Publication No. 2

IMPLEMENTING THE ENHANCED HIPC INITIATIVE: KEY ISSUES FOR HIPC GOVERNMENTS

Matthew Martin and Alison Johnson

Debt Relief International Ltd
2001

ISBN 1-903971-04-7

Published by
Debt Relief International Ltd
4th Floor, Lector Court, 151-153 Farringdon Road
London EC1R 3AF, United Kingdom
Tel.: 44 (0)20 – 7278 0022 Fax: 44 (0)20 – 7278 8622 Email: publications@dri.org.uk

Printed in the United Kingdom by
In One, London

Foreword

This publication series has been launched in response to the increasing number of requests *Debt Relief International (DRI)* has received for information on the activities of the *Heavily Indebted Poor Countries (HIPC) Initiative Capacity Building Programme (CBP)* and on the technical aspects of debt analysis and negotiations needed to develop and implement national debt strategies. The aim of the HIPC CBP, funded by five European governments (Austria, Denmark, Sweden, Switzerland and the United Kingdom), is to build and strengthen the capacity of HIPC governments to develop and implement their own national debt relief strategy, and a new borrowing policy consistent with long-term debt sustainability, without having to rely on international assistance. DRI is its non-profit implementing organisation.

This series arises from DRI's experiences of working with 32 HIPC countries and in particular conducting national, regional and international workshops on debt strategy, debt negotiations, macroeconomic forecasting and poverty reduction. It is targeted mainly at senior officials and policy makers in HIPC countries, but it will be useful for officials of regional African, Asian and Latin American organisations, NGOs and academics in developing and developed countries.

The aim of the series is to present particular topics in a concise, accessible and practical way for use and implementation by HIPC governments. The series should enable senior officials and policy makers to focus on some of the key issues relating to long-term debt sustainability, macroeconomic forecasting and poverty reduction in HIPC countries. Each publication is intended to be reasonably self-contained.

The views expressed in the publications are those of the authors and not necessarily those of the HIPC CBP donors.

We welcome any comments on this publication or suggestions for other topics to be included.

Alison Johnson
Publications Editor

Yolande Eyoum
Publications Administrator

CONTENTS

Tables, Charts and Boxes

ACRONYMS AND ABBREVIATIONS

AfDB	African Development Bank
BEAC	Banque des Etats de l'Afrique Centrale
BCEAO	Banque centrale des Etats de l'Afrique de l'Ouest
BWIs	Bretton Woods Institutions (IMF and World Bank Group)
CEMLA	Centro de Estudios Monetarios Latinoamericanos
CIRRs	Commercial Interest Reference Rates
DBR	Domestic Budget Revenue
DRI	Debt Relief International
DS	Debt Service
DSA	Debt Sustainability Analysis
EIB	European Investment Bank
FSO	Fund for Special Operations (Inter-American Development Bank)
GDP	Gross Domestic Product
HIPC I	Original Heavily Indebted Poor Countries Initiative (est. 1996)
HIPC II	Enhanced Heavily Indebted Poor Countries Initiative (est. 1999)
HIPC CBP	Heavily Indebted Poor Countries Debt Strategy and Analysis Capacity Building Programme
IBRD	International Bank for Reconstruction and Development (of the World Bank Group)
IDA	International Development Association (of the World Bank Group)
IMF	International Monetary Fund
I-PRSP	Interim Poverty Reduction Strategy Paper
LIBOR	London Inter Bank Offer Rate
MEFMI	Macroeconomic and Financial Management Institute for Eastern and Southern Africa
MUV	Manufactured Unit Value
NGO	Non-governmental Organisation
NPV	Net Present Value
ODA	Official Development Assistance
OECD	Organisation for Economic Cooperation and Development
PFP	Policy Framework Paper
PRGF	Poverty Reduction and Growth Facility
PRS	Poverty Reduction Strategy
PRSP	Poverty Reduction Strategy Paper
PV	Present Value
RDB	Regional Development Banks
TDS	Total Debt Service
UNCTAD	United Nations Conference on Trade and Development
UNDP	United Nations Development Programme
WAIFEM	West African Institute for Financial and Economic Management
XGS	Exports of goods and services

SUMMARY

This paper focuses on key issues which Governments of the Heavily Indebted Poor Countries (HIPC) need to examine when analysing their own debt sustainability and implementing the Enhanced HIPC Initiative. It is designed to provide HIPC debt managers with information on the technical aspects of debt analysis, essential to doing debt sustainability analysis and preparing a national debt strategy. It covers the following issues:

- *overview of the HIPC Initiative* and eligibility criteria;
- *timing and procedural steps* of debt relief and poverty strategies (PRGF) under HIPC II;
- *debt data*: debt covered by HIPC Initiative, data reconciliation and present value calculation;
- *debt relief and new borrowing simulations*, for all different creditor types including the Paris Club bilateral, non-Paris Club bilateral, multilateral and commercial;
- *macroeconomic data*, particularly for the calculation of exports and budget revenue;
- *macroeconomic projections*, notably for the main components of the balance of payments and budget;
- *analysis of the sensitivity* and vulnerability of HIPCs to alternative macro scenarios;
- *timing of debt relief* under HIPC and how it relates to the country's track record;
- *availability of international assistance for capacity-building* and information.

I. INTRODUCTION

This paper was originally prepared as a background document for Regional and National Debt Analysis and Strategy Workshops in Heavily Indebted Poor Countries (HIPCs), organised by *Debt Relief International* (DRI). The results of these workshops are a national Debt Strategy Report for achieving debt reduction during and after the HIPC Initiative, and a national Debt Strategy Capacity-Building Plan, to ensure that the country concerned is capable of executing and updating its strategy without external assistance. Both are presented to senior government officials, the donor community, trade unions, the media and civil society organisations at Debt Awareness Seminars, held at the end of the national workshops.

The aim of a workshop is to assist the government to design a national debt strategy in the context of the Enhanced HIPC Initiative (HIPC II). Therefore this paper focuses on key issues which HIPC governments need to examine, when analysing their own debt sustainability and implementing the Initiative.

The paper is based on Debt Relief International's experience in advising and training of 32 of the Highly Indebted Poor Countries during the last six years, sometimes in co-operation with the Commonwealth Secretariat, UNCTAD and UNDP, and with funding from the Governments of the Netherlands, Sweden, Switzerland and the United States, the UNDP and the World Bank. It is also based on DRI's work for the Commonwealth Secretariat, the Group of 24, UNCTAD and UNDP in analysing the global evolution of the debt issues, the HIPC Debt Initiative, and alternative concepts of debt sustainability. In July 1997, the Governments of Austria, Denmark, Sweden and Switzerland formalised this support by creating a HIPC Debt Strategy and Analysis Capacity-Building Programme to be implemented by Debt Relief International. The United Kingdom joined this programme as a core donor in 1998. We are most grateful to all of these institutions — and especially to the Governments of the 32 HIPCs with which DRI is working, whose policy-makers and staff should take the real credit for any expertise we have gained. For, ultimately, it is the people of HIPCs who know whether the debt is sustainable or not.

The paper also draws extensively on IMF and World Bank Board papers, which have been provided to us in our official capacities as government advisers. It has been our experience that frequently — due to failures of communication— such papers do not reach the debt managers themselves in the HIPCs. Hence our concern in this paper to disseminate such information as exists on the details of implementing the HIPC Initiative, so that countries can have a clear idea of the huge demands the Initiative will place on their staff. Although this document was initially formulated to explain the original HIPC Initiative (HIPC I – established in 1996), it has been revised and updated to reflect changes incorporated in the Enhanced HIPC Initiative (HIPC II – established in 1999).

The paper is divided into sections that look in turn at key sets of issues in implementing the Enhanced HIPC Initiative. They deal with:

- **HIPC II: the eligibility criteria and timing and procedural steps** of debt relief and poverty reduction strategies (PRSPs);
- **debt data**: debt covered by the HIPC Initiative, data reconciliation and present value calculation;
- **debt relief and new disbursement simulations**, for all different creditor types;
- **macroeconomic data**, particularly on exports and budget revenue;
- **macroeconomic projections**, notably of the balance of payments and budget, and analysis of the sensitivity of HIPCs to alternative macro scenarios;

- **the availability of international assistance for capacity-building** and information.

II. THE ENHANCED HIPC INITIATIVE

2.1 HIPC ELIGIBILITY CRITERIA

The main features of HIPC II are as follows:

- To be eligible a country must be IDA-only (see Section 4.2.1) and PRGF-eligible and have established a track record of performance under adjustment programmes with the IMF and the World Bank, including approval by the IMF and World Bank Boards of an Interim Poverty Reduction Strategy Paper (I-PRSP). It must also not be expected to achieve sustainable external debt after the full use of traditional debt-relief mechanisms.

- Eligibility is determined on the basis of a tripartite debt sustainability analysis (DSA).

- A country is eligible for HIPC status if, after receiving Naples Terms treatment (67% stock reduction) by the Paris Club:
  - its present value of debt to exports ratio (PV/XGS) exceeds 150% (reduced from 200%-250%),[1]

  or
  - its present value of debt to budget revenue ratio (PV/DBR) exceeds 250% (reduced from 280%).

- Access to relief via the *fiscal window (PV/DBR ratio)* also requires a country to meet two further thresholds: the *openness criterion* of an export to GDP ratio of 30% or more and the *revenue criterion* of a budget revenue to GDP ratio of 15% (reduced from 40% and 20%, respectively, by the G7 Agreement in Cologne in 1999).

- Although it is no longer a binding criterion, the IMF and World Bank Boards have indicated that the debt service to exports ratio should fall below 15%-20% by the Completion Point.

2.2 DEBT RELIEF

The amount of debt relief to be provided to a country, on a burden-sharing basis by all creditors, is calculated at the Decision Point (see below). All creditors are encouraged to ***front-load*** debt relief and provide as much relief as possible between the Decision and Completion Points. As a result most HIPCs can now expect to receive a large proportion of their relief as soon as their Decision Point is reached.

2.3 TIMING OF RELIEF AND TRACK RECORD

The HIPC Initiative specifies two ‘stages’ and two key points for its implementation:

---

[1] The figures in brackets are HIPC thresholds used from 1996 to 1999.

- the **'First Stage'**, which lasts up to three years from the point when the country receives "Naples Terms" service treatment from the Paris Club, during which time it stays on track with its IMF / World Bank adjustment programme. This ends with:
- the **'Decision Point'**, which coincides with eligibility for stock treatment under the Naples Terms, at which a country's eligibility for and the amount of debt relief will be decided. If a country is eligible, i.e. if the ratio of either PV / exports or PV / budget revenue is greater than the threshold levels at the Decision Point , this leads into:
- the **'Second Stage'**, during which the country receives up to 90% flow reduction from the Paris Club (and other non-multilateral creditors), or more if needed to achieve sustainability, and a large part of its multilateral relief. The duration of this phase is linked to the country's success in developing and implementing its poverty reduction programme. In general, the Bretton Woods Institutions' Executive Boards expect countries to implement for at least one year, a full PRSP which they have agreed. This may take more or less than 3 years and its end date is '**floating'.** It ends with:
- the '**Completion Point'** when all creditors provide sufficient relief to achieve debt sustainability, including 90%, or more, stock treatment by the non-multilaterals, and whatever additional debt reduction is needed from the multilaterals for the country to reach sustainability.

The notion of floating Completion Points is designed to provide flexibility as to the timing of debt relief. So countries which are furthest along the road to developing and implementing their poverty reduction programmes will receive debt relief sooner. However, linking the delivery of relief in this way can be seen as adding to the 'conditionality' of debt relief.

Chart 1 sets out the different stages and timing of the HIPC Initiative and the debt relief countries can expect to receive at each point.

2.4 PROCEDURAL STEPS TO RELIEF

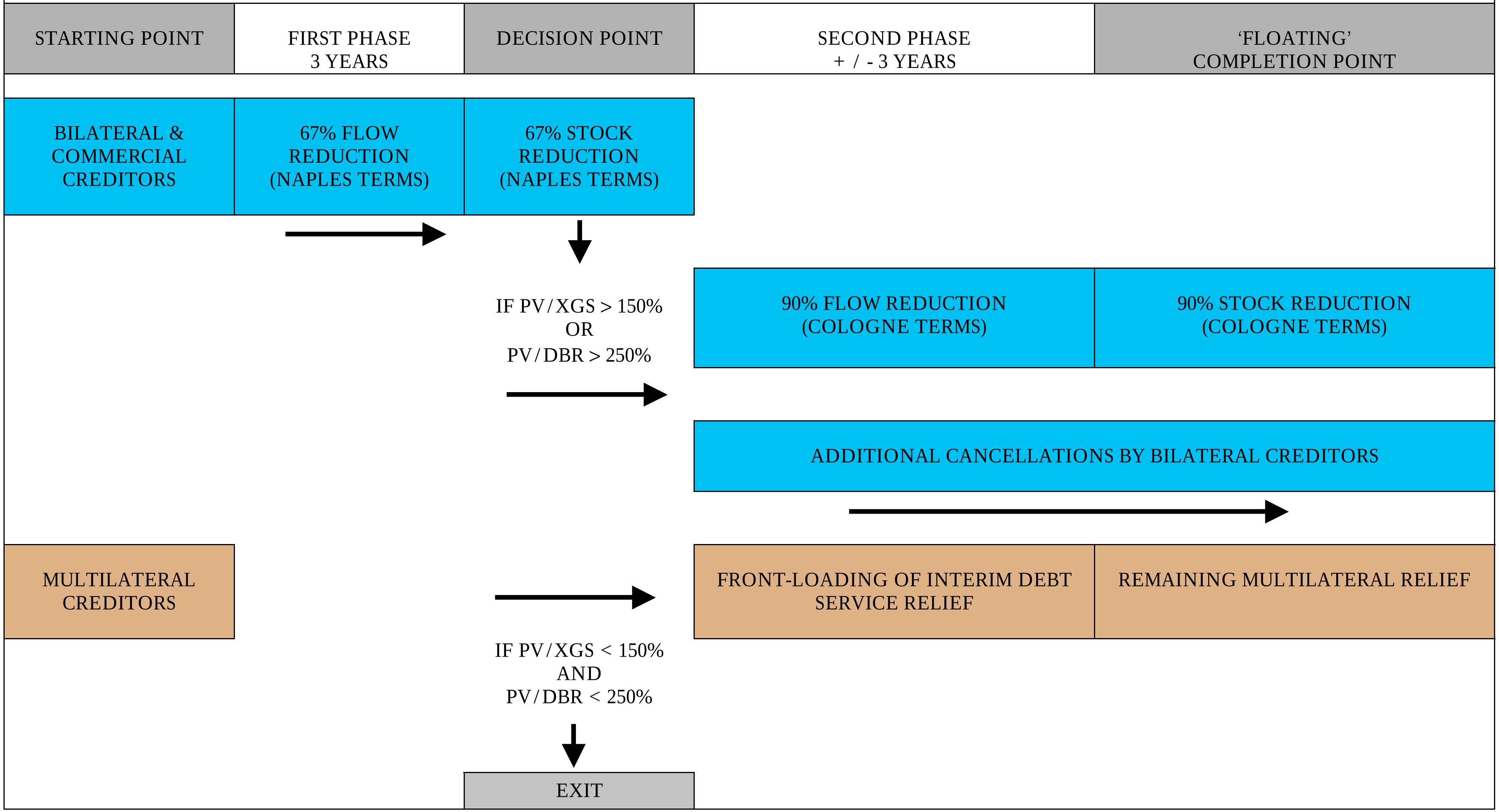
In more detail, each country has to complete a mind-bogglingly complicated and lengthy series of tasks in order to gain debt relief. The steps include:

- agreement on latest debt stock, debt service and export and budget data, including a complete reconciliation of debt data with creditors;
- preparation of a preliminary tripartite Debt Sustainability Analysis by the IMF, the World Bank and the HIPC government, including preparation of long-term debt relief, new financing and macroeconomic scenarios;
- IMF and World Bank discussion of the preliminary DSA and IMF / World Bank staff recommendations on timing and amounts for relief;
- consultations with creditors and donors on their readiness to provide relief;
- preparation of a national Interim Poverty Reduction Strategy (PRS) through consultation with civil society organisations and the donor community;
- agreement between the IMF and World Bank and the HIPC government on a formal HIPC Decision Point Document (including a final tripartite DSA) and Interim Poverty Reduction Strategy Paper (I-PRSP) and accompanying Letter of Intent for the IMF and World Bank Boards;

- IMF / World Bank Board Meetings on the HIPC Decision Point Document and Interim PRSP — ***the Decision Point***;
- a Paris Club meeting to provide relief shortly after the Decision Point;
- (between the Decision and Completion Points) annual reviews of the development and execution of the I-PRSP, and debt sustainability, and Board meetings to review the timing of the Completion Point;
- preparation and 1-year implementation of a final PRSP and revised DSA, and IMF and World Bank Board meetings to approve the HIPC Completion Point Document (including final DSA) and PRSP;
- possible additional meetings of the Paris Club and Consultative Group in order to secure adequate pledges of relief and support for poverty reduction.

This daunting list will give HIPC governments a clear idea of the scale of the tasks to be completed before receiving HIPC relief. (See Section 7 for a discussion of capacity-building needs and available international assistance.)

CHART 1: THE HIPC INITIATIVE



*Sub-criteria: XGS/GDP > 30% and DBR/GDP > 15% must also be met.

III. DEBT DATA

This section discusses three sets of issues relating to debt data: the debt covered by the Initiative; data validation and reconciliation; and the calculation of the present value of debt.

3.1 DEBT DATA COVERAGE

Under the HIPC Initiative, the Bretton Woods institutions have specified that, for the calculation of debt sustainability ratios, the debt coverage is 'limited in all cases to *public and publicly guaranteed external debt*' (IMF and World Bank, 1996). This includes all medium- and long-term borrowings of the central government, the central bank and parastatals from multilateral institutions (including the IMF), bilateral governments (Paris Club and non-OECD) and commercial credits from banks, exporters and suppliers whether or not the government directly guarantees them.

However, many have argued that, in order to assess the overall sustainability of a country's total debt burden, other categories of debt should be considered,[2] namely:

- *private sector borrowings not guaranteed by government*. This debt is particularly important in countries where foreign loans are financing large private sector projects, such as in the mining sector, which are expected to contribute significantly to export earnings;[3]
- *short-term external debt* (whether owed by government or by the private sector). In many countries, this is significant (and often it is public or publicly guaranteed). Central Bank lines of credit, which are often not reported to the World Bank, are also often important;
- *domestic debt of the government*. In order to evaluate the debt burden on the government budget, domestic debt needs to be taken into account.[4] Since domestic and external debt are alternative ways of financing the government deficit, calculation of the fiscal effects of relief on external debt needs to take into account whether the gains will be diverted to servicing domestic debt. Equally, a switch in government borrowing from external to domestic debt can present a falsely optimistic picture of the fiscal burden if only external debt is examined. In addition, with the liberalisation of foreign-exchange flows in many HIPCs, the boundary between external and domestic debt is becoming increasingly blurred, especially when countries issue domestic debt denominated in convertible currencies such as US$ or CFA Francs.

To date, the IMF and World Bank have made it clear that additional types of debt (private sector, domestic) will not be included in the debt sustainability ratios that are crucial for calculating the amounts of relief needed under the Initiative. However, there is growing pressure for the focus of relief to be on budget liquidity, taking account of the domestic debt burden (with solutions for the latter to be found outside the framework of the HIPC Initiative, see HIPC Ministerial Network, 2000), and the IMF has agreed that, where it is important, domestic debt will be fully analysed in PRGF Board Papers. It is therefore very important to have accurate data on these types of debt.

[2] See Government of Bolivia (1996); Government of Uganda (1995); Martin (1996) and (1999a); UNCTAD/UNDP (1997).

[3] The inclusion of private non-guaranteed debt in the analysis would not imply that a country was seeking relief on this debt (see Baball, 2001).

[4] Again, this inclusion would not imply that debt relief was being sought on domestic debt (see Johnson, 2000a).

3.2 DEBT DATA VALIDATION AND RECONCILIATION

One of the procedural steps leading to a country's Decision Point is the reconciliation of its debt data records with those of all its external creditors. This needs to be done on a loan-by-loan basis, with agreement on debt stock, arrears and debt servicing terms. This reconciliation needs to be extremely precise and comprehensive, and to be based on written confirmation from creditors that they agree the reconciled amounts: in other words, it is virtually a 'debt audit'. This will be an extremely time-consuming task, demanding diversion of staff time and effort to contact creditors, obtain and verify creditor records and resolve any differences between creditor and debtor data.

In addition, a number of complicated and/or controversial issues can arise:

- the valuation of non-concessional multilateral debts on a market or book value basis;
- the acknowledgement of disputed debts, such as the military debts owed to the former Soviet Union;
- the exchange rate for converting debts to the currency of repayment, such as some debts denominated in Russian roubles or Indian rupees;
- the 'ownership' of debts which have been traded directly or on the secondary market;
- the level of arrears on 'old' loans, particularly if late interest charges have been accruing;
- the inclusion of parastatal, both government guaranteed and non-guaranteed, debts which are used to calculate HIPC ratios;
- the existence of 'passive' debts, that is, loans in arrears for which creditors do not actively demand payment, and whether or not these debts have been confirmed in writing as being cancelled.

This reconciliation needs to have been completed before the Decision Point, and hence it will need to begin 6-9 months beforehand. The Bretton Woods Institutions will normally expect 95%+ of debts to be fully reconciled at the Decision Point, with some allowance for delay in reconciling disputed debts or failure of some creditors to reply.

Under HIPC II, the calculation of debt relief is done on the basis of the latest actual data available at the Decision Point (originally it was on the basis of the Completion Point). In practice, this means that the 'as of' date for freezing a country's debt database is the end of the calendar or fiscal year prior to the year of the Decision Point, depending on the annual period used in its IMF programme. So, for a country with a Decision Point in 2001 and a calendar year IMF programme, the end-2000 debt and macro data will be used to calculate eligibility and debt relief under the Initiative.

3.3 CALCULATION OF PRESENT VALUE

The key ratios used by the Bretton Woods institutions to evaluate debt sustainability (described in more detail in section 4) involve calculating the 'present value' of debt and relating it to exports or budget revenue. The rationale for using present value, instead of nominal value, is that the present value takes into account the terms and concessionality of the loan portfolio and therefore reflects accurately the costs of servicing the debt in today's money (see Box 1).[5]

[5] See Martin (2000) for arguments against the use of present value.

BOX 1 PRESENT VALUE CALCULATION

The present value of the debt is the stream of future debt service payments, discounted for the time value of money. The idea underlying the present value calculation is that money paid today is more burdensome than money paid in the future because of the opportunity cost and inflation. This means that a debt service payment of $100 today will in 'real' terms cost less if paid next year.

The general formula for calculating the present value of a payment stream is:

$$PV = \frac{S^1}{(1+r)} + \frac{S^2}{(1+r)^2} + \frac{S^3}{(1+r)^3} + \ldots + \frac{S^n}{(1+r)^n}$$

where PV = present value of the stream of future payments
S^n = debt service payments in time period n
r = discount rate

An example: if the debt service payments of a loan are $10,000 per annum for three years, the nominal value of these payments at the end of the three years is $30,000, whereas the present value of the payment stream, assuming a discount rate of 10%, is:

$$PV = \frac{10,000}{(1+0.1)} + \frac{10,000}{(1+0.1)^2} + \frac{10,000}{(1+0.1)^3} = 24,86$$

The Bretton Woods Institutions erroneously refer to Present Value (PV) of debt as Net Present Value (NPV).

Implementing the HIPC Initiative involves two sets of present value calculations:

(i) the present value before debt relief and new borrowing, which means that service on all future disbursements must be excluded;

(ii) the present value after debt relief and new borrowing simulations, when service on new disbursements will be included (for further discussions of new borrowing, see Section 4.2).

For the first of these calculations, present value will be calculated accurately only if projected debt service payments on undisbursed amounts are excluded. In addition, in order to calculate present value correctly, all future service must be included—implying that the projection period must be as long as the longest maturity period on a loan, currently up to 50 years.

A second set of present value issues revolves around the interest rate to use to discount the stream of projected debt service payments. In principle, the *discount rate* should represent the alternative cost of borrowing in financial markets (though few HIPCs can actually borrow in the markets). For HIPC Initiative purposes, the Bretton Woods Institutions use the currency-specific Commercial Interest Reference Rates (CIRRs) agreed by the OECD for officially supported export credits of the OECD countries. For non-G7 currencies, the US$ CIRR rate is also used for the Chinese Yuan, Iraqi Dinar, Russian Rouble and Inter-American Development Bank Fund for Special Operations local currency payments, if currencies or payments are linked to the US dollar. The CIRR rate for the SDR is used for all other currencies, including the African Development Bank and Inter-American Development Bank Units of Account and IBRD pooled loans.[6]

[6] If countries are unable initially to disaggregate data on a loan-by-loan currency-by-currency basis, they can calculate an initial estimate by using an average CIRR based on the currency composition and maturity of loans.

The OECD issues information on the most recent CIRR rates,[7] and the rates for the most commonly used currencies are then published by *The Financial Times* and *Le Monde*. The IMF and World Bank use the average CIRRs for the six months before the debt 'as of' date, which are available on the Debt Relief International website (see bibliography).

IV. DEBT RELIEF AND NEW DISBURSEMENT SIMULATIONS

The second major task to be performed under HIPC II is a Debt Sustainability Analysis, under which the debt data need to be treated with simulations of various debt scenarios. Two types of simulations need to be performed to calculate debt sustainability under the HIPC Initiative: debt relief simulations and new disbursement/gap-filling simulations.

4.1 DEBT RELIEF SIMULATIONS

The ultimate aim of designing debt relief scenarios is to evaluate whether a country is eligible for relief under the HIPC Initiative, and if so, the amount of relief creditors need to provide for a country to achieve sustainability at the Decision Point and the most effective way of achieving the front-loading of relief to reduce the liquidity burden between the Decision and Completion Points. It is essential to look at possible scenarios on a creditor-by-creditor basis. The more detailed the debt relief scenarios are, the more accurate will be the projections of future debt service and hence the calculations of debt sustainability and possible debt relief needs under HIPC II. It is also useful to know what precedents have been achieved by other HIPCS, as this can lead to much more rapid advances towards debt reduction.

Table 1 sets out options for each of the main creditor categories available under HIPC II.

TABLE 1 DEBT RELIEF SCENARIOS

Eligible debt types	**Debt relief options**
I. BILATERAL: **I.1. Paris Club** <u>Pre-cut-off date</u> ODA Non-concessional - not previously rescheduled - previously rescheduled under Venice, Toronto, London and Naples terms	1. <u>HIPC II terms</u>: - 67% debt service reduction before Decision Point - 67% stock reduction to test eligibility for HIPC status. If insufficient: * 90% debt service reduction between Decision and Completion points, or more by some creditors. * 90% stock reduction at Completion Point, or more on case-by-case basis.
<u>Post-cut-off date debt</u> - arrears/current service <u>Moratorium interest</u>	2. <u>Additional to HIPC II</u>: - Deferral of service (e.g. post-cut-off, moratorium interest) - Cancellation of all ODA and/or non-ODA, pre- and/or post-cut-off date debt

[7] See http://www.oecd.org/media/new-numbers/index.htm for the latest CIRR rates issued by the OECD; and http://www.dri.org.uk for tables of 6-month averages for CIRR rates.

Ineligible debts (e.g. de minimis) **I.2. Non-Paris Club**	- Conversion (price, amount up to 100% of ODA, 10% of non-ODA) 3. Exclusive from HIPC II therefore pay on schedule 1. Paris Club comparable 2. Cancellation up to 100% 3. Conversion or buyback (price, amounts) 4. Pay essential creditors
II. COMMERCIAL	1. Reschedule (terms) 2. Conversion or buyback (price, amounts) 3. Pay essential creditors
III. MULTILATERAL Concessional Non-concessional	A. Prior to Decision Point: 1. Pay all service to clear arrears (maybe with donor grant assistance through a Multilateral Debt Fund) 2. Fifth dimension for IBRD/RDBs B. Between Decision and Completion Points and After Completion Point: 1. Reduce debt service (partial payment by multilateral creditors) with emphasis on front-loading to reduce liquidity burden 2. Reschedule or refinance service 3. Buyback loans

4.1.1 Paris Club Creditors[8]

Under the HIPC Initiative, the baseline scenario will normally be to test whether a country will be eligible for the Initiative by analysing whether, after it receives the Naples terms of 67% stock reduction, its debt will reach sustainable levels.

Once a country is found to be eligible for the HIPC Initiative (i.e. its debt ratios are unsustainable after 67% relief), the Paris Club will provide up to 90% debt service reduction during the period between its Decision and Completion Points and this will be followed by 90% debt stock reduction at the Completion Point. If this is not sufficient to achieve sustainability (in terms of PV/exports or PV/revenue ratios), then Paris Club creditors will provide up to 100% reduction on pre-cut-off date[9] debt and then cancel (on a case-by-case basis) whatever percentage of post-cut-off date debt as needed to reach debt sustainability. Each creditor also implements its relief using one of two options (Option A, debt reduction or Option B, debt service reduction). A few creditors still prefer to provide relief through debt conversions.

In addition, most OECD creditors have in principle agreed to forgive all ODA debt. Some countries, notably Canada, the United Kingdom and the United States, have gone further and are providing 100% cancellation of all bilateral debt, including export credits. Another way in which the Paris Club has often in the past provided more early relief to countries has been through the deferral of service on post-cut-off date debt or of interest resulting from the rescheduling known as moratorium interest. On the other hand, if the Paris Club is less generous, countries may have to pay all post-cut-off service and moratorium interest. (Some Paris Club creditor governments have also refused until

[8] See Vilanova and Martin (2000) for details of how debt relief is implemented via the Paris Club.

[9] For the Paris Club, a cut-off date is applied whereby all loans must have been contracted before a given agreed date in order to qualify for reorganisation. The cut-off date is generally determined during the first negotiation. Loans signed prior to the cut-off date are defined as pre-cut-off date debt, whereas those signed after are post-cut-off date debt.

recently to include certain types of debt —postal, hospital or monetary debt, debt to parastatal organisations— in the debt reorganisation.)

Beyond these overall commitments, many details have to be negotiated. Countries may therefore need to simulate different types of treatment by the Club using the different Paris Club options (A/B) by creditors.

4.1.2 Non-Paris Club Bilateral Creditors[10]

For non-Paris Club bilateral creditors, the baseline scenario would be terms which are comparable with those just discussed for the Paris Club —as required under the Initiative, and agreed by all governments. However, the reality may be more complex in several ways, making scenarios more difficult. In particular:

- There is normally no cut-off date for non-Paris Club bilateral debt. HIPCs need to analyse for themselves whether creditors are likely to apply a cut-off date.
- Many non-Paris Club creditors have not charged interest on arrears, but some are starting to do so. This is a key issue for many HIPCs whose debts to such creditors are mostly in arrears, because interest arrears can substantially increase total debt.
- Some non-Paris Club creditors have provided debt relief greater than what is now available from the Paris Club (i.e. buybacks or conversions at 8% of face value). On the other hand, some have resolutely refused to reduce debts and have insisted on being paid in full. This is particularly true where loans have been disbursed recently (or are still disbursing) and would be considered 'post-cut-off' by the Paris Club. Though it has been suggested that such creditors should simply be forced to tolerate arrears, this would mean that the debt would remain in the present value of the debt and therefore increase PV ratios. As a result, for the sake of realism, several HIPCs have, in designing their own strategies, tested the potential effects of lower levels of relief by some non-Paris Club creditors.

4.1.3 Commercial Creditors

For HIPCs that have already implemented an IDA-financed buyback of commercial debt, this category of debt will not be large. Nevertheless, simulating scenarios for the remaining commercial creditors raises questions similar to those in the previous sub-section:

- some creditors —particularly those that have begun lending only very recently or are providing finance for essential imports— will refuse to provide relief on terms comparable to those of the Paris Club;
- others have refused to participate in buyback operations —and some are currently suing the HIPC government for higher settlements than the buyback price;
- some creditors insist on charging interest on arrears, where others do not.

Again, many HIPC governments have, in order not to misproject relief, tested the possible effects of different levels of participations in buybacks or Brady Deals, or different relief terms by such creditors.

4.1.4 Multilateral Creditors

Although the Enhanced HIPC Initiative enables countries to receive a large part of their multilateral debt relief from multilateral creditors between the Decision and Completion Points, in addition to

[10] For more details on debt owed to these creditors, see IMF and World Bank (2000) and DRI (2001b).

relief after the Completion Point, there remain only a few options prior to the Decision Point:

- some countries use grant funds from bilateral donors to pay multilateral debt service. Bolivia, Burkina Faso, Guinea-Bissau, Mozambique and Uganda have found that the best way to do this, enhancing debtor leadership and co-ordination, was by setting up a government-run *Multilateral Debt Fund*. Other countries have followed suit and have therefore simulated the effects of such Funds on their debt burdens before *the HIPC Initiative period*.
- countries will also continue to have access to existing facilities such as the Fifth Dimension for paying the service on their IBRD debt. These should be taken into account in simulations.
- finally, it is important to remember that countries must clear all arrears to multilateral creditors before the Decision Point, and not accumulate new arrears thereafter.

HIPC II provides for countries to receive a large part of their multilateral relief between their Decision and Completion Points as well as relief after the Completion Point (DRI, 2001a). The principle underlying the relief provided by each creditor is that of burden-sharing, and this can be achieved through a range of creditor options to achieve present value reduction of debt, namely:

- reducing debt service by a certain percentage (the creditors to pay the reduction from the sources listed below),
- rescheduling or refinancing debt service at lower interest rates and longer maturities (the subsidy is provided with the resources below), and
- buying back loans.

The modalities for delivering this relief by the multilaterals are:

- the HIPC Trust Fund, which receives contributions from participating multilateral creditors and bilateral donors and is administered by IDA,
- donor grants, and
- institutions' own resources.

The key issue is the mode of delivery of this relief as it can significantly affect a country's liquidity burden in the period between Decision and Completion Points. The ***front-loading*** of relief by, for example, 100% reduction of service in this interim period, will yield substantially more liquidity relief than a buyback which provides debt service relief over the entire debt maturities (e.g. up to 50 years). So it is essential to assess the liquidity implications of each creditor option.

Almost all multilateral institutions have agreed the way in which relief is to be delivered. However, only the African Development Bank, the European Investment Bank, the IMF and the World Bank have agreed to front-load their relief.

4.2 NEW DISBURSEMENT SIMULATIONS[11]

While debt relief scenarios simulate the restructuring of the existing debt portfolio to achieve sustainability, it is also crucial to consider how future disbursements of pipeline debt and new

[11] See Martin (2000) for a discussion of the wider issues relating to new financing; and DRI (2001c) for a discussion of country experiences.

borrowings will impact on sustainability. If HIPC governments are to achieve long-term debt sustainability, it is essential to evaluate all potential sources of new financial inflows and their cost, timing, predictability and stability, in order to design New Borrowing Policies. A New Borrowing Policy sets out the types of new finance that are most appropriate to meet the country's needs and guidelines for contracting it. For HIPCs, the optimal policy is to establish a preference for grants, followed by IDA-comparable loans, and to prohibit non-concessional loans (including export credits). This is best achieved by systematic calculation of grant elements using currency / maturity-specific discount rates.

The aim of new disbursement simulations is to calculate accurate projections of future debt service. Ideally, the new disbursement assumptions will be conducted separately for pipeline debt (loans / grants already agreed but not yet disbursed), loans / grants currently being negotiated, and possible new loans / grants to finance projects as well as balance of payments or budget support to fill financing gaps. The more detailed the new disbursement scenarios, the more accurate will be the projections of future debt service and hence the calculation of sustainability.

Table 2 shows an example of new borrowing scenarios. The parameters to be considered when projecting new disbursements include the amounts and terms, creditor-by-creditor or loan-by-loan, and the expected disbursement profile. They should also take account of any government new borrowing policy (e.g. use of grants instead of loans) or any ceilings agreed under IMF / World Bank programmes. It is crucial that the projections are very cautious, and based on recent disbursement performance (ideally project-by-project) rather than expiry dates of loans. Excessively high projections can inflate the projected present value of debt. It is also important to check whether creditors (especially the World Bank and the IMF) are using different assumptions, by sharing information with them.

TABLE 2 NEW BORROWING SCENARIOS

Creditors	New borrowing options
MULTILATERAL: IMF - PRGF IDA RDBs Other development banks Other multilaterals	Concessional (amounts, terms and disbursement profiles) Non-concessional (amounts, terms and disbursement profiles) Grants (amounts and disbursement profiles)
BILATERAL: OECD (creditor-by-creditor) Non-OECD (creditor by creditor)	Concessional (amounts, terms and disbursement profiles) Non-concessional (amounts, terms and disbursement profiles) Grants (amounts and disbursement profiles)
COMMERCIAL:	Amounts, terms and disbursement profiles
SHORT-TERM:	Amounts, terms and disbursement profiles

DOMESTIC: Treasury Bills (short-term) Treasury notes, bonds and loans Other instruments	Amounts, terms and disbursement profiles

4.2.1 Multilateral Creditors
Although many multilateral institutions lend on both concessional and commercial terms, all HIPCs are ‘IDA only’, which means they receive only concessional new commitments from the multilateral development banks and the IMF. The terms and conditions of these loans are non-negotiable. Their sizes and disbursement speeds depend on the purpose of the borrowing and the lending programmes of the institutions, with IMF loans also related to the country's quota and access limits for Poverty Reduction and Growth Facility (formerly ESAF) loans.

4.2.2 Bilateral Creditors
Bilateral creditors also lend on both concessional (aid) and non-concessional (export credit) terms. The purpose of the loan may affect the terms: for example, lending for projects or sectoral development may be concessional, whereas trade credit is always non-concessional. A few governments also offer mixed credits, which combine aid and export credit terms. However, most HIPCs have clauses in their PRGF programmes which prevent (or at least severely restrict) such loans.

4.2.3 Commercial Creditors
Most HIPC governments undertake little commercial borrowing. This reflects policies to avoid such loans whenever possible, and the high cost or lack of access to commercial loans. There is usually also a ceiling on such loans in IMF programmes. However, there may be substantial new private sector commercial loans, especially in HIPCs with liberal private sector borrowing regimes. Their disbursements and debt service have an impact on the balance of payments gap, increasing government new borrowing needs, so it is vital to project private sector loans accurately.

4.2.4 Grants
Although grants are deemed the lowest-cost finance for HIPCs, this is not necessarily true as the practice of tying aid to procurement from donor country suppliers and donors’ bureaucratic disbursement procedures can mean that grants do not represent value for money. This is particularly true of project grants, although faster disbursing programme grants for budget and/or balance of payments support are not immune to donor delays. So in projecting new grants, it is important to distinguish between project and programme grants, if possible, and to be realistic about future disbursements, taking into account a country’s own past experience on a donor-by-donor basis.

4.2.5 Domestic Debt[12]
It may be possible for governments to borrow domestically through Treasury Bills and other instruments, rather than externally: the decision may depend on interest-rate differentials and the availability of external finance. However, this is highly undesirable for countries that have high fiscal domestic debt burdens. In addition, such borrowing can destabilise fragile financial sectors. HIPCs need to take full account of the desirable balance of external and domestic borrowing.

4.3 FINANCING GAP ASSUMPTIONS

[12] See Johnson (2000b) for fuller discussion of the key issues.

Having examined the underlying assumptions for new borrowings, the next step to be considered is how any financing gaps (either in the balance of payments or the budget) will be filled — by grants, concessional loans or commercial borrowing. As with assumptions on new disbursements, gap-filling assumptions can have a crucial impact on the sustainability of the debt burden and the relief needed under the HIPC Initiative. The terms of any gap-filling loans can be the same as the assumptions on new disbursement terms, or they can vary according to a creditor-by-creditor assessment of willingness to fill the financing gap — if this is possible to assess.

V. MACROECONOMIC DATA

Under the HIPC Initiative, a country's capacity to service its debt burden is measured in terms of its export earnings and its budget revenue. This section looks at the different ways in which these denominators of sustainability ratios can be calculated.

5.1 EXPORT DATA

As one of the two key ratios used to judge debt sustainability (present value of debt to export ratio of 150%) is based on export earnings[13], export data have become a key consideration in implementing the Initiative: notably the definition of exports, and the date as at/period over which they will be measured.

5.1.1 Definition of Exports

For the purposes of the HIPC Initiative, the Bretton Woods Institutions have defined the export denominator of the sustainability ratios as exports of goods and services, as in the IMF *Balance of Payments Manual*, Fifth Edition, 1993. According to this manual,

> ‘Exports of goods are defined on a gross basis to include goods for processing, and services are defined excluding factor services.’

This means that all *exports of factor services*, including receipts for factors of production or inputs employed in a country other than where their owner resides, such as interest or dividends received from national capital invested abroad, *are excluded from the export denominator*.

In some countries *workers' remittances* are classified as factor service receipts because they are treated as payments for inputs of labour, resident in the HIPC but used abroad. Their inclusion or exclusion in exports has been a contentious issue because, in some HIPCs, these inflows can account for a large proportion of all foreign receipts from goods and services and hence have a significant impact on the assessment of sustainability. Initially the Bretton Woods Institutions stated that ‘where workers' remittances make a significant contribution to the country's debt servicing capacity, such inflows would be included in the denominator for the NPV debt-export ratio’ (IMF and World Bank, 1996). However, it has proved to be virtually impossible to include workers remittances because of difficulties in distinguishing them from other income and capital flows: there are no reliable data for

---

[13] Under HIPC II the debt service to export ratio is no longer used as a benchmark of sustainability (formerly 20-25%). Instead it is expected ‘that this ratio would fall within a range of 15-20%, or below’ by the Completion Point. See IMF and World Bank (1999a).

most HIPCs. Therefore, the Bretton Woods Institutions are now recommending that workers' remittances be excluded from the calculation of exports (IMF and World Bank, 1997a: 4, note 3).

In 2000, the Bretton Woods Institutions agreed to exclude from exports estimates of *transit and re-export trade* as 're-export does not involve a change in ownership vis-à-vis residents', and therefore 'this trade should not be recorded in balance of payments statistics, as set out in the Balance of Payments Manual (5th Edition)' (see IMF, 2000: 48). This means it should be excluded from both exports and imports. However, while agreeing to exclude re-exports from the calculation of exports and imports, the Bretton Woods Institutions have insisted that the service-related costs of the re-export trade, such as transport and insurance, provided by local businesses, plus an estimate of their profits, must be included in the calculation of non-factor service receipts. In the case of The Gambia, these receipts were estimated to be equivalent to 21.75% of re-export trade. The basis for such estimates needs to be thoroughly investigated before they are included in the calculation of exports.

5.1.2 Dates for Measurement

The issue of the dates to be used to measure debt sustainability raises two separate questions. The first is how to establish the 'as of' date whose export (and debt) data will be used in calculating the sustainability ratios. Under the Enhanced HIPC Initiative the 'as of' date for calculating both exports (and debt) data is the end of the calendar or fiscal year in the year prior to the Decision Point.

The second issue is the time period over which to measure exports. Large fluctuations in internationally priced commodities or in crop yields can give rise to export booms or slumps. To smooth out the fluctuations in annual export figures, the Bretton Woods Institutions have now agreed to calculate the present value of debt/export ratio on the basis of average exports in the 3 years prior to the year of the Decision Point. They have indicated that there could be exceptions to this rule, where detailed country-specific calculations indicate that the average would be misleading: in this case, a country-specific trend estimate will be used instead. However, this rule has not yet been applied, and countries need to evaluate carefully the implications of using different base years.[14]

5.2 BUDGET REVENUE DATA

Under the Enhanced HIPC Initiative the second eligibility criterion is a present value of debt to revenue ratio of 250% or above. To qualify for this 'fiscal window' countries must also meet two sub-criteria: the openness threshold (exports to GDP ratio of 30% or more) and the revenue threshold (revenue to GDP ratio of 15% or higher). As stated in the Board paper, Bretton Woods Institutions staff are 'not aware of a firm analytical basis which would provide specific guidance on the levels at which the exports-to-GDP and revenue-to-GDP ratios should be set' and ratios are based on 'pragmatic considerations of assuring eligibility for the most deserving cases but also containing additional costs of the Initiative' (IMF and World Bank, 1997b: 3).

It has been made clear that this denominator will be measured excluding grants, and also will be based on a sustainable definition of budget revenue (e.g. excluding privatisation receipts, and based only on central government rather than consolidated public sector data). In addition, the ratio will be calculated based on only 1 year of fiscal revenue (the year before the Decision Point data) (IMF and World Bank, 1997c). Nevertheless, countries should look closely at the volatility of their revenue, as they may wish to argue for greater flexibility.

Although it is not considered by the IMF and World Bank as an eligibility criterion for debt relief

[14] The debt service ratio will continue to be calculated on the basis of annual exports.

under the HIPC Initiative, the ratio of external debt service to budget revenue (TDS / DBR), which measures the liquidity burden of debt on the budget, is a much more crucial one, from a HIPC government's point of view, for assessing the sustainability and the timing and method of delivery for debt relief. In particular, countries need to closely examine this ratio in order to argue for the maximum front-loading of debt relief. It is also useful to look at the ratio of debt service to government expenditure as a measure of the diversion of government funds from other expenditures, such as a poverty reduction, to debt servicing.[15]

VI. MACROECONOMIC PROJECTIONS

Macroeconomic projections have two key roles in debt sustainability analysis. Firstly, the projections of exports of goods and non-factor services and fiscal revenue are the denominators of sustainability ratios, so the assumptions underlying projections of these line items are crucial. Secondly, the overall projections of the balance of payments and the budget will result (for most HIPCs) in two financing gaps (balance of payments and budget) which have to be filled through additional new borrowings or debt relief. So the accuracy of forecasting other line items in the balance of payments and the budget becomes equally important, because a larger balance of payments or budget financing gap means additional new borrowings, which in turn will increase present value and debt service, and future debt ratios.

This section highlights some of the key issues to consider in making macroeconomic projections. It does not cover issues of macroeconomic modelling —and ideally, all projections should be checked for consistency through a macroeconomic model tailored to the country circumstances.[16]

6.1 BALANCE OF PAYMENTS PROJECTIONS

6.1.1 Current Account Line Items

Projecting *export earnings of goods* depends on forecasts of both prices and volumes. Because most of the exports of HIPCs are agricultural commodities or minerals traded in world markets, a HIPC has little, if any, influence on the prices it receives for its exports. Instead, these prices are determined on international markets and, in some cases, are quite volatile. Often countries are tempted to use world market prices in conducting simulations. However, in many HIPCs, actual prices paid for their exports may diverge considerably from international market prices, due to premiums or discounts for high or low quality.

Similarly, while growth in volumes of traditional commodities may in general be related to recent trends, with a ceiling based on historical production peaks, there may be divergences because initial export price increases or marketing liberalisation may cause sharp volume increases which will not be repeated; or historical peaks may never be repeated, due to depletion of reserves or soil (as a result of overmining / overfishing, desertification or drought).

In some HIPCs, the export base is being diversified with the development of non-traditional projects in agriculture, fishing, mining, petroleum or manufactures. Some of these proposed developments have the potential to increase exports substantially when they come on stream. However, it is important to be realistic about the potential impact and timing of such exports, because over-

---

[15] See Johnson (2000a) for a more detailed discussion of the fiscal burden of debt.

[16] For more details of macroeconomic forecasting techniques, including the real and financial sectors, modelling and other issues, see Martin (1999b).

optimistic projections of the impact of such projects can mistakenly reduce the apparent need for debt relief. A useful rule of thumb might be not to include any earnings from such projects until production has actually started.

It is also useful to check whether historically there has been any consistency between export and GDP growth, and what trends should be expected in the export/GDP ratio.

Forecasting *imports of goods* involves similar assumptions about price and volume growth. If large export projects are expected then it is important to ensure that all imports required for such projects are reflected in the balance of payments projections. In addition, many HIPCs lack accurate import price or volume data (even value data may not be reliable). In such circumstances, many rely on IMF-supplied data on the prices of international manufactured goods, weighted by trade partners —so-called MUV (manufactured unit value) indices. Volumes are therefore derived from these series.

This makes it very difficult to project *import elasticities*[17] and the effects of imports on growth. Nevertheless, using such international price indices, import elasticities have been found to be around 1 for most HIPCs: i.e. import growth is roughly in line with GDP growth. Such elasticities can be used as another rule of thumb for import projections. However, it is vital to look at recent trends in the specific country in order to make sure the projections are realistic - i.e. that elasticities are no lower than recent trends, unless there are excellent reasons for such an assumption. In addition, during the development phase of large projects, or if, for example, food imports rise because of a drought, import elasticities may need to be even higher.

Service exports may often be simplistically linked to goods exports (especially for freight and insurance). But they can be positively or adversely affected by infrastructure improvements or problems (e.g. in port or rail facilities), or the development or collapse of financial services such as insurance, or of tourism projects (again caution is necessary here on possible earnings from tourism).

Imports of services can also not be linked simplistically to goods imports. *Interest payments* on external debt must obviously be consistent with the debt coverage and include the servicing of private non-guaranteed debt. *Dividend payments* must be related to investment projects in the pipeline, with a realistic rate of return higher than US$ LIBOR interest rates by a factor which takes account of country risk, and may be expected to increase gradually over time if dividend remittances are treated liberally by government.

Transfers projections should also be far more complex than simple trends. Forecasts of *workers' remittances* should be adjusted for potential political and economic changes in the host countries. *Official transfers* (aid grants) projections should reflect the most recent Consultative Group meeting pledges for the forthcoming two-three-year period, and the disbursement of these funds must be as accurate as possible and reflect recent disbursement trends. However, such aid data are often confidential to donors and difficult for HIPC governments to obtain.

6.1.2 Capital Account Line Items

The main items in the capital account for most HIPCs will be disbursements of *new borrowings* and outflows of *principal payments*. These flows must be consistent with the public and private sector borrowings anticipated in new disbursement assumptions and principal repayments resulting from the debt relief scenarios. As stressed above, it is very important that new disbursements are projected as realistically as possible for both 'pipeline' debt and new debt.

[17] Import elasticities are the percentage change in imports divided by the percentage change in GDP.

The growth of *foreign direct investment* inflows should also be realistic. As with the export projections, projections based on historical trends should not be increased until at least the moment when deals are signed, and preferably when disbursements start —because applications for or pledges of investment frequently fail to materialise. The *other capital flows* which need to be forecast include *portfolio investment* as well as other short-term and long-term capital, and it will be vital under HIPC II to try to reduce catch-all residual categories such as private transfers, other capital flows and errors and omissions. It is also essential to see such flows in net terms — i.e. allowing for all offsetting outflows of dividends and capital, and for the large external borrowings which are often associated with investment projects (and for imports of goods and services as well as exports) — and to take into account the likely speed of development of local capital markets in order to attract these flows.

The final line item to be considered is expected *reserves*. Instead of simply extending historical trends, it is essential to project a build-up of reserves which makes them adequate to fund a certain proportion of annual imports of goods and services ('import cover' which was previously defined in relation to goods only), in order to guard against severe foreign-exchange shortages. Though the desirable level of import cover is not universally agreed, many suggest ranges of between 4 and 6 months of imports. Nor is the basis for calculation agreed: many HIPCs have argued that it should even protect against US$-denominated deposits in the banking system's foreign-currency accounts.

6.2 BUDGET PROJECTIONS

6.2.1 Budget Revenue Items

As already discussed (in Section 4.2), budget revenue has only recently become a key variable in the HIPC Initiative, as a denominator in the second critical ratio. Past projections of revenue increases under adjustment programmes have often proved over-optimistic. Therefore, budget revenue projections should be highly cautious. In particular, there is no necessary reason to assume that revenue levels can quickly (or in some countries ever) return to previous historical peaks. In countries where trust in the state, or the tradition of tax payment, has disintegrated, due to protracted civil war or other internal problems, it may take decades to restore a culture where tax revenues can rise.

Most HIPCs are highly dependent on *revenue from trade taxes*. Projections of these revenues need to be closely linked to projections of imports or exports but, as already discussed in 5.1.1, exports and imports are themselves likely to be highly volatile and revenues will therefore be difficult to predict. Revenues will also depend on expected trade liberalisation policies by the government, including any preferential tariffs being given to imports from regional neighbouring countries. In addition, governments must take account of tax elasticity and buoyancy based on analysis of past reactions to changes in tax policies. Over time, given accelerating trade liberalisation, most HIPCs would be unwise to project rises in trade tax revenue.

The recent tendency in many HIPCs has been to liberalise and reduce *direct taxes on personal or corporate income*. High levels have been regarded as a disincentive to entrepreneurship: however, the evidence on whether reducing tax levels leads to higher production and therefore higher tax revenues is highly mixed, and HIPCs should avoid being too optimistic about such effects. *Indirect taxes* such as VAT have been the new focus for broadening the tax base: however, they have been subject to considerable delay (and sometimes reversal), and their revenue levels have been extremely difficult to produce —sometimes falling way short of expectations, and in other countries far exceeding them. *Land taxes* have also proved extremely complex to introduce and therefore subject to long delay.

Projections of one-off receipts from *privatisations* should be particularly cautious, because they may be subject to delay (which in turn will reduce the sale price of the enterprise). In addition, it is vital to treat them as temporary, and preferably to exclude them from revenue/GDP targets in order to ensure that permanently collectable revenues are the focus of government measures.

Finally, all projections of revenue may be linked to changes in *tax administration structures*. Many countries have established independent revenue authorities, with different management structures and salary incentives to overcome non-collection and corruption. However, in most countries, initial increases in revenue levels have levelled off, and governments have realised that an independent authority is no 'quick fix' for increasing revenue. In particular, they have found that many of the 'exemptions' from tax granted in the past have been linked in one way or another to donor projects, and that donors are reluctant to surrender these privileges.

6.2.2 Budget Expenditure Items

Budget expenditure projections (like import projections) should ideally be based on calculation of the expenditures which are necessary to produce high rates of per capita GDP growth and rapid poverty reduction, or at least the measures envisaged in the Poverty Reduction Strategy Paper (PRSP) – formerly Policy Framework Paper (PFP). Recent research has indicated that certain types of expenditure (notably on infrastructure and on human development) are much more growth-promoting, and many countries are switching to optimal methods such as medium-term expenditures frameworks and 'programme budgets' under which they budget the costs of 3-year expenditures necessary to achieve key poverty reduction programme targets.

However, given the difficulty of establishing a clear quantifiable link between budget expenditure and growth, some governments continue to base projections on increasing the nominal or real levels of different types of expenditures. More specifically, projections of *capital expenditures* are usually based on a 3-year Public Investment Programme, which is then projected for a longer period based on a certain level of nominal or real increase. Capital expenditures have often fallen short of projections in the past, due partly to delays in aid disbursements. Projections of *subsidies and transfers* have usually assumed sharp cuts due to the commercialisation or privatisation of loss-making parastatals. However, delays in privatisations, privatisations of profit-making parastatals, and payments to clear the debts of privatised companies, have often reduced net savings to negligible levels. Projections of *wage expenditures* have also often assumed nominal stabilisation or even considerable cuts, based on civil service reform programmes that are intended to reduce staff levels. However, redundancy payments have often caused initial increases in expenditures, and restructuring the salaries of the remaining public officials, in order to increase incentives, has often absorbed most of (or even exceeded) savings from staff cuts.

6.2.3 Below-the-Line Items

All of the above factors —in the absence of sharp mid-year tax rises or expenditure cuts through cash budgets— have often led countries to have to borrow more domestically or externally in order to fill budget gaps. However, the major reason for additional borrowing has usually been shortfalls in aid loan or grant disbursements. Therefore, even if these line items are not normally included in revenue, the assumptions relating to such disbursements are crucial for calculating the budget financing gaps.

Additional crucial below-the-line items may be such balancing items as payments for bond issues to recapitalise commercial or central banking systems or to clear parastatal debts or arrears of other government domestic debts. Finally, assumptions about exchange rates are central in assessing the impact of externally-driven line items (external debt service and aid/grant disbursements) on the budget balance and gap.

6.3 SENSITIVITY ANALYSIS AND VULNERABILITY INDICATORS

6.3.1 Sensitivity Indicators

HIPCs are highly prone to 'shocks' – unexpected events beyond the control of the government which impact negatively on the balance of payments or the budget.[18] As a result, it is essential to test the sensitivity of the sustainability ratios to changes in the macroeconomic environment. In particular, countries need to evaluate possible shortfalls in export earnings (arising from, for example, commodity price falls, droughts) and budget revenues and the implications these will have on debt sustainability. In other words, will a drought result in a country's debt burden becoming unsustainable again? Assessing the risks of, for example, exchange-rate changes on future debt servicing –a depreciating national currency will raise the fiscal burden of debt - is also important. Countries also need to review the volatility and reliability (or unreliability) of past forecasts which will provide guidance on the forecasting risks – for instance, whether over-optimistic export price projections have been used, growth forecasts are consistently too high and so on.

The DSA and HIPC Board paper include the results of alternative macroeconomic scenarios, comparing them with the baseline scenario on which the Poverty Reduction Strategy Paper is based. The main factors that have been tested so far in HIPC Board papers have been lower export prices and production, higher import elasticities, and changes in external financing terms. Sensitivity is then judged through the effects of the alternative scenarios on the critical ratios. These tests are fully discussed with the government, making it important for the government to establish a clear analytical base for alternative scenarios —for example:

- justifying the degree of divergence from baseline projections by basing it on country-specific analysis of the recent volatility of different line items of the balance of payments or budget;
- testing the results for consistency by combining them into overall macro scenarios using macroeconomic models;
- expanding sensitivity analysis beyond the balance of payments to the budget and GDP;
- considering, where appropriate, wider factors such as drought or natural disasters.

6.3.2 Vulnerability Analysis

It may also be useful to assess a country's vulnerability indicators in order to reinforce its arguments for debt relief in addition to HIPC treatment. Under the original HIPC Initiative, the vulnerability indicators were used to determine the precise target ratios of present value/exports and debt service/exports, within the ranges of 200-250% and 20-25% respectively. Though vulnerability indicators were eliminated under the Enhanced HIPC Initiative, they may help countries to argue for front-loading of HIPC relief or relief additional to HIPC.

The main vulnerability indicators are:

- ***export concentration***: this is to be measured as the percentage share in total exports of the main product and the three main products in the most recent year;
- ***variability of exports***: this is defined as the standard deviation in export values over the latest 10-year period for which data are available, as a percentage of the average level of exports of goods and non-factor services;
- ***current account deficit***: as a percentage of GDP, excluding interest and official transfers.

---

[18] For more details on shocks, see Martin and Alami (2001).

- ***foreign-exchange reserve coverage*** (see previous sub-section);
- ***primary budget balance*** (i.e. excluding grants and interest payments) as a percentage of GDP will also be assessed;
- ***present value of public and publicly-guaranteed debt as a percentage of GDP***;
- ***burden of government domestic debt and private sector external debt*** .

For each of the above indicators, there is currently no 'desirable' internationally established level. It is up to countries to argue their own cases based on their perceptions of vulnerability compared to other countries.

VII. CAPACITY-BUILDING NEEDS AND ASSISTANCE AVAILABLE

7.1 CAPACITY-BUILDING NEEDS[19]

Given the multiple, complex and continuous tasks envisaged for HIPC government officials (and the staffs of the IMF and World Bank) under the Initiative, it will be obvious that some governments will need vastly to strengthen their institutional structures and capacities to perform the tasks.

In particular, the multiple meetings, documents and data requirements may need higher staffing levels in key departments or divisions which are responsible for debt recording and negotiation, for export or fiscal data recording and other macroeconomic projections, and for poverty reduction programming. This may need to occur as part of a civil service reform programme that provides enhanced incentives for a slimmed-down service. In addition, many countries will require institutional reforms such as enhanced co-ordination among these different departments, and the creation of a national debt and poverty reduction strategy or debt sustainability analysis team involving all of the key agencies of government. Such structures will vary from country to country depending on the national circumstances.

The need to produce PRSPs will require in many countries the establishment of a poverty reduction analysis team of staff drawn from the key sectoral, or line, departments and agencies of government, and this may necessitate institutional reform, higher staffing levels and training for staff in the necessary analytical techniques. As part of this process government will also need to consult broadly with civil society and the donor community, and this may require in some countries a more transparent attitude on the part of government and its agencies. Those responsible for poverty reduction will also need to coordinate closely with the debt strategy and macroeconomic policy teams to ensure that i) they know the scale of the debt relief savings available for poverty reduction spending, and ii) they analyse sufficiently the links between macroeconomic policies and poverty reduction.

7.2 INTERNATIONAL ASSISTANCE FOR CAPACITY-BUILDING AND INFORMATION

[19] For details on capacity-building needs, see Debt Relief International (2000b).

In addition to institutional reforms, many HIPCs will require assistance in comprehensive capacity-building training in how to formulate their own debt and poverty reduction strategies and analyse their own debt sustainability - and regular provision of key types of information on debt, new financing, macroeconomic trends and best practices in poverty reduction programming.

Many types of assistance are available in building capacity in these areas in HIPCs. In particular, *Debt Relief International* (with financing from the governments of Austria, Denmark, Sweden, Switzerland and the United Kingdom) has been assisting 32 HIPCs through the Debt Strategy and Analysis Capacity-Building Programme (CBP). The aim of the CBP is to provide HIPC governments with full independent capacity to develop and implement their own national debt relief strategy and a new borrowing policy consistent with long-term debt sustainability, and to analyse how savings from debt relief can best be used for poverty reduction.

DRI assists governments in many different ways:

- ***demand assessment missions*** where we help them to assess their need and demand for capacity-building assistance on institutional reform, operational external and domestic debt management, debt renegotiations, new financing policies (external and domestic debt, aid and private capital flows), macroeconomic forecasting and poverty reduction programming;
- ***regional and national debt strategy workshops*** in which teams of national officials responsible for all these technical areas (12 in regional workshops and around 30 in national workshops) jointly prepare a national debt strategy report, and a capacity-building plan, for presentation to their senior policy-makers and the international donor community;
- ***regional and international subject-specific workshops*** on areas such as debt strategy analysis software (the Debt-Pro© software used by the IMF and World Bank), debt renegotiations (live simulations of negotiations with, for example, the Paris Club), domestic debt, new financing strategies (aid management and private capital flows), macroeconomic forecasting and poverty reduction programming;
- ***follow-up missions*** which provide intensive assistance on aspects of debt strategy formulation and poverty reduction programming;
- ***short-term capacity-building advisers*** (around 1-year contract), who focus on intensive training and building institutional capacity in all the above area;
- a ***HIPC Ministerial Network*** which brings HIPC Ministers of Finance and their senior officials together twice a year to agree their views on the HIPC Initiative, Poverty Reduction Strategies and their capacity-building needs and to present them to the international community;
- a ***HIPC Technical Network*** which allows HIPC officials to keep up to date on all the latest developments by contacting each other direct and confidentially. We also put them in touch with all other appropriate international and regional organisations, NGOs, private sector organisations and sources of best practice and information on issues such as commodity price forecasts, poverty reduction or international interest-rate trends;
- ***publications and a website*** which allow HIPCs to be kept up to date with the latest international best practice in debt management, macro forecasting and poverty reduction.[20]

Since its inception, DRI has trained more than 1300 officials in more than 40 events worldwide. DRI's work is fully funded by the sponsoring donors, with occasional additional co-financing for

[20] More details about DRI's activities are available on the DRI website at: http://www.dri.org.uk

specific projects. It aims at building capacity within governments but, where appropriate authorisation is given by these governments, it is also possible to involve international organisations and NGOs in some aspects of the programme.

One DRI's main aims is to hand over the implementation of the programme to regional partner organisations which are owned and run by the HIPC governments themselves. These include the BEAC/BCEAO Pôle-Dette for Francophone Africa, the Centro de Estudios Monetarios Latinoamericanos (CEMLA) for Latin America, the Macroeconomic and Financial Management Institute for Eastern and Southern Africa (MEFMI), and the West African Institute for Financial and Economic Management (WAIFEM) for Anglophone West Africa. Pending this handover DRI concentrates on building the capacity of regional experts. Of the current 92 experts it uses regularly, 72 are from the HIPCs.[21]

[21] For more details, see (Debt Relief International, 2000a).

BIBLIOGRAPHY

Baball, Balliram (2001), *Best Practices in Private Sector Debt Management*, London: Debt Relief International, forthcoming.

Boote, Anthony R., and Thugge, Kamau (1999), *Debt Relief for Low-Income Countries – The HIPC Initiative*, IMF Pamphlet Series No. 51, Washington, DC: IMF.

Debt Relief International, London: DRI.

(2000a), HIPC Debt Strategy and Analysis Capacity Building Programme.

(2000b), HIPC Capacity-Building Needs.

(2001a), *Multilateral Debt Relief Under HIPC II*, London: DRI, forthcoming.

(2001b), *HIPC Experiences of Debt Renegotiations*, London: DRI, forthcoming.

(2001c), *Negotiating New Financing for HIPCs*, London: DRI, forthcoming.

Government of the Republic of Uganda (1995), *A Strategy for Reducing the External Debt of Uganda*, Kampala: Govt. of Uganda, July.

Government of the Republic of Bolivia (1996), *Bolivia's Enhanced Debt Strategy and Proposal for Multilateral Debt Relief*, La Paz: Govt. of Bolivia, September.

HIPC Ministerial Network (2000), *Implementing the HIPC Initiative*, Declaration of the 2nd HIPC Ministerial Meeting, Geneva, 7 June.

International Monetary Fund (2000), *The Gambia – Staff Report for the 2000 Article IV Consultation*, Washington, DC: IMF, 7 July.

IMF and World Bank, Washington, DC

(1996), *The HIPC Debt Initiative - Elaboration of Key Features and Possible Procedural Steps*, 26 August.

(1997a), *CAP Paper for the Preliminary HIPC Initiative Documents for Bolivia, Burkina Faso, Côte d'Ivoire and Uganda*, 1 April.

(1997b), *HIPC Initiative - Guidelines for Implementation*, 22 April.

(1997c), *HIPC Initiative – Note on the Use of a Central Government Revenue Base*, 3 November.

(1999a), *Modifications to the Heavily Indebted Poor Countries (HIPC*), 23 July.

(1999b), *HIPC Initiative – Strengthening the Link between Debt Relief and Poverty Reduction*, 26 August.

(1999b), *Notes on Modalities for Implementing HIPC Debt Relief Under the Enhanced Framework*, 10 December.

IMF and World Bank, Washington, DC (cont.)

(2000), *HIPC Initiative – A Progress Report*, Washington, DC: IMF and World Bank, 14 April.

Johnson, Alison

(2000a), *The Fiscal Burden of Debt*, paper presented at the Commonwealth Secretariat Workshop on the HIPC Initiative, 17-18 July.

(2000b), *Analysing Domestic Debt Sustainability*, London: Debt Relief International, August.

Martin, Matthew

(1996), *A Multilateral Debt Facility: Global and National*, report for the Group of 24, London: External Finance for Africa, March.

(1999a), *Changing the HIPC Indicators*, DRI report for DFID, London: DRI, March.

(1999b), *Best Practices in Macroeconomic Forecasting: Key Issues for Discussion*, Background paper for DRI/MEFMI Regional Workshop, Dar es Salaam, Tanzania, 15-22 November.

(2000), *Financing Poverty Reduction in the Heavily-Indebted Poor Countries: Beyond HIPC II*, paper presented at the Commonwealth Secretariat Workshop on the HIPC Initiative, 17-18 July.

Martin, Matthew and Alami, Randa (2001), *Long-Term Debt Sustainability for HIPCs: How to Respond to Shocks?* London: Development Finance International, 30 January.

UNCTAD/UNDP (1997), *Debt Sustainability, Social and Human Development and the Experiences of the HIPCs*, Geneva: UNCTAD.

Vilanova, Juan Carlos and Martin, Matthew (2000), *The Paris Club*, London: DRI, August.

Websites

Debt Relief International	http://www.dri.org.uk
IMF	http://www.img.org
OECD	http://www.oecd.org
Paris Club	http://www.clubdeparis.org
World Bank	http://www.worldbank.org

DEBT RELIEF INTERNATIONAL PUBLICATION SERIES

All publications are also available in French, Portuguese and Spanish

1. Heavily Indebted Poor Countries Debt Strategy and Analysis Capacity-Building Programme
2. Implementing the Enhanced HIPC Initiative: Key Issues for HIPC Governments
3. The Paris Club
4. Overview of Debt Conversion
5. Key Issues for Analysing Domestic Debt Sustainability
6. HIPC Capacity-Building Needs

Copies of these publications can be obtained from:

Debt Relief International
4th Floor, Lector Court, 151-153 Farringdon Road, London EC1R 3AF, U.K.
Telephone: 44 (020) – 7278 0022
Fax: 44 0(20) – 7278 8622
publications@dri.org.uk