THE DEBT-RELIEF INITIATIVE FOR POOR COUNTRIES

GOOD NEWS FOR THE POOR?

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The Debt-Relief Initiative for Poor Countries

Good news for the poor?

Gustav Ranis & Frances Stewart

> "The initiative is a breakthrough...It deals with debt in a comprehensive way to give countries the possibility of exiting from unsustainable debt. It is very good news for the poor of the world."
>
> James Wolfensohn, President, World Bank

Introduction

Recently a major debt-relief initiative was introduced by the International Monetary Fund (IMF) and the World Bank, with the support of the developed countries, for Highly-Indebted Poor Countries (HIPCs). The HIPC initiative in principle extends to 36 countries;[1] by June 2001, 23 countries had been approved for relief (reached the 'decision point') and just two (Uganda and Bolivia) had reached completion (the 'completion point') under the enhanced initiative. The initiative was originally accepted by the IMF, the World Bank and the G7 in 1996. After a very slow start, the terms were revised and made more generous at Cologne in 1999. In principle, for the 23 countries approved for relief, debt relief is projected to amount to $34billion over time, or $20bn in terms of net present value (NPV), amounting to about one-third of their debt-servicing obligations. The remaining 13 countries are projected to

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[1] Four other countries qualify for HIPC but are expected to reach a sustainable debt situation under traditional mechanisms.

receive less per country—a total of approximately another $10bn in terms of NPV.

The initiative was a response to three factors: first, strong pressure from the NGO community for debt relief, led by Jubilee 2000;[2] second, the apparently successful experience of the Brady Plan of the late 1980s in reactivating Latin American economies as private capital returned to the region once the debt burden seemed sustainable; third, since countries were not in practice servicing much of their debt, and full repayment seemed highly unlikely, debt relief appeared to be a rather cheap response to political pressures (Krugman 1990).

Debt write-off seems an obvious response to the plight of low-income, and especially sub-Saharan African, economies, where development has been extremely slow, and often negative over the last two decades. It is also an eminently campaignable issue, as Jubilee 2000 and other NGOs showed. Yet like other campaigns led by the NGOs, there is a danger that an over-simple solution is advocated and then adopted, possibly in an unhelpful form—that is in a way which does not respond to the real problems of the economies in difficulties. The aim of this paper is to investigate whether this is the case with respect to HIPC.

The HIPC initiative can be criticised from two perspectives—its design fails to ensure major new resources on reasonable terms and without cumbersome procedures; and in a sense it is answering the wrong question—the problem is not debt, nor insufficient flows of externally unearned resources, but lies elsewhere, in the failure of countries to earn foreign exchange, and in deep structural and political problems that are not addressed by HIPC.

Problems with the design of the initiative

Additionality

The extra resources apparently provided by HIPC will not generate anything like proportionate additions to the foreign exchange transfers of recipient countries. One reason is that many donor countries are likely to reduce their aid resources simultaneously. In recent years development aid has been falling generally, including to the poorest countries, and is likely to be reduced even further as a result of HIPC. Aid to Africa, for

[2] According to Clare Short, the UK Minister for Development: "There could not have been an enhanced debt-relief initiative without the NGOs" (*Financial Times*, July 17 2001).

example, was $32 per capita in 1990 and fell to only $19 per capita in 1998. As a result of HIPC, some pre-existing International Development Agency[3] credits to a number of HIPC countries have been cancelled to make way for the HIPC relief. This means that in part HIPC is simply taking away with one hand what it is giving with the other. Among bilateral donors, Japan has made it clear that any country participating in the HIPC initiative will have its concessional finance from Japan cut. Secondly, HIPC countries are currently not paying their full debt service because of their severe foreign exchange problems. The market value of their debt is far less than the face value (around 50%—see Krugman, 1990; Cohen, 2000). Putting these two factors together, it is likely that the actual additionality of resource flows will be just a fraction of the nominal relief, and could even be negative. By the same token the resource cost to donors will be very small. For example, Krugman estimates that general debt relief for developing countries would cost US tax payers less than one twentieth of the costs of the US Savings and Loan bail out.

Conditionality and the poverty reduction objective

Debt relief potentially can involve untied resources, in contrast to the project aid of much bilateral lending and the policy conditionality attached to most of the International Financial Institutions' (IFI) lending. This potential has not been realised in the formulation of HIPC. Two types of conditionality are involved in HIPC: first, all countries have to have three prior years of 'good' performance, i.e. adherence to programmes agreed with the IMF and World Bank; second, after this, forward-looking Poverty Reduction Strategy Papers (PRSPs) have to be agreed before debt relief is given. The PRSPs are apparently more participatory than the pre-agreement programmes, as local participation is a condition of their formulation. In practice, however, it seems that this supposed 'ownership' is rather token. For example, 39 organisations and regional networks in 15 African countries agreed at a meeting in Kampala, May 2001, that PRSPs "were simply window dressing".[4] The statement concluded that

> ...the PRSP process is simply delivering repackaged structural adjustment programmes and is not delivering poverty-focused development plans, and has failed to involve civil society and parliamentarians in economic policy discussions.

[3] The arm of the World Bank that provides loans to low-income countries on soft terms.
[4] 'PRSPS are Just PR say Civil Society Groups'. http://www.BrettonWoodsproject.org/topic/adjustment/a23prspsstats.html

The whole process then takes on a shape reminiscent of the structural adjustment programmes of yester-year, which, to put it mildly, were not a signal success. One major problem was that these programmes were never truly 'owned' by the recipient countries and that, consequently, the entire process came to resemble a ritual dance, with commitments officially made which were not really accepted by the body politic, and with resource flows expected to take place regardless of non-compliance—at worst with a delay—and both parties fully aware of the eventual outcome from the outset.

Although all the evidence is not yet in, from a preliminary review of PRSPs it appears unlikely that the HIPC strategy will make a major contribution to poverty reduction. Essentially the approach adopted consists of a modest increase in social sector expenditure, together with a series of piecemeal programmes which will not be enough to ensure that the condition of the great majority of the poor is, in fact, improved.

There is also a problem about tying relief rigidly to the PRSPs, since countries may face some important economic problems that lie outside direct poverty reduction, or they may require a different sequencing of reforms. Of course, if the PRSPs are really no more than dressed-up structural adjustment programmes, they face problems of rigidity that we are familiar with from experience with normal adjustment programmes.

Slow procedures

The Cologne agreement speeded up what had been an extremely cumbersome and slow process, reducing the period of prior 'good behaviour' from six to three years. Moreover, countries can go 'off-track' if they fail to meet some of the conditions in the pre-programme adjustment agreements. For example, both Guyana and Tanzania went off track in the 1990s, severely delaying their qualifying, as did Côte D'Ivoire for political as well as economic reasons. Even after Cologne, the process still takes considerable time and resources. World Bank and IMF staff have estimated that countries might take two years to prepare a PRSP.[5] Uganda worked on the programme for considerably longer.

[5] World Bank Background Press Briefing on HIPC Initiative, Dec. 18, 2000.

Inclusion/exclusion

HIPC qualification requirements lead to important exclusions from the programme. Low-income countries which do not meet the 'debt' tests[6] are disqualified irrespective of their poverty or needs—e.g. India, Bangladesh, and Nigeria are not HIPC countries. The numbers of people in poverty in these large countries hugely exceed the numbers in HIPC countries (see below).

Another category of countries that is generally 'excluded' is countries at war, or recently at war, since they do not have a record of good performance (although we should note that Uganda's current involvement in wars has not excluded it). According to the World Bank HIPC unit, "roughly a dozen countries which have yet to qualify for HIPC debt relief are either currently engaged in, or have recently ended, internal or cross-border armed conflict, or are struggling with severe governance problems which make it impossible to move forward with HIPC assistance".[7] Yet these countries are in special need of foreign resources. They need foreign exchange because of the downward movement of export earnings during war, which leads to major economic disruptions, often threatening livelihoods and lives (Stewart, 2001). These are the poorest countries in the world; eight of the ten countries with the lowest Human Development Index have recently experienced, or are currently experiencing, war. While it can be argued that the appropriate form of external assistance during war depends on political conditions, and that in some cases debt relief may not be the best way of providing aid, their exclusion from HIPC reflects and continues the general neglect of such countries by the development community, which can greatly add to the costs of war.[8]

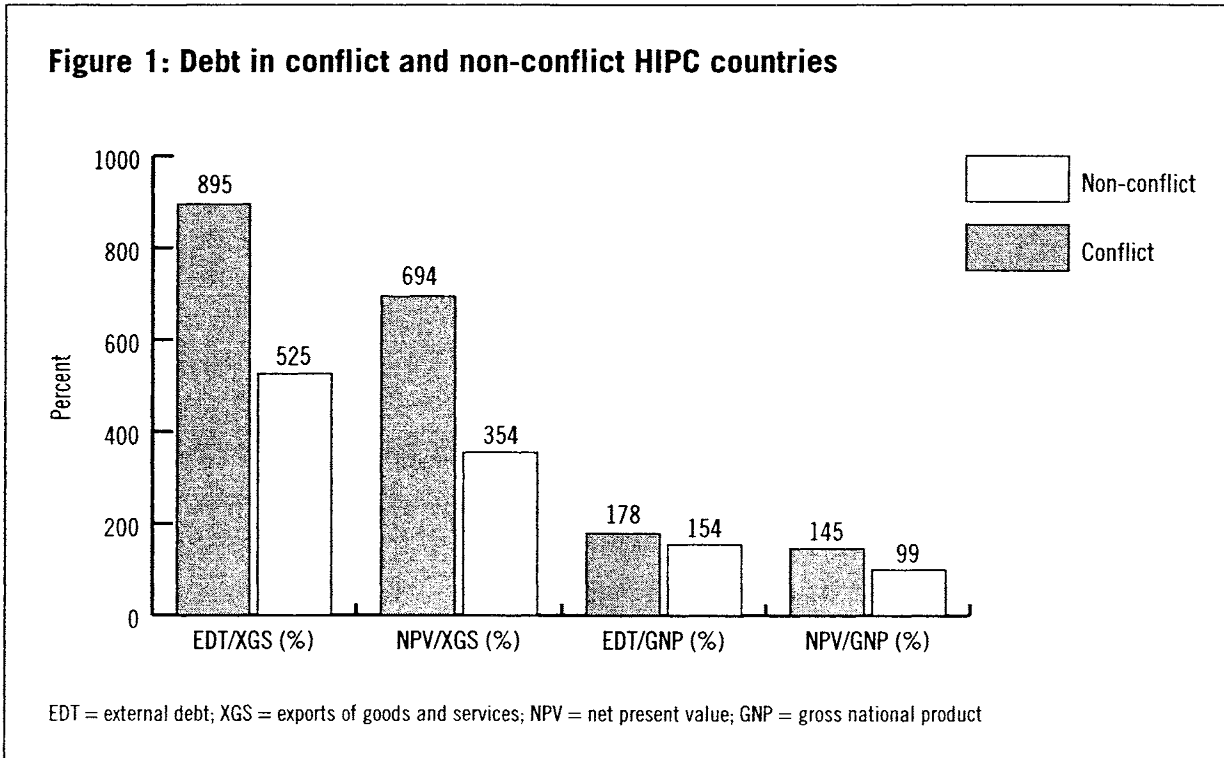
Debt relief is a particularly appropriate response to post-war situations. During war, countries typically accumulate substantial debt (see Figure 1), much of it war-related, to buy arms or meet short-term consumption requirements. Little of the borrowing goes towards economic projects that might generate potential means of servicing or repayment of debt.

[6] Low-income countries qualify for HIPC if the following three criteria are met, with the first apparently given most weight: Net Present Value of debt/exports ratio of more than 150%; debt service/exports of 15–20%; Net Present Value of debt/government revenue of more than 250%.

[7] HIPC Unit, 2001.

[8] Three of the 23 countries—Guinea-Bissau, Rwanda and Uganda—that have reached 'decision point' by June 2001 could be defined as being currently war-affected, although in each case the war does not currently affect central parts of the country—while nine war-affected countries, which include the poorest countries in the world, are not in this group.

Figure 1: Debt in conflict and non-conflict HIPC countries



EDT = external debt; XGS = exports of goods and services; NPV = net present value; GNP = gross national product

Comparisons of the debt of war-affected countries with that of other HIPC countries shows higher indebtedness on every criterion.[9] Those countries that have just ended wars urgently need untied foreign exchange resources for reconstruction.

Sustainability

The aim of the initiative is to enable countries to 'exit' from severe debt problems and enter a sustainable situation. Yet there are serious doubts about whether this objective will be realised. In many cases the debt burden remains heavy, and in some continues to rise, even after the relief has been provided. In the case of Zambia, repayments in 2001–3 will be 46% higher than in 1997–8. Debt service, after HIPC relief, is estimated to fall in 2001 compared with 2000 but rise substantially from 2004. Other countries where debt service in 2005 will exceed the 2000 level are Bolivia, Chad, Honduras and Uganda.[10] Sustainability broadly requires that growth in export earnings exceeds (or is equal to) debt servicing. The past poor record of many HIPC countries on export earnings—even after a

[9] Their relative debt would appear even greater if one allowed for the fact that a good deal of war-affected countries' borrowing is short-term, private and unguaranteed, for which data are generally deficient.
[10] HIPC Unit, June 13, 2001, Table 3a. Other countries show a greater and more sustained reduction in debt servicing after relief.

sustained record of IFI-approved adjustment—make this problematic, as does the recent trend for reduced aid flows. Export projections for the HIPCs appear to be unrealistic—for example, in four cases exports were projected to rise by over 9% per annum for twenty years.

Inadequacy in relation to needs

Even if all the resources involved in HIPC were additional, which, as noted above, is most unlikely, the extra resources would not be adequate to permit most low-income countries to generate growth sufficient for poverty reduction to fulfil the agreed international targets for halving country poverty by 2015. One report estimates that the relief would amount to no more than one-third of the additional resources needed. In Mozambique, for example, it was estimated that the HIPC package would deliver $15–20 million, while a health plan to meet basic health needs alone would cost $173m per annum (Roy, 2000).

Country distribution of net flows of external assistance

Assuming there is some addition to resource flows, HIPC distributes assistance according to the extent of indebtedness (and within the category of high indebtedness, according to past policy behaviour). This is not likely to be consistent with an 'ideal' distribution of external resources—whether defined according to needs (country poverty), or performance. As noted above, India, which has huge numbers in poverty, is excluded from the programme on the grounds of having rather low debt, as are Bangladesh, Indonesia, Nigeria and Pakistan.

As Table 1 shows, the number of poor people affected by current and potential HIPC agreements is less than a quarter of the total number in

Table 1: Low-income countries' HIPC status (IDA-status developing countries)

	HIPC granted	HIPC potential	Non-HIPC[b]
Number of countries	23	17	20
Population, millions	213	257	1672
Estimated poverty rate[a] (%)	46	28	32
Estimated numbers in poverty, millions	98	72	535

[a]Unweighted average of poverty rates for those countries for which data are available.
[b]Excludes China.
Source: UNDP, 2001; HIPC, 2001.

poverty in IDA-status low-income countries (the fraction would be substantially lower if China were included).

The rather arbitrary distribution of debt relief under HIPC is illustrated in Figures 2 to 4. These include the 23 HIPCs already granted debt relief and also the non-HIPC IDA-status developing countries. (The HIPC 'potential' countries are not included as the amount of relief they are to be granted is not known.) The amount of relief is shown as the reduction in the net present value of their debt (as calculated by the World Bank's HIPC Unit), while the non-HIPCs are shown as receiving zero relief. As the diagrams show, HIPC relief is not systematically related to countries' per capita income (Figure 1), nor to their human development failures, as indicated by the under-five mortality rate (Figure 2), nor to their past economic record, as indicated by the growth in per capita income over the 1990s (Figure 3). What the three diagrams show is that the amount of HIPC relief given to the qualifying countries is not systematically related to the criteria of either need or performance, which are generally accepted as being relevant to the distribution of aid. The diagrams also show that country inclusion in or exclusion from HIPC relief is not related to these criteria either.

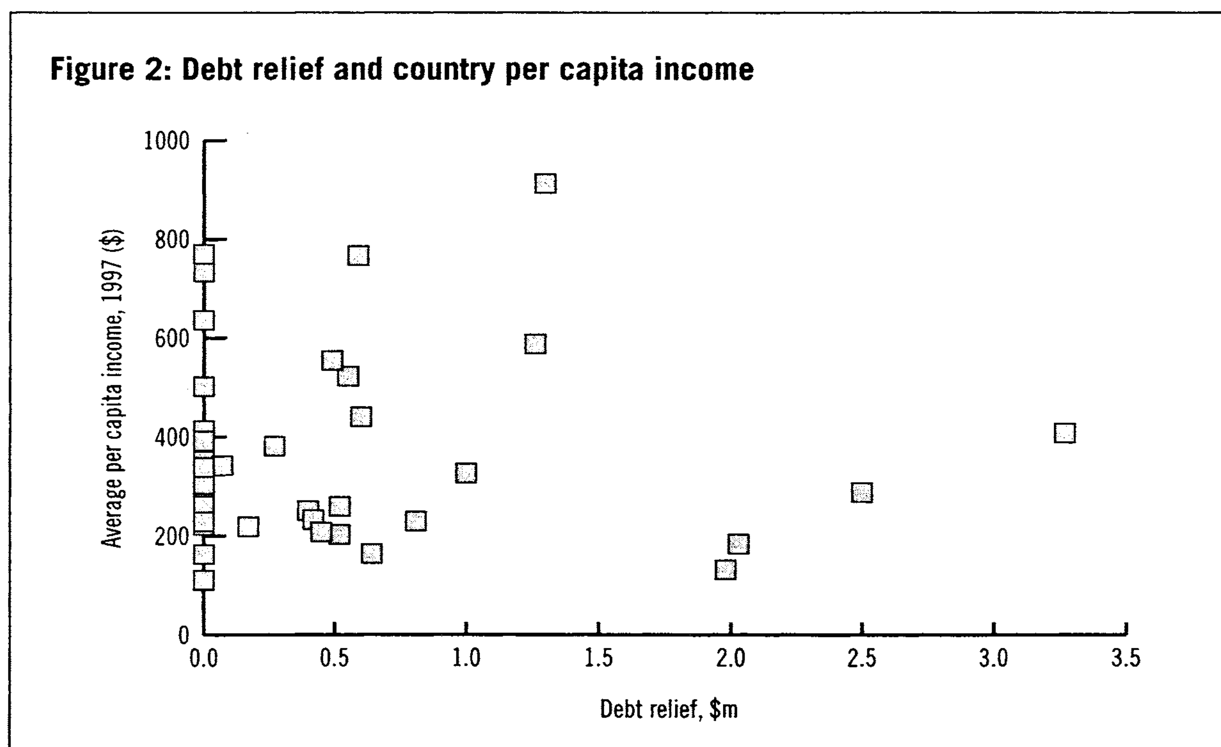


Figure 2: Debt relief and country per capita income

Figure 3: Debt relief and country under-five mortality rate

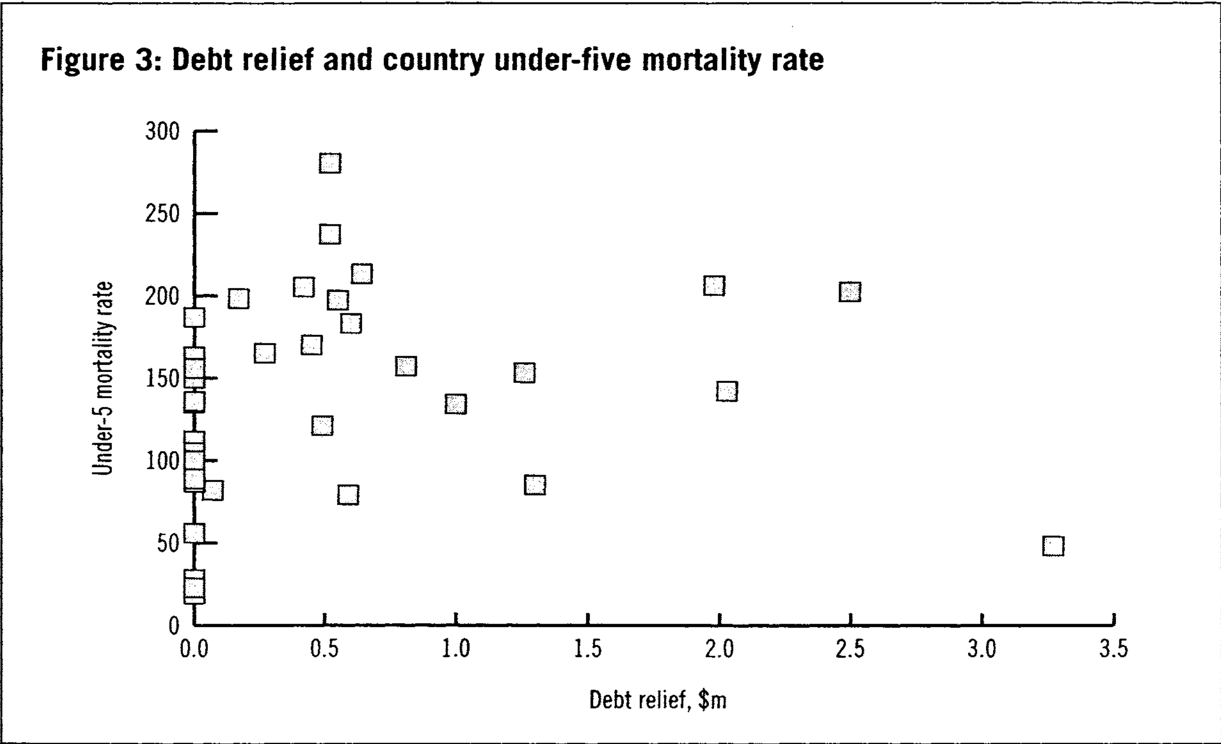
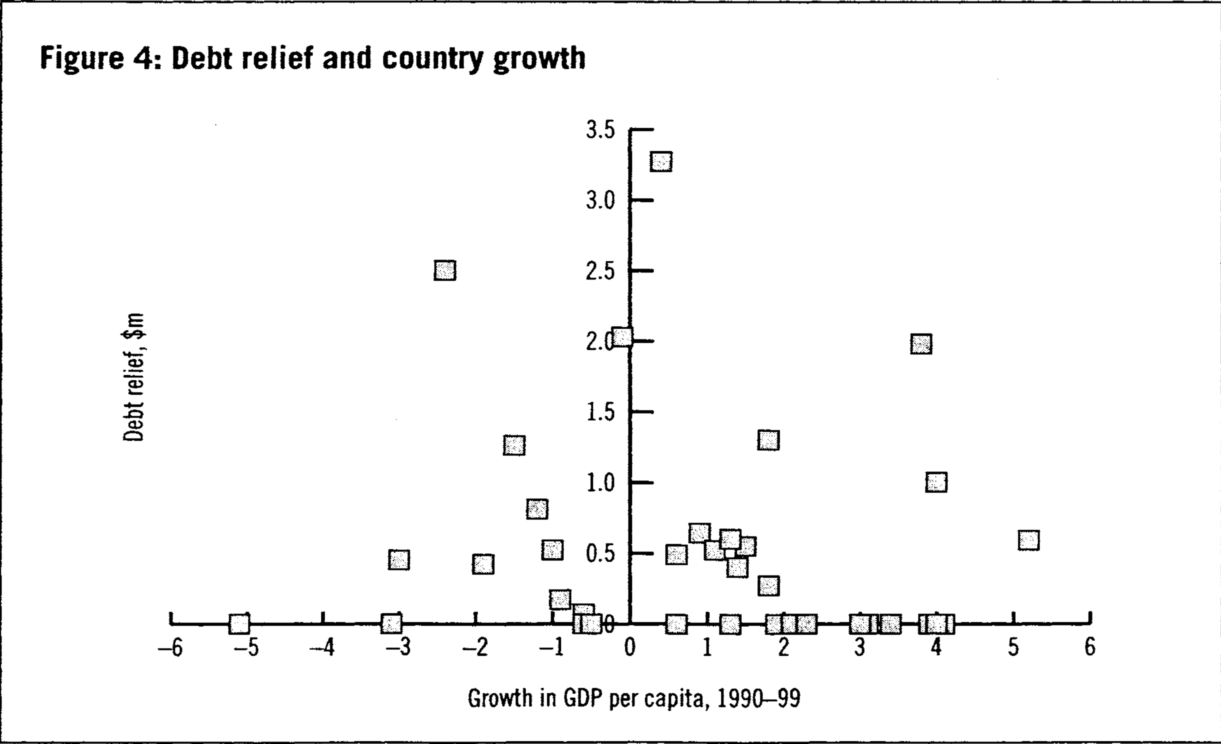


Figure 4: Debt relief and country growth



Debt is a problem, but is it *the* problem?

So much political resources and publicity have been given to the HIPC initiative that it has substantially diverted other development efforts in the HIPC countries, on the apparent assumption that it is debt that is the major factor constraining their development. The implicit comparison being made is with Latin America in the 1980s, where debt appeared to be the major obstacle to resumed growth—and indeed, following the Brady Plan, private sector inflows reemerged and growth did resume. But the situation in low-income countries, and especially in Africa, is a very different one. In the first place, most of their debt and resource inflows are from the public sector, multilateral or bilateral—approximately 37% of total external debt of poor countries is multilateral, 48% bilateral, and only 15% private (Roy, 2000). In the Brady Plan, external public funds provided the private sector with relief, revived the confidence of that sector, and led to resumed private inflows. With HIPC, however, it is public debt, not private, that is being written off. The external public sector, moreover, is likely to use this as a reason for reducing (rather than increasing) its other contributions, as noted earlier, while foreign private capital is likely to become even more cautious, unless there are other significant reforms (see below) which makes private lending to HIPC countries more attractive. It is generally not public debt burdens but other constraints that are preventing large inflows of private capital. The introduction of HIPC is not likely to make a major difference here, as indeed has been shown by the early results of countries already receiving some HIPC debt relief.

The availability of foreign capital of all kinds is obviously one important factor constraining low-income countries. But there are others that are frequently of greater importance. Three of particular relevance, especially among African economies, are the failure to *earn* sufficient foreign exchange through exports; the prevalence of civil war and political instability, which has affected as many as half of the low-income countries over the past quarter of a century; and the AIDS pandemic.

Over the last quarter of a century, African export earnings (excluding S. Africa) have increased only at the pace of population growth (2.9% p.a.), greatly handicapping growth possibilities. This failure is partly due to slow

growth in the volume of exports, but deterioration in the terms of trade[11] has played a major role. Cumulative terms-of-trade losses for sub-Saharan African non-oil exporters (excluding S. Africa) amounted to nearly 120% of average GDP, 1970–1997. Over the same period, aid transfers amounted to 178% of GDP, but the increase after 1970–73 was little more than the terms-of-trade loss (World Bank, 2000, p.21). Behind the poor performance lies a failure to diversify exports out of primary products, a failure that has not been addressed at all effectively by successive adjustment programmes. Sustained growth in export earnings is essential for sustained economic growth and poverty reduction. This is one of the reasons why HIPC conditions—which largely follow conventional adjustment programmes—are not necessarily the right ones.

Civil war has been another cause and consequence of many African countries' poor development achievements. Between 1960 and 1995, almost half the countries in the region were in conflict, and an estimated 1.5% of the 1995 population is estimated to have died directly or as a result of war-related famine. HIPC is not likely to make a significant contribution to reducing the incidence of conflict, particularly since its conditions are difficult for war-affected countries to meet.

The economic costs of AIDS in many low-income countries are very high, since it affects a huge proportion of the working-age population, in deaths, morbidity and lower productivity (Dixon, McDonald et al, 2001). Preventive action, through education and public health campaigns, is the first priority. While the current efforts to reduce the prices of retrovirals are in the right direction and may maintain the health of some HIV-affected people, it will only be effective on a large scale with greatly improved health sector infrastructure. Effective policies to reduce HIV/AIDS prevalence, as seem to have occurred in Senegal and Uganda, are essential not only for human development but also for economic growth. The fight against HIV/AIDS is noted as one element in some HIPC programmes, within the context of a rise in social expenditure, but it is generally not given the priority that is warranted.

The typical HIPC programme does not deal centrally with any of these three major development issues. There are other development problems

[11] This means that the value (as opposed to quantity) of the goods being exported by African countries has fallen relative to the prices of goods that they are importing.

in low-income countries, such as poor infrastructure, inadequate agricultural research and extension, and serious governance issues, many of which are touched on in HIPC-related adjustment programmes, but rarely tackled effectively, on present evidence.

Conclusions

Concern with the debt problem of poor countries is an important issue for those worried about the development process. The campaign of the Jubilee 2000 movement and the subsequent actions by governments and the IFIs were undoubtedly well intentioned. But James Wolfensohn's promise that HIPC offers hope to the poor of the world appears to be a false one; HIPC offers limited and highly conditional resources, most of which are not likely to be additional; the resources are not distributed according to need, and the policy packages accompanying HIPC are unlikely to do much for the major development problems which are constraining these countries' development efforts.

The volume of assistance transferred by the HIPC initiative is highly limited, and not only is the total amount potentially transferred small in relation to needs, but it seems certain that not all of it will represent additional resources. Moreover, in order to merit participation in HIPC, countries still have to undergo lengthy and cumbersome procedures. The advantages that should flow from untied programme aid are not being realised because of the considerable conditionality involved.

The qualification tests for HIPC result in the exclusion of many poor countries—including all the large ones—which means that at its fullest the programme will affect less than a quarter of the world's poor in poor (ie IDA-status) developing countries, when China is included.[12] Among HIPC countries, the actual debt relief allocation is not according to need (represented either by country per capita income or by the mortality rate among under-fives), nor according to past economic performance (as indicated by per capita income growth).

One question that should be asked is whether it is desirable that any conditionality should be associated with debt relief. Bilateral relief is given unconditionally, on the basis that the aid to these poor countries should

[12] Or around a third excluding China—see Table 1.

have been grant aid rather than loans in the first place, and that any conditionality required had been associated with the initial loans. Equally, with multilateral debt, the initial loans were associated with conditions which should have ensured repayment capacity, but failed to do so. To add a further set of conditions on relief—likely to meet the same fate as the previous conditions— severely dilutes the value of the relief, while it slows the procedures. However, political realism about the HIPC process, and also moral hazard concerns, make it certain that conditionality will remain.

There are two issues raised by the policy conditionality associated with HIPC: one is the appropriateness of the content of the packages, the other is the lack of real ownership of the package. On the first, for many countries the packages do not fully, or sometimes at all, address the major development constraints, such as absence of export diversification, prevention of wars, AIDS, and infrastructural deficits, among others. Moreover, in terms of poverty reduction alone, the Poverty Reduction Strategy Papers associated with HIPC consist of a large number of individual initiatives instead of a comprehensive programme aimed at reaching the great majority of a country's poor.

As far as process is concerned, despite a superstructure of consultative mechanisms, it is our view, endorsed by many others, that the nature of the programmes is still very much Washington-designed. True ownership requires that countries design their own programmes unconstrained by the IFIs' expectations.

We, of course, accept that making poverty reduction a major priority is highly desirable. However, the way in which this priority is to be achieved needs to be fully shifted to the recipient country, with the IFIs assuming a much more passive role. Each programme is bound to be highly country-specific, not only because economic and social circumstances differ, but also because political constraints and objectives vary greatly. Debt relief recipients should be, of course, free to seek third party advice in putting together their action programmes, and the IFIs and bilateral donors are free to respond to the proposals and suggest amendments. Such a change in modus operandi will produce more differentiated policy packages that take into account country circumstances, and also ones to which the governments are fully committed. Most importantly, they will take into account political as well as economic dimensions that need to be part of

any realistic, truly indigenous programme. Multilateral as well as bilateral donors all too often cite their own political problems, while viewing political constraints and objectives among recipients as an unwelcome and unnecessary annoyance.

Since HIPC is a current political reality, we are not suggesting that it should be abolished, but rather that it has some major defects and offers rather little for the world's poor. The major problem is the illusion that has been created that it will provide a major solution to poverty in indebted countries, rendering other actions seemingly unnecessary. The dramatic reductions in aid to these very countries—which is likely to continue—and the worsening terms of trade, dwarf any positive effects from HIPC debt relief. Moreover, the initiative diverts attention from the needs of the great majority of the world's poor who do not live in HIPC countries.

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