
Deepening and Extending Debt Reduction

We start from the premise that industrial countries should do more to help promote development in poor countries, because the evidence indicates that without more help poor countries will not achieve the Millennium Development Goals to which the world is ostensibly committed, even if all developing countries adopt good policies. It seems clear that the extra help needs to exceed by far any estimate of the savings of HIPC's in annual debt service under the enhanced HIPC Initiative, which we roughly suggested at the end of chapter 3 would be little more than \$4 billion annually, even if all 42 eligible countries eventually reached completion points.

Debt campaigners have argued that the need to service debt has been a serious drain on the resources of low-income countries that has inevitably impeded their efforts to provide even minimal social services to their people and to develop their economies. Even though they have sometimes failed to acknowledge that the net resource flow to these economies has always remained positive, our analysis of the efficiency benefits of debt relief suggests that they were basically right in this argument. But some portion of those efficiency benefits, as well as the selectivity benefit we identify, has or will be reaped with the debt reduction that has by now happened, or that is due to happen, under the enhanced HIPC Initiative. Are further reductions warranted? Will they bring additionality, and if not, which other developing countries will pay for them?

This is the question that prevents us drawing the conclusion that all HIPC debt should be canceled. That might make sense if debt cancellation were the only politically feasible way of goading industrial countries into

doing more. But given the likelihood that full debt cancellation would not lead to full additionality, there is a danger of diverting resources to countries where it would not necessarily be best used. Indeed, full debt cancellation altogether ignores the legitimate concern of the people in poor countries (and the debt campaigners) that future governments could waste or steal the resulting freed tax revenues and future creditors would more easily begin a new round of irresponsible lending. Complete debt cancellation for the HIPCs may not be the optimal way to advance development or increase the likelihood that the world's goal of at least halving poverty by 2015 will be achieved.

We do not claim to know the exact trade-off between the greater efficiency that deeper relief might bring and the perverse effects of any redistribution of total aid if additionality is less than complete. Instead, we ask what changes need to be made to the HIPC Initiative to make sure that debt is more predictably sustainable—so that it ceases to be a serious burden likely to impede the development process—in all the low-income countries. We suggest three avenues: deepening relief where necessary to ensure that a country's budget is not excessively burdened by debt-service payments; increasing the number of HIPC Initiative-eligible countries; and introducing a contingent mechanism to prevent debt sustainability from being undermined by circumstances beyond a country's own control. Our ideas for financing these proposals take into account our strong emphasis on maintaining intercountry equity.

Deeper Relief

The most profound of the criticisms leveled at the enhanced HIPC Initiative is that it has still got the key wrong, by focusing on the debt-export ratio as the primary measure of how much debt a country can afford to carry. If one is concerned about a country having to divert resources from basic social expenditures to servicing debt, then debt campaigners have argued that one should instead focus on what proportion of the resources available for government expenditure is preempted for debt service. For example, Oxfam (2001) has proposed that no low-income country should be expected to spend more than 10 percent of government revenue on debt service: debt should be canceled to the extent that it generates a higher burden than that. An even more profound departure from the current approach has been urged by Eurodad, in arguing for a country-by-country analysis of how much debt each country can afford to carry without preempting resources available for spending on a basic level of social service delivery.

The difficulty that we see with the Oxfam suggestion is the incentive that it gives a government to limit its search for tax revenue. Under the Oxfam formula, 10 percent of any extra tax revenue is immediately

siphoned off for debt service. Perhaps 10 percent is not a high enough figure to generate a severe disincentive effect, but it is hard to be sure. And even if there is no disincentive effect, there is surely an equity effect: a country is rewarded for having failed to collect enough taxes to pay for a decent level of social expenditures. In any event, there seems to us to be a better formula. Instead of keying the debt-service ceiling to the level of tax revenue, why not key it directly to the level of GNP? This is one variable no government is going to suppress to minimize its debt-service bill, and it provides the best single estimate of the ability to afford social services.

Currently, the decision-point HIPCs collect about 20 percent of their GNP in tax revenue.¹ If one accepts the Oxfam figure for legitimate expenditure on debt service as a proportion of revenue, one would conclude that no country should be required to spend more than 10 percent of 20 percent of GNP—that is, 2 percent of GNP—on debt service to official debtors. If a country's debt is such as to generate official debt service of more than 2 percent of GNP, then the excess should be forgiven. Table 5.1 calculates the amount of additional debt reduction that would be needed in each of 11 HIPCs that have already passed the decision point to limit debt service on publicly guaranteed debt to 2 percent of GNP. (Debt service is already no more than 2 percent of GNP in the other 11 HIPCs that are past the decision point.)

The first two columns of table 5.1 show the projected debt stock and service at completion point. The next two columns show GNP and the present percentage of GNP spent on debt service. Then there is a column that shows the debt-service goal (2 percent of GNP), followed by one that calculates the corresponding debt-stock goal, assuming the same ratio of service to stock at the completion point. The final column shows the needed reduction in debt stock. According to the calculation, the cost would be \$5.5 billion for the 11 of 24 decision-point HIPCs whose debt service currently exceeds 2 percent of GNP.

Because projections of debt stock and service at completion point are not available for HIPCs yet to reach the decision point, we make a rough estimate of the cost of debt reduction to the threshold of 2 percent of GNP for these countries. The first four columns of table 5.2 present the current debt stock, debt service, GNP, and exports for the 14 non-decision-point HIPCs.² The fifth column estimates a post-HIPC debt stock as 150

1. The average ratio of fiscal revenue (excluding grants) to GNP in 1999 for decision-point HIPCs was 19 percent, with a standard deviation of 7.5 (revenue data from World Bank 2001a; GNP from World Bank 2001b). The 20 percent figure is slightly less than in the United States and Japan, much less than in Europe, and somewhat above the average—but well below the peak—for developing countries.

2. This does not include the four HIPCs projected to reach sustainable levels of debt without receiving HIPC Initiative assistance. These four—Angola, Kenya, Vietnam, and Yemen—

Table 5.1 Additional reduction needed for post-decision point HIPCs that are above the 2 percent threshold
(billions of dollars)

	NPV of debt	Debt service	GDP	Ratio of debt service to GDP (percent)	Service goal	Stock goal	Stock reduction needed	IMF share ^a
Bolivia	1,649	260	8,660	3	173	1,098	551	33
Gambia	202	15	476	3.2	10	128	74	2
Guinea	1,254	78	2,239	3.5	45	720	534	21
Guyana	552	48	678	7.1	14	156	396	39
Honduras	2,912	204	6,649	2.5	133	1,898	1,014	48
Malawi	767	45	1,565	2.9	31	533	234	8
Mali	994	64	2,813	2.3	56	874	120	8
Mauritania	612	108	2,400	4.5	48	272	340	16
Nicaragua	1,320	116	2,231	5.2	45	508	812	21
Senegal	2,149	174	5,553	3.1	111	1,372	777	62
Zambia	2,231	151	4,059	3.7	81	1,199	1,032	213
Total							5,883	471

NPV = net present value

a. Hypothetical cost to the IMF based on current share of outstanding debt.

Note: Figures for Bolivia and Malawi include additional pledged bilateral assistance.

Source: HIPC decision-point documents. All figures are post-HIPC assistance.

Table 5.2 Cost to bring all non-decision point HICPs below the 2 percent debt-to-GNP threshold
(millions of dollars)

Country	NPV of debt ^a	Debt service	GNP	Exports	Post-HIPC debt stock	Ratio of debt service to GNP	Reduction needed	IMF share ^b
Burundi	639	27	705	79	119	0.7	n.a.	
Central African Republic	528	17	1,035	157	236	0.7	n.a.	
Comoros	120	7	193	45	67	2.0	1	
Congo, Democratic Republic of	8,022	3	n.a.	1,561	2,342	0.0		
Congo, Republic of	3,748	5	1,662	1,700	2,550	0.2		
Côte d'Ivoire	9,459	1,003	10,425	5,272	5,625	5.7	3,659	220
Ghana	4,304	468	7,634	2,309	2,204	3.1	800	44
Lao PDR	1,382	37	1,393	469	704	1.4	n.a.	
Liberia	1,318	3	n.a.	n.a.	n.a.	n.a.	n.a.	
Myanmar	3,998	88	n.a.	1,655	2,483	n.a.	n.a.	
Sierra Leone	806	21	652	77	115	0.5	n.a.	
Somalia	1,796	1	n.a.	n.a.	n.a.	n.a.	n.a.	
Sudan	8,973	57	8,819	716	1,074	0.1	n.a.	
Togo	1,004	36	1,380	539	809	2.1	39	3
Total							4,498	247

n.a. = not applicable

NPV = net present value

a. The NPV of publicly guaranteed debt is calculated by discounting the nominal public or publicly guaranteed debt figures by the ratio of nominal to net present value of total outstanding debt presented in GDF, table A1.4.

b. Hypothetical cost to the IMF based on the current share of outstanding debt.

Note: The post-HIPC debt stock (fifth column) assumes a 150 percent debt-export ratio and the hypothetical post-HIPC ratio of debt service to GNP (sixth column) assumes a constant ratio of debt stock to debt service.

Source: World Bank, *Global Development Finance CD-ROM, 2001* (GDF).

percent of exports, and the sixth calculates the ratio of debt service to GNP that such a stock would yield, again holding the ratio of service to stock constant. All but three of the countries—Côte d'Ivoire, Ghana, and Togo—would already fall below the threshold of 2 percent of GNP. The cost of additional debt reduction for these three countries is estimated at \$4.5 billion. Our total estimate to reach the 2 percent threshold for the HIPCs is thus \$10 billion.³

Consider next the alternative Eurodad proposal for limiting debt service to what it calculates each country can afford to pay. Table 5.3 shows the cost of this proposal. Total resources consist of tax revenue plus grants, whereas minimum essential spending consists of social expenditures that vary between \$40 and \$95 per head, plus domestic debt service. The difference between the two is the remaining resources reckoned to be available for such inessential expenditures as servicing foreign debt. Affordable foreign debt service is then one-third of those remaining resources. This is compared with the actual level of debt service paid abroad.

In the majority of cases, actual debt service exceeds the affordable level, leading Eurodad to advocate sufficient debt-service relief to reduce actual service to the affordable level. But in 5 of the 21 cases, affordable debt service exceeds actual service so that there is no need for further relief, whereas in 7 cases its calculation of affordable service is zero and additional grants (shown by the superscript *a*) would be needed to allow the countries to provide a minimum level of social services. The additional needs as calculated by Eurodad are \$638 million in debt-service relief and \$795 million in additional new grants, a total of slightly more than \$1.4 billion. The final column then shows the reduction in the net present value of the debt stock that would be required to generate the required level of debt-service relief, assuming that the debt-stock reduction is proportional to the debt-service reduction. This sums to \$11.8 billion.

This cost is slightly more than that of our proposal to reduce debt stock to a level that will generate debt service of no more than 2 percent of GNP, which would, we estimated, cost about \$10 billion in additional debt relief. But cost is not the issue. The really interesting feature of table 5.3 is that it shows that Eurodad calculates that achievement of their target would actually require a greater increase in grants than reduction

together represent 44 percent of the total outstanding debt of the HIPCs, but most of this debt, especially in the cases of Angola and Vietnam, is held by bilateral creditors and will be reduced with traditional Paris Club mechanisms according to Naples terms.

3. This estimate does not take into account additional bilateral debt reduction (in some cases a 100 percent write-off) that has been pledged by some European governments because data on these pledges are not yet available. This additional bilateral reduction has been estimated at \$8 billion (personal communication with the World Bank HIPC unit). Although bilateral reductions of this kind would ease pressure on the multilaterals to provide additional debt relief, they still represent an additional "cost" to the donor community.

Table 5.3 Cost of Eurodad proposal for limiting debt service (millions of dollars)

Country	Total resources	Essential spending	Remaining resources	Affordable debt service	Actual debt service	Additional resources needed		NPV of debt stock	Needed debt reduction
						Debt service reduction	Grant increase		
Benin	543	419	124	37	46	8	0	685	123
Bolivia	2,300	1,224	1,076	323	185	0	0	1,672	0
Burkina Faso	614	644	0	0	30	30	30 ^a	233	233
Cameroon	1,961	1,427	534	160	226	66	0	5,341	1,549
Gambia	96	191	0	0	16	16	95 ^a	191	499
Guinea	521	438	83	25	78	53	0	1,870	130
Guinea-Bissau	90	122	0	0	6	6	31 ^a	293	1,870
Guyana	348	280	68	20	48	27	0	282	161
Honduras	1,353	496	858	257	134	0	0	2,740	0
Madagascar	854	722	132	40	64	25	0	2,129	809
Malawi	558	750	0	0	59	59	193 ^a	839	839
Mali	661	534	127	38	64	26	0	906	376
Mauritania	436	218	217	65	80	15	0	945	170
Mozambique	1,145	930	215	65	48	0	0	761	0
Nicaragua	938	546	392	118	108	0	0	2,274	0
Niger	325	578	0	0	28	28	253 ^a	568	568
Rwanda	374	352	22	7	16	9	0	244	142
Senegal	1,168	620	548	164	159	0	0	2,007	0
Tanzania	1,626	1,816	0	0	142	142	190 ^a	2,587	2,587
Uganda	1,251	1,253	0	0	48	48	3 ^a	745	745
Zambia	895	738	157	47	136	89	0	1,575	1,024
Total						647	795		11,825

NPV = net present value

a. Needed increase in grants to supplement elimination of debt service.

Source: Eurodad (2001a).

in debt service. In other words, even a dedicated group of debt campaigners has been driven to the conclusion that further debt relief is inherently unable to deliver all that is needed.

One curiosity of table 5.3: It shows that the country that would get the largest increase in grant aid is Niger, which is a rather small country of about 10 million people but nevertheless is awarded almost a quarter billion dollars of extra grant aid. This is not because Eurodad projects Niger's social expenditure needs to be particularly high; the figure is actually slightly below Eurodad's average for per capita expenditure needs.⁴ Rather, Niger is an outlier because it raises less tax revenue as a percentage of GDP (only 10.2 percent) than any other HIPC. Does one really want to reward countries for failing to get their citizens to pay a reasonable level of taxes?⁵

This indicates the basic problem with the Eurodad suggestion: the likelihood that it would divert funding away from other low-income countries toward the HIPCs irrespective of the relative quality of countries' tax effort and spending allocations. This is much more than a hypothetical danger. The increasing dependence on aid of the heavily indebted poor countries, primarily in Africa, has played a role in reducing aid to India (from 1.5 percent of its GNP a decade ago to as little as 0.1 percent currently), despite the fact that India's tax and spending programs are relatively reasonable and its record in reducing poverty much better than that of most of the HIPCs. We conclude that our proposal to use 2 percent of GNP for debt service as a benchmark is both more straightforward and transparent, and more supportive of countries' own efforts.

Making More Countries Eligible

We have emphasized our conviction that most debt campaigners have overlooked the distributional implications of their proposals for debt cancellation. We have identified the channels through which the reduction of some countries' debt could come at the cost of other low-income countries: by diverting bilateral aid from non-HIPCs to HIPCs, by inducing a rise in the interest charges of the multilateral development banks, and by reducing new IDA lending. We have argued that maintaining the trust fund to finance HIPC debt reduction, rather than raiding World Bank reserves, is an important way to limit redistribution. Nevertheless, it is

4. Another problem with the Eurodad proposal is the likely difficulty in reaching international agreement on a formula that awarded different per capita expenditure requirements to different countries.

5. Van de Walle (2001) argues that dependence on donors has allowed some African governments to avoid the accountability to their citizens that a tax system creates.

Table 5.4 Debt indicators for potential HIPCs, 1999 (percent)

Country	Ratio of NPV of debt-to-exports	Ratio of NPV of debt-to-GNP	Ratio of debt service to exports	Ratio of debt service to government revenue	Ratio of debt service to GNP
Armenia	135	42	11	n.a.	2.9
Azerbaijan	49	18	6	11	2.3
Bangladesh	134	23	10	n.a.	1.6
Cambodia	157	59	3	n.a.	1.0
Georgia ^a	136	45	11	33	3.7
Haiti	113	15	10	n.a.	1.3
Indonesia	140	62	16	37	7.2
Kyrgyzstan	177	81	5	17	2.2
Moldova	120	70	24	n.a.	14.3
Nigeria	142	70	5	n.a.	2.7
Pakistan	219	37	19	19	3.2
Sri Lanka ^a	104	45	7	19	3.2
Tajikistan	36	29	4	n.a.	1.6
Turkmenistan ^a	116	54	30	n.a.	14.0
Uzbekistan	114	10	16	n.a.	n.a.
Zimbabwe	125	61	22	n.a.	10.5

n.a. = not available

NPV = net present value

a. Lower-middle-income countries.

Note: Public and publicly guaranteed debt only.

Source: World Bank, *Global Development Finance* (2001).

not possible to be certain that no redistribution will occur, especially through the redirection of bilateral aid.

A way of limiting inadvertent redistribution is to include more countries in the HIPC Initiative. Compare a situation in which all outstanding HIPC debt is canceled with another in which the same value of debt is canceled but by reducing the debt service of all low-income countries to x percent of GNP. In the former case, the benefit of debt relief is concentrated on the present HIPCs; in the latter case, it would be more widely distributed, and therefore less likely to penalize the countries that would be excluded under the former approach.

The danger of giving complete debt relief to a limited group of countries is that the countries that built up the deepest debt problems in the past are likely to include the countries that were most prone to waste external resources. We therefore believe that there is a strong case for making virtually all low-income countries eligible for inclusion in the HIPC Initiative.

Tables 5.4 and 5.5 give critical debt statistics for two other groups of countries. Table 5.4 contains the statistics for 16 countries that we have

Table 5.5 Debt statistics for other low-income countries, 1999
(percent)

Country	Ratio of NPV of debt-to-exports	Ratio of NPV of debt-to-GNP	Ratio of debt service to exports	Ratio of debt service to government revenue	Ratio of debt service to GNP
Afghanistan	n.a.	n.a.	n.a.	n.a.	n.a.
Eritrea	71	19	2	n.a.	1.0
India	91	13	13	16	1.9
Lesotho	91	45	9	n.a.	4.6
Mongolia	91	57	5	14	2.9
Nepal	120	32	8	21	2.0

n.a. = not available

NPV = net present value

Source: World Bank, *Global Development Finance* (2001).

seen mentioned as candidates for HIPC status, either by debt campaigners or (in the case of economies in transition) in a recent British proposal. Table 5.5 contains similar statistics for the 6 other low-income countries with populations of more than 1.5 million that belong to the IMF and World Bank.

Three of the countries in table 5.4 (Georgia, Sri Lanka, and Turkmenistan) are lower-middle-income countries rather than low-income (i.e., their GNP per capita, converted at the market exchange rate, exceeded \$755 in 2000). It is true that two of the existing HIPCs, namely Bolivia and Guyana, are also lower-middle-income countries. Tables 2.3 and 2.4 above shows that both of these were indeed very heavily indebted countries. Of the three lower-middle-income countries in table 5.4, none is comparably overindebted: although the debt-GNP ratios of both Georgia and Sri Lanka are more than 40 percent, they are only modestly more. It is true that seven HIPCs have lower debt-GNP ratios, but these are all much poorer countries. We therefore propose not considering Georgia, Sri Lanka, or Turkmenistan as candidates for an extended HIPC program.

Only three of the remaining 22 countries listed in tables 5.4 and 5.5 have a debt-export ratio above the HIPC threshold of 150 percent: Cambodia, Kyrgyzstan, and Pakistan. This group's indebtedness looks more severe according to the criterion of debt stock to GNP, whereby 12 of the 22 exceed the 40 percent norm. Ratios of debt service to exports exceed the 15 percent norm in 6 cases. Statistics for debt service to government revenue exist for only 9 of the 22 countries, and Indonesia's is more than 30 percent. The ratio of debt service to GNP looks quite high relative to the existing HIPCs, especially relative to the post-debt-relief levels shown in the final column of table 2.4. All but six are at or above the 2 percent maximum for the ratio of debt service to GNP that we suggested in the

previous section, while 7 countries exceeded the 4.1 percent pre-debt-relief average for the existing HIPC.

Although few of these countries suffer an external debt problem as severe as those of the existing HIPC before they received relief, we believe that they should be brought on board if debt relief for existing HIPC is to be deepened as proposed above. To do otherwise would be to penalize these countries for having conducted their affairs prudently in the past,⁶ and probably to redirect some aid away from countries where it would be more effective in reducing poverty. That would be both unjust and quite probably—to the extent that countries with bad policies in the past continue to have bad policies in the future—inefficient.

How much would it cost to reduce the public or publicly guaranteed (PPG) debt of these 22 countries to a level that would cut their debt-export ratio to 150 percent and their external PPG debt service to 2 percent of GNP (the levels that we selected as desirable targets in the case of the existing HIPC)? Table 5.6 shows our estimates of the cost of extending the HIPC Initiative to all other low-income countries. We lack data for Afghanistan and Uzbekistan. Six of the remaining 17 already fall below both thresholds and would therefore not be entitled to any debt reduction. The cost for the remaining 11 is estimated in two steps. First is the reduction in bilateral debt that these countries would receive under Paris Club Naples terms treatment. Receiving Naples terms from the Paris Club is a prerequisite for consideration under the current HIPC Initiative. This cost would be borne by bilateral creditors according to their share of debt owed by these countries. Second is the cost under HIPC terms (burden sharing across all creditors) of a post-Naples reduction to the threshold of a 2 percent ratio of debt service to GNP or the threshold of a 150 percent ratio of debt to exports.

The extension of Paris Club Naples terms would cost bilateral creditors about \$39 billion (column E of the table). Naples treatment would bring four countries—Azerbaijan, Kyrgyzstan, Nepal, and Nigeria—under the 2 percent threshold. Additional debt relief for the remaining seven countries would cost another \$41.5 billion (column K). Columns L-O estimate the cost to the different creditors that this \$41 billion ticket would entail. Private debt with a public guarantee makes up about \$11.5 billion, debt owed to bilateral creditors \$8 billion, and debt owed to multilateral creditors \$22 billion. This means that the overall cost to official creditors of bringing these non-HIPC under the 2 percent threshold is about \$69 billion (\$47 billion bilateral and \$22 billion multilateral).

6. In some cases, this record of past prudence has been violated more recently, but it is still true that it was earlier prudence that qualified a country like Pakistan to be a blend country, which then disqualified it as a HIPC candidate under the decision that HIPC be limited to countries with IDA-only status.

Table 5.6 Cost to bring all low-income countries below the 2 percent threshold for debt service to GNP and 150 percent threshold for debt to exports (in millions)

(A)	(B)	(C)	(D)		(E)	(F)	(G)		(H)	(I)	(K)	(L)	(M)	(N)	(O)	(P)			
Country	GNP	NPV of debt	Debt service	Share of outstanding PPG debt (percent)	Hypothetical Naples-terms treatment	Post-Naples-terms debt stock	Share of outstanding PPG debt (percent)	Post-Naples debt service	Ratio of debt service to GNP	Stock reduction needed	Bilateral cost	Cost via multi-lateral trust funds	IMF share	Cost to private sector	Total bilateral cost (E+L)				
				Bilateral			Bilateral												
				Multi-lateral			Multi-lateral												
				rate			rate												
				value			value												
Armenia	1,919	627	56	26	74	0	106	10	90	0	47	2.4	91	10	82	25	0	116	
Azerbaijan	3,449	646	78	18	77	5	79	7	87	6	69	2.0	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Indonesia	132,467	82,250	9,558	42	36	21	22,994	20	50	30	6,886	5.2	36,458	7,288	18,323	6,263	10,847	30,282	30,282
Kyrgyzstan	1,175	953	26	33	65	2	208	14	83	3	20	1.7	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Lesotho	1,110	494	51	18	74	8	58	7	84	9	45	4.1	221	15	185	6	21	73	73
Moldova	1,196	843	171	23	63	14	126	9	74	17	145	12.2	599	54	446	137	99	180	180
Mongolia	862	492	25	41	56	2	134	19	77	3	18	2.1	19	4	15	2	1	138	138
Nepal	5,155	1,627	105	12	87	1	128	4	95	1	97	1.9	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Nigeria	31,432	21,811	835	58	17	26	8,282	32	27	41	518	1.6	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Pakistan	58,817	21,912	1,877	40	52	7	5,851	19	72	10	1,376	2.3	2,328	437	1,665	179	226	6,288	6,288
Zimbabwe	5,234	3,195	551	34	56	10	722	15	72	13	427	8.1	1,866	280	1,341	249	244	1,002	1,002
Total							38,688						41,582	8,088	22,057	6,861	11,438	46,776	46,776

n.a. = not applicable

NPV = net present value

PPG = public or publicly guaranteed

Note: In all cases, the post-Naples debt stock (column F) brings the debt-export ratio below 150 percent, therefore making the ratio of debt service to GNP the binding constraint. Column E calculates a hypothetical 67 percent Naples terms reduction on bilateral debt; column H is calculated assuming a constant ratio of debt service to stock. Column K shows the stock reduction needed after Naples terms to get countries below the 2 percent threshold in column I. Columns L-O break down this reduction by creditor.

Source: World Bank, *Global Development Finance* CD-ROM, 2001. Debt-stock and service data refer to public and publicly guaranteed debt only, and all figures are presented in NPV terms. 'Stock reduction needed' is calculated assuming a constant stock-service ratio, and the costs to official creditors are calculated assuming a constant burden-sharing arrangement based on the current composition of outstanding debt.

This scenario envisages the possibility of seven small countries qualifying for debt reduction of less than \$1 billion each. The amount would be larger for Zimbabwe (\$2.6 billion), although it seems in tragically little likelihood of qualifying in the near future. Nigeria would be entitled to \$8.3 billion under Naples terms, which we assume it would take as soon as it could, because it has been requesting debt relief ever since the military despot that used to rule it was replaced. Pakistan would have been entitled to \$8.2 billion, before its December 2001 Paris Club agreement, which already reduced the NPV of its debt stock by about \$3 billion. Pakistan would also be obliged to seek further relief of \$249 million from its private creditors if the principle of comparable sacrifice of the official and private sectors were strictly maintained, which might jeopardize its relations with its private creditors who have already agreed to one restructuring. This was presented as an argument against seeking debt relief by a committee that examined Pakistan's debt problems last year (Debt Reduction and Management Committee 2001).

The really big-ticket sum, however—nearly \$60 billion—relates to Indonesia (\$11 billion of which would be borne by the private sector). Indonesia accounts for no less than 75 percent of the total cost to official creditors of providing debt relief to all 19 countries—more than twice the cost of the entire enhanced HIPC Initiative. Given how indebted Indonesia is, one cannot assume that it would not apply for debt relief.

The case of Indonesia sharply points up the dilemma of debt relief. Its inclusion would result in a major escalation in the cost of our proposals, from \$30 billion plus (\$10 billion for deepening, \$20 billion for expanding to other low-income non-HIPCs, plus the cost of the contingency facility) without participation by Indonesia, to a total of about \$79 billion plus. Until its implosion following the Thai crisis in 1997, Indonesia was a fairly heavily indebted lower-middle-income country but appeared to be making good use of the resources it borrowed and to be capable of carrying its debt load.

But contagion hit Indonesia with a vengeance, and capital flight led to severe currency depreciation after the rupiah was allowed to float, magnifying foreign-currency-denominated debts to a point where large swaths of the economy became insolvent. The consequences include a decline in income to levels that have carried the country back into the ranks of low-income countries and a major increase in the burden imposed by external debt. Surely this is a country that desperately needs the sort of debt relief that is provided by the HIPC Initiative, and its past record even under a corrupt government suggests it has the institutional capacity to make good use of it. We find the case for making Indonesia eligible to be compelling, especially given its turn to democracy.

A Contingency Facility

One of the grounds on which the analysis underlying the HIPC Initiative has been justifiably criticized by the debt campaigners is that it uses

overoptimistic assumptions to support the conclusion that the scaled-down debt of the HIPCs is now sustainable. Our own analysis of this issue in chapter 3 concluded that the assumptions, though not ludicrous, are certainly on the optimistic side. This is especially serious because low-income countries tend to be particularly susceptible to exogenous shocks to export prices and to the climate, and in some cases to import prices as well. The IMF has accepted this in principle, and it is currently estimated that the 21 countries between decision and completion points may be entitled to another \$500 million topping up at the completion point. But that still leaves them vulnerable to such shocks occurring after the completion point.

We propose that this should be corrected by creating an ability to grant additional relief if shocks that are clearly exogenous to the country result in a new erosion of debt sustainability.⁷ Technically, this would require a mechanism for identifying when a country had suffered an exogenous shock and for quantifying its balance of payments effects, as well as a fund that would finance the additional relief.

The way in which exogenous shocks should be identified is by explicitly specifying the expectations about the key exogenous variables that affect poor countries' balances of payments at the time HIPC relief is agreed to. For most countries, these will be the terms of trade (i.e., the price of exports relative to that of imports), market growth, and the climate. Expectations about the first are already quantified in the debt-sustainability analyses that have been undertaken by the World Bank-IMF HIPC unit. Expected market growth is implicitly (in most cases) the projected growth rate of export volume. Nor is it difficult to identify climatic events that seriously affect balance of payments outcomes: frosts that kill coffee crops or hurricanes that ravage a country's infrastructure are not state secrets. Quantifying the effects of a departure from expectations would be an essentially technical exercise, although there will always be scope for debate at the margin (nor is there any way to dictate *ex ante* the complete insulation of the process from political pressures).

This kind of insurance against exogenous shocks would need to cover a substantial period into the future, at least a decade,⁸ if it were to serve the role of reassuring investors that the public sector's debt burden is

7. Such contingent facilities are not completely new to the international system. For many years, the IMF has operated a Contingency Financing Facility that lends (though it does not grant) money to IMF member countries experiencing a shortfall in export proceeds due to circumstances outside their control. Similarly, the Mexican bonds issued under the Brady Plan included contingent payments to their holders that allowed them to benefit if the price of Mexican oil exports exceeded a benchmark level.

8. But probably it ought not to cover much more than a decade, so as not to create moral hazard (by destroying a country's incentive to diversify its economy to reduce its vulnerability to exogenous shocks).

sustainable. It is impossible to cost such a facility *ex ante*, because the outlay will depend upon the particular size and sequence of shocks to which the countries are subjected. Nevertheless, the \$500 million expected cost of topping up for the 20 decision-point HIPCs at completion point gives some idea of what the actual cost would be, admittedly during a world recession that has weakened commodity prices. Thus \$5 billion would be a pessimistic estimate of the cost for these 20 countries over 10 years. Considering that 10 of the remaining 12 HIPC-eligible countries yet to reach the decision point are highly dependent on commodity exports, a cost of \$5 billion for the entire set of HIPCs over 10 years may be optimistic.⁹

Another way to get a sense of the hypothetical cost of such a contingency facility is to suppose that the value of each HIPC's exports for the next decade rose only at the same rate as in the 1990s (or remained flat, for countries whose exports declined in the past). Suppose also that this occurred because of much less favorable developments in the terms of trade than were assumed in the World Bank-IMF study, which would qualify as an exogenous development. Our calculation as to how much this would cost is shown in table 5.7, where it can be seen that the cost would be about \$5.2 billion for the 24 post-decision-point countries. Of course, it is not likely that all countries would end up mirroring the experience of the 1990s—perhaps equally unlikely as their achieving 8.2 percent annual export growth—but the estimate again suggests that \$5 billion may be an optimistic figure for the cost of such a procedure for all HIPCs.

Because the IMF already has a great deal of experience in operating a contingency facility that requires similar expertise, it would be natural to locate such a facility there. Every year, the IMF would calculate whether each HIPC's debt-export ratio exceeded 150 percent. If it did, then it would examine whether the excess (or how much of the excess) could be attributed to shocks to the terms of trade, low market growth, bad weather, or other factors that could reasonably be considered exogenous, as compared with the baseline that had been previously established. These country analyses would be made available to the public. If a country's debts had increased in relation to its exports because of circumstances beyond its control, then the IMF would provide the resources to reduce the debt to 150 percent of exports, perhaps by paying IDA or other multilaterals to write off the requisite amount of IDA debt. We discuss subsequently where this money should come from.

Financing More Debt Relief

The program that we have proposed above would not be cheap. Figure 5.1 compares the cost to official creditors of our proposals as compared

9. The extra countries that we are suggesting adding are mostly much less vulnerable to commodity shocks.

Table 5.7 Hypothetical cost of contingency procedure (in millions)

	HIPC export projections		Export growth (1990-99 average)	Revised export projections (2010, based on 1990s growth)	2010 debt stock (HIPC projection)	Debt-to-export ratio (revised)	Stock goal (at 150 percent)	Reduction
	2001	2010						
Benin	392	791	2.5	489	795	1.63	734	62
Bolivia	1,442	3,108	3.6	2,054	3,333	1.62	3,081	252
Burkina Faso	305	751	-2.6	305	1,024	3.36	458	567
Cameroon	2,586	4,248	0.0	2,586	4,248	1.64	3,879	369
Chad	242	1,978	0.6	255	934	3.66	383	552
Ethiopia	952	1,815	2.6	1,199	2,439	2.03	1,799	641
Gambia	128	233	2.7	163	301	1.85	245	57
Guinea	860	1,647	-1.0	860	1,565	1.82	1,290	275
Guinea-Bissau	71	181	7.5	136	248	1.82	204	44
Guyana	718	1,037	5.0	1,114	736	0.66	n.a.	n.a.
Honduras ^a	2,673	5,456	8.5	4,361	3,323	0.76	n.a.	n.a.
Madagascar	1,046	1,811	6.5	1,731	1,929	1.11	n.a.	n.a.
Malawi	480	763	2.1	579	1,148	1.98	869	280
Mali	662	1,190	2.3	812	1,520	1.87	1,218	302
Mauritania ^b	433	528	-2.5	433	656	1.52	650	7
Mozambique	805	3,451	6.8	1,455	1,611	1.11	n.a.	n.a.
Nicaragua ^a	932	1,570	10.0	1,651	1,712	1.04	n.a.	n.a.
Niger	279	484	-4.5	279	768	2.75	419	350
Rwanda	126	367	-3.0	126	541	4.29	189	352
São Tomé and Príncipe	18	42	5.0	28	59	2.11	42	17
Senegal	1,692	2,765	-1.0	1,692	2,364	1.40	n.a.	n.a.
Tanzania ^a	1,194	2,274	7.9	1,884	3,525	1.87	2,826	699
Uganda	801	1,953	11.5	2,134	1,320	0.62	n.a.	n.a.
Zambia	1,038	2,207	-3.0	1,036	2,575	2.49	1,554	1,021
Total ^c								5,292

n.a. = not applicable

a. Stock in 2007.

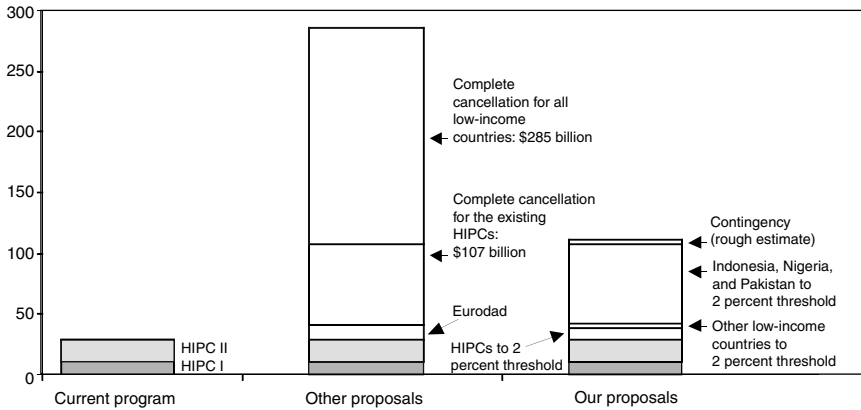
b. Stock in 2006.

c. Chad is excluded from the total because of the likely increases in exports due to exploitation of oil reserves.

Source: World Bank, *Global Development Finance CD-ROM* (2001), and HIPC Debt Sustainability Analysis (DSA) documents.

Figure 5.1 Cost estimates to public sector

billions of dollars, NPV



NPV = net present value

Note: HIPC I is the HIPC Initiative; HIPC II is the enhanced initiative.

Source: Authors' calculations.

with certain other proposals. The first bar shows the cost of the HIPC Initiative (HIPC I) and the enhanced initiative (HIPC II). The second bar adds to them the cost of the two main proposals tabled by the debt campaigners: the Eurodad proposal and the proposal to cancel all the debt of the existing HIPCs. It also shows the cost of an even more ambitious proposal, to cancel all the debt of all the low-income countries.

The figure's third bar again starts by presenting the cost of HIPC I and HIPC II, and then adds the cost to official creditors of our three proposals: to bring all the existing HIPCs down to a maximum ratio of debt service to GNP of 2 percent (\$10 billion); to expand HIPC Initiative eligibility to all other low-income countries (shown separately for the smaller debtors—\$4 billion—and then for Indonesia, Nigeria, and Pakistan—\$64 billion); and to create a contingency facility (\$5 billion). The total cost of this proposal would be comparable to the most ambitious proposals of the debt campaigners, but the distribution of the benefits would be very different, with the extra benefits accruing to other debt-burdened low-income countries rather than existing HIPCs. We now consider various ways in which additional debt relief could be financed, and then summarize our specific proposal.

IMF Gold Mobilization

As was described above, the IMF has already used an off-market gold transaction to mobilize a sum of \$3.9 billion, the interest from which helped finance the IMF's share of HIPC relief. That transaction involved a mere 14 percent of the IMF's gold holding, which in total amounts to

some 10 percent of the world's monetary gold. Because gold has long since ceased to serve any serious monetary function, IMF members could at any time agree to use additional IMF-held gold in the same way. It is true that this would amount to reducing the IMF's reserves, but, unlike the multilateral development banks, the IMF does not need a reserve to reassure lenders and thus permit it to borrow cheaply. The only function of the IMF gold stock is to reassure central bankers that their funds are safe with the IMF. We believe that the needs of the HIPC's and other poor countries are many times more compelling than safeguarding against the contingency of central bank irrationality.

An economist might argue that it would be preferable to mobilize this gold by a straightforward sale rather than by replicating the off-market transaction used in 1999, because that would release real resources to finance the debt cancellation. Such a sale might raise around \$21 billion, if all the gold were sold and the sale depressed the gold price from its present level by 10 percent. This operation would require support by 85 percent of the IMF board, which means that US support would be essential for such an operation to be approved.

But it may prove politically easier to mobilize gold by further off-market transactions, which would not offend gold producers by threatening to reduce the gold price. This would also have the advantage of releasing somewhat more money (about \$23 billion at the current price).

Some would argue that—despite the possible resistance in the US Congress to mobilizing IMF gold (or the complication that Congress would insist on other reforms at the IMF in exchange for its approval)—using gold is all too easy and cheap an escape for the donors. We do not think this logic warrants rejecting the use of gold altogether. Debt relief (and new transfers) have large potential benefits for reducing poverty, even if they do not appear to “cost” the traditional donors anything. In any event, the donor community could tie its own hands by linking gold mobilization for debt reduction to rising ODA disbursements, to avoid the gold becoming an easy out or, worse, a substitute for new donor commitments.¹⁰

10. Soros (2001) has urged that the IMF revive periodic issues of its fiat reserve asset, the Special Drawing Right (SDR), and use the proceeds to finance additional aid to developing countries. The SDR now carries a commercial interest rate (equal to the average short-term interest rate in the currencies that compose the SDR basket); he suggests that SDRs be issued to all IMF members in accordance with their quotas as provided in the IMF's Articles of Agreement, and then that the industrial countries donate their share for distribution to developing countries. They would presumably retain responsibility for paying the interest service, or would appropriate resources in their budgets at the moment of exchanging the SDRs for dollars or other currencies. We do not include this proposal because it is equivalent to a straightforward increase in donor aid budgets, though we note that it would have the advantage of providing a built-in answer to the question as to how the burden of additional relief would be spread among the industrial countries: They would bear the burden in proportion to their IMF quotas.

Increased Donor ODA

Even allowing for the possibility that Pakistan and perhaps Indonesia would not avail themselves of any debt relief offered to them, it is clear that the cost of the more ambitious of these proposals is large. In particular, extension of debt relief to Indonesia on terms similar to those that we have argued would be appropriate for the existing HIPC would be possible only if the donors were prepared to increase ODA substantially. In principle, there is plenty of scope for this: if all the donors achieved the UN aid target of 0.7 percent of GNP, the annual flow of aid would increase from about \$56 billion now to \$160 billion. Although the debt relief to which Indonesia would be entitled is massive relative to the scale of the existing HIPC Initiative, it would take less than a year's increment to the aid flow to provide that level of relief to Indonesia.

An increase in ODA would occur semiautomatically if the donors maintained their ODA disbursements at a constant level while high-income members of the Paris Club granted Cologne terms (or better) on the bilateral debt of the additional countries admitted to an expanded HIPC program. This is what we recommend. The reduction of bilateral debt would then increase ODA during the following years, as long as new disbursements were unaffected. Reduction of the multilateral debt would need to be financed by increased donor contributions to the trust fund, which would need to come from an increase in new ODA disbursements, if debt relief for some were not to be at the expense of other developing countries. (If one believes that HIPC Initiative-inspired reforms like the introduction of Poverty Reduction Strategy Papers have now created the conditions for larger aid flows to be effective, it is particularly important to ensure that other poor countries with decent institutions and policies are not inadvertently squeezed out by expanded debt relief.)

Higher Multilateral Bank Charges

Although an inadvertent passing of the burden of HIPC relief to other low-income countries as a result of drawing down the World Bank's reserves should be strongly resisted, that is not to deny the case for deliberately increasing the interest rate charged to the World Bank's middle-income borrowers. Such a step was urged by a commission sponsored by the Carnegie Endowment for International Peace (2001).¹¹ The commission's report on the future of the multilateral development banks argued that such higher interest rates were a way to encourage countries to self-

11. One of the authors of this study directed the work of the commission, and both participated as members. The commission was cochaired by Angel Gurría of Mexico and Paul Volcker of the United States.

graduate. They would also raise the profits of these banks, which would enable them to funnel increased support to the HIPC program (the World Bank already provides \$200 million a year). Given that about \$92 billion of the IBRD's outstanding loan portfolio of \$118 billion is lent to middle-income countries, this might yield the World Bank about \$460 million a year if the interest rate were raised by 0.5 percent. If the higher interest rate were charged only to upper-middle-income countries (those with a per capita income above \$2,995 a year), the annual yield would be \$235 million. If the same pricing approach were adopted by the regional development banks as well, we estimate that the annual yield would be about \$200 million.¹²

No country could be expected to welcome the prospect of paying higher interest charges for its loans. If the upper-middle-income countries were asked to bear the greater part of the burden of financing further debt relief for poor countries without the rich countries increasing their ODA, they would surely have a legitimate grudge. But if this action were to be taken in concert with higher ODA levels by the industrial countries (perhaps excluding the five that already reach the 0.7 percent target), one could hope that the upper-middle-income countries would accept it gracefully as their part of an international compact.¹³

Summary

First, by mobilizing its gold (through the off-market transaction already used once), the IMF is in a position to finance its own role in an expanded debt relief effort. That role would involve some further write-down in PRGF loans, mainly to help some of the existing HIPCs achieve the maximum ratio of 2 percent of GDP being devoted to debt service (about \$1 billion). In addition, seven of the countries on our list of potential new HIPCs had PRGF loans to reduce as of October 2001, totaling about \$900 million. IMF loans to Indonesia and Pakistan are much larger, and writing them down as part of an expanded HIPC Initiative could cost the IMF \$7 billion.

We have also suggested that the IMF should be responsible for operating the contingency facility that would provide assurance that HIPCs will not go back above a 150 percent debt-export ratio as a result of circumstances beyond their control for the next 10 years. It is in principle impossible to forecast the cost of such a facility, but experience with the existing HIPCs suggests that it might be of the order of \$5 billion. That again appears well within the capacity of the IMF to fund via gold. The IMF members' gold could in this way play an important role in relieving the burden imposed

12. The loan portfolio of middle-income countries and upper-middle-income countries in the regional banks is currently \$90 billion and \$38 billion respectively.

13. The Carnegie-sponsored commission also noted that the middle-income countries might then also expect a greater role in collective decisions about use of the additional net income.

by debt on the poorest countries (while leaving open the possibility that the IMF might even end up with as much as \$12 billion of its \$21 billion gold stock intact, if things turn out as well as its own forecasts suggest).

But the largest contribution must come from securing a major increase in the flow of ODA from donors. Some bilateral donors have already pledged a complete debt write-off to HIPC's in addition to participating in the enhanced HIPC Initiative. This is estimated to cost about \$8 billion, which could go a long way toward bringing all HIPC's under our 2 percent ratio of debt service to GNP.¹⁴ A subsequent real increase in ODA of 8 percent a year for 10 years would easily generate a cumulative total of more than \$60 billion (which is actually far less ambitious than many European countries are currently proposing). This would cover the estimated \$47 billion cost to bilaterals (table 5.6) for the extra countries that would be entitled to debt relief under our proposal. That would be true even if Indonesia, Nigeria, and Pakistan were to be offered those terms and accept them. That increase would also permit the augmentation of the trust funds that have been established to reimburse IDA and the regional development banks for the debt relief that they extend, bringing all the multilateral development banks into an expanded debt relief effort without damaging the interests of their other clients (estimated cost: \$15 billion).¹⁵

As was noted above, these "cost" estimates exaggerate the accounting cost to donors, to the extent they have already written off the uncollectible portion. In the United States, for example, a good deal of bilateral debt owed by poor countries was accounted for as a loss throughout the 1990s, so that the actual legislative authorizations for debt reduction in 2000 were much smaller than the face value of such a reduction.

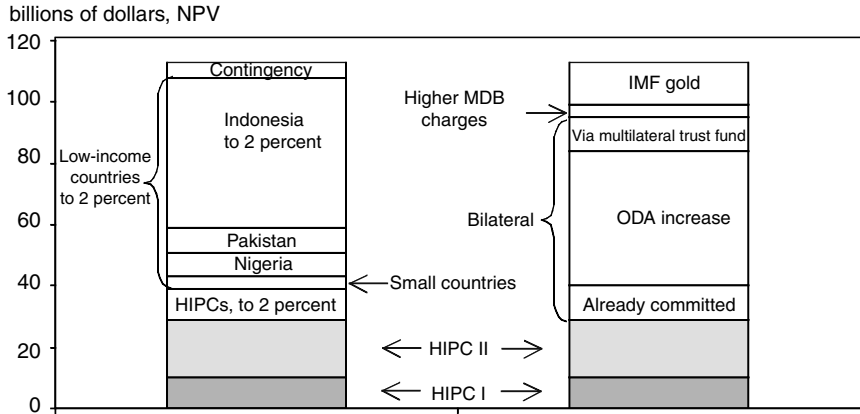
Such an increase would also give industrial countries the moral right to ask upper-middle-income countries to accept higher interest charges on their loans from the multilaterals, thus generating possible additional resources of about \$4 billion over 10 years. Though the amount is small, this approach has the advantage of involving the upper-middle-income countries as donors in the international community, beginning to eliminate what is becoming an increasingly false distinction between donors and recipients.¹⁶

14. This \$8 billion already pledged more than covers the bilateral component of our \$10 billion estimate to bring all of the HIPC's under our threshold 2 percent ratio of debt service to GNP, thus providing some funds to go to the multilateral trust funds.

15. Indonesia represents 25 percent of the Asian Development Bank's (ADB's) total outstanding loan portfolio (\$10-40 billion) and has \$11 billion in IBRD outstanding loans. Table 5.6 shows that after Naples terms, Indonesia would still need a 50 percent reduction in its multilateral debt, which would mean a \$5 billion hit for both the ADB and IBRD. In this context, donors should allow the ADB access to the HIPC Trust Fund to finance part of the ADB's debt reduction for Indonesia, and to ensure the financial integrity of the institution.

16. Note that Mexico and South Korea are already members of the OECD, and several of the upper-middle-income borrowers in Eastern Europe are hoping to join the European Union.

Figure 5.2 Authors' proposals



MDB = multilateral development bank

NPV = net present value

Figure 5.2 summarizes our financing proposal. The right-hand bar shows HIPC I and II, the bilateral share (about \$70 billion—\$11 billion of which has already been pledged via complete cancellation for HIPCs and Pakistan’s Paris Club deal in December 2001, plus about \$59 billion that would finance additional bilateral cancellation and funding of the multilateral trust funds), higher financing from multilateral development bank charges (\$4 billion over 10 years), and use of IMF gold (\$9 billion for deepening and extending, plus the \$5 billion estimate for the contingency facility).

If the donors do not agree to an increase in their ODA budgets for this debt reduction, then it would not be possible to make the three large countries—Indonesia, Nigeria, and Pakistan—eligible for debt reduction. We think eligibility should be offered to these countries. But if some of the donors refuse to sanction modest aid increases, then the resources for such an expanded program simply will not be present. One could still expand debt relief for the existing HIPCs by adding the 2 percent ceiling (estimated cost: \$10 billion), adding the seven other small countries that would qualify for debt relief to the list of HIPCs (at an estimated cost of \$4 billion), and putting in place the contingency facility we discussed. This program could be financed by the already pledged bilateral debt reduction plus IMF gold. In either event, it will be critical to monitor donor commitments to not squeeze existing aid programs, by holding donors to steady disbursements for future aid programs.¹⁷

17. Complete debt cancellation for the existing HIPCs would certainly threaten the level of ODA to non-HIPCs in the absence of higher ODA; the one circumstance in which it would be justifiable would be if it led to a high measure of additionality (and therefore did not squeeze non-HIPCs).