required for arrears clearance, as well as on the types of assistance the World Bank and the IMF would provide in the pre-arrears clearance period.

Obviously, the infrastructural and economic devastation suffered by postconflict countries has left them with severely limited institutional implementation capacity. For this reason, the World Bank and the IMF will do more to provide the technical assistance and policy advice needed to help rapidly restore the critical functions of government to these countries and to help them fulfill the specific poverty-reducing capacity requirements of the HIPC Initiative in a timely way. For its part, the IMF is prioritizing and coordinating ways to improve the delivery and effectiveness of technical assistance to build capacity in areas that are vital to restoring macroeconomic stability, such as public expenditure management, monetary and exchange rate policies, and the financial sector. In giving increased priority to technical assistance, the World Bank and the IMF, together with other providers of technical assistance and the country authorities themselves, will assess the country's technical assistance needs early on and develop a concrete plan for delivering this assistance into the medium-term. While the World Bank and the IMF can provide policy advice and technical assistance in their respective areas of competence, this effort also will require a considerable involvement of other donors through financial support and direct provision of expertise over an extended period.

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