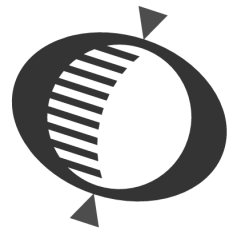

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Reducing the Debt of the Poorest: Challenges and Opportunities

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INTRODUCTION

Of the 41 countries that fall within the World Bank/International Monetary Fund's Heavily Indebted Poor Country (HIPC) group, 29 are classified by the United Nations (UN) as "least developed"—countries experiencing long-term impediments to economic growth.[1] If that HIPC group is extended to the 50 suggested by the Jubilee 2000 campaign, the number of least developed rises to 35.[2] In addition, it should also be noted that 85.1 % of the debt owed by the 41 HIPCs in 1998 was owed to multilateral and bilateral creditors (i.e. the Bretton Woods Institutions, regional banks, and sovereign countries).

These facts clearly suggest that, for countries at the centre of the current debt crisis, the typical profile is one of high poverty levels, weak economic structures, and a large (and unrepayable) foreign debt owed largely to public rather than private entities. This profile distinguishes the current debt crisis from that of the mid-1980s when the countries typically recognized as severely indebted were from the middle-income group, had fairly advanced economic infrastructures, and their debt was owed largely to private commercial creditors.[3]

This profile of the typical HIPC country presents the international community with both opportunities and complications. The public nature of the debt means that debt relief is directly amenable to collective fiat. Decisions as to how, when, and by how much the debt of these countries can be reduced is very much a public decision, to be implemented within the public domain. The world's wealthiest countries dominate the bilateral creditor group, lay claim to most of the capital base of the international financial institutions (quota subscriptions in the case of the IMF), and have overwhelming control over these institutions' governance structures. In short, these groups of creditor countries, loosely coincident with the Paris Club group, have the wherewithal to ensure that any collective decision taken on debt relief can be implemented quickly.

However, this also places debt relief much more within the political than the economic arena. Neither creditor governments nor multilateral institutions are subject to the discipline of secondary markets in the manner that commercial banks were in the mid- to late 1980s. This unfortunately means that political expediency rather than economic rationale dictates how much of the debt will be forgiven. Yet the anticipated effects of debt relief are largely based on an assumption that relief will be at economically effective levels. It is quite conceivable that this fundamental incongruity between the philosophy and practice of debt relief may doom the enterprise to failure from the start by limiting the scope of debt relief in the face of heightened expectations.

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[1] The 41 countries that form the HIPC group are: Angola, Benin, Bolivia, Burkina Faso, Burundi, Cameroon, Central African Republic, Chad, Democratic Republic of Congo, Congo, Côte d'Ivoire, Equatorial Guinea, Ethiopia, Ghana, Guinea, Guinea-Bissau, Guyana, Honduras, Kenya, Laos, Liberia, Madagascar, Mali, Mauritania, Malawi, Mozambique, Myanmar, Nicaragua, Niger, Rwanda, Saô Tomé and Principe, Senegal, Sierra Leone, Somalia, Sudan, Tanzania, Togo, Uganda, Vietnam, Yemen, Zambia. The Jubilee 2000 additions are: Bangladesh, Cambodia, Comoros, The Gambia, Haiti, Malawi, Nepal, Philippines, and Zimbabwe.

[2] Jubilee 2000 is a multinational coalition of NGOs and other like-minded organizations that argue for "one-off cancellation of the unpayable debts of the world's poorest countries by the year 2000, under a fair and transparent process."

[3] As will be pointed out later, this does not imply that the debt problems of the poorest countries had not yet reached crisis proportions. The difference was that, at that time, the debt of most (though not all) of the poorest countries was not recognized as being excessive.

The fact of extreme and pervasive poverty in the debtor countries means that debt relief has the potential to greatly stimulate efforts at poverty reduction in particular and human development in general. However, there is significant potential for a slip between cup and lip. Given that most of these countries were able to service (on average) less than 50 % of their debt, anything less than a significant (and front-loaded) reduction in the current debt burden may provide little or no debt relief dividend that can be applied to poverty reduction. Even if such a dividend was forthcoming, it risks being squandered in non-productive government spending. Beyond that, the presence of a debt relief dividend and its proper application could actually lead to a slow-down in poverty alleviation and human development in these countries if debt relief is accompanied by a reduction in the Official Development Assistance (ODA) they would have received.

The structural weaknesses in those economies mean that debt relief could provide the breathing space these countries need to concentrate on required institutional and infrastructure development, thereby laying the groundwork for future, sustained, economic growth. However, if these structural weaknesses are ignored in favour of an obsessive focus on macroeconomic variables, these countries' long-term development may be further delayed in the face of futile attempts to generate short- and medium-term growth at all costs. Such an approach might well set into motion another cycle of ill-advised borrowing (however concessional), followed by stagnation, over-indebtedness, and further stagnation.

This paper attempts to put current debt reduction efforts into perspective by explicitly addressing the above mentioned opportunities and complications of debt relief for the poorest countries. The aim is to help current attempts at debt relief become more cognizant of both the opportunities and limitations of debt relief, particularly in the context of wider global efforts at poverty reduction and continued human development in the developing world.

These issues will be addressed in three sections. Section one deals with the developing-country cost of heavy debt burdens—the cost in terms of foregone human development. The second section addresses the mechanics of debt relief, the options for structuring debt relief, potential instruments, and the role and nature of conditionality. Section three deals with the creditor costs of debt relief and the potential conflict between debt relief and ODA. The paper ends with a summary of the issues raised and a discussion of the direction of future research.

I. THE DEVELOPMENT COSTS OF HEAVY DEBT BURDENS

How did we get here?

As will be made clear later in this section, there are definite growth and human development costs associated with the heavy debt burdens of some of the world's poorest countries. However, it is instructive to ask how we have come to the point when most of the world's poorest people, outside of China and India, carry an additional burden of unrepayable debt. The cause of the current debt crisis cannot be explained simply as the thoughtless accumulation of foreign debt by these countries. Unlike the middle-income countries, the typical HIPC country benefited only marginally from the large private credit flows that marked the late 1970s. Originally, most of these countries' debt was accumulated from bilateral (mainly export) credit. More recently, a significant proportion of the debt has been accumulated from multilateral credit, provided by the international financial institutions as counterparts to stringent adjustment programs.

For answers we need to look beyond the mere accumulation of debt itself. Foreign borrowing—and the resultant accumulation of foreign debt—has been a *sine qua non* of the development process for well over a century, and has been practiced by the most successful economies. There is a sound economic (and accounting) logic that favours public sector borrowing in developing (and developed) countries.

In countries with less-than-spectacular savings rates, foreign borrowing by the public sector simultaneously provides needed resources for public investment (or other essential services), avoids the crowding out of private investment that results from domestic borrowing, and provides scarce foreign exchange. Such borrowing will have no distortional effects on the economy as long as future growth (and a commensurate increase in the revenue-generating capacity of the government) provides additional revenues to cover debt servicing obligations (out of the government budget), and the foreign exchange provided by exports, new capital inflows, and foreign reserves can readily accommodate the requisite foreign exchange demand for debt servicing (in addition to normal import demand).

Unfortunately, the level of debt and debt servicing obligations at which these requirements are no longer met (i.e. when government revenues and/or available foreign exchange are no longer adequate) may be quite low for many developing countries. More importantly, it varies over time depending on the state of the global economy. The current debt crisis facing the poorest countries is thus due less to the reckless borrowing that precipitated the debt problems of the middle-income countries in the 1980s than it is to the fact that changes in the global economy had placed new, permanent, limits on these countries' debt carrying capacities—a reality the rest of the world was slow in recognizing.

Table 1 (see Appendix) suggests that most of the current HIPC countries were perhaps still solvent in the late 1970s (in the period immediately after the first oil shock) despite carrying substantial debt loads. Though debt service commitments generally accounted for a substantial proportion of government revenues (13.8 % on average), export prices were still high and there was room for revenue expansion. In the early 1980s, these countries increased their debt loads in an attempt to cope with another downturn in the global economy. Most of them were not considered heavily indebted at that time but, in retrospect, they had already gone beyond the limit of non-distortional debt burdens. They appear to have reached the limit of short-term revenue expansion, the terms of trade had worsened significantly, and exports were a declining proportion of output. In contrast, some of the now less-indebted countries which were then at similar income levels (referred to as selected non-HIPC countries) experienced terms of trade improvements that enabled them to meet, out of revenue, the doubling of debt service requirements caused by increases in world interest rates at the time.

Beyond this point, the two groups of countries moved in opposite directions. The HIPC countries increased their debt load as they engaged in more borrowing, much of it while implementing stabilization and structural adjustment programs, in vain attempts to adjust to global conditions.[4] The selected non-HIPC countries reduced their debt burdens as their increasing export revenues, steady growth, and improving savings rates allowed them to reduce their net dependence on both aid and debt flows (Appendix, Tables 1-3).

[4] The increased concessionality of the new loans had little net effect because the *size* of the debt increased more than proportionally, thus the debt-servicing burden was not reduced. In short, these countries exchanged (less) more expensive money for (more) cheaper money with little net effect where it mattered—the debt service burden.

It appears, in retrospect, that the terms-of-trade decline was sufficiently drastic to make the HIPC countries insolvent, even at what appeared to be modest debt-to-income ratios. Thus, in the absence of a reduction in the stock of debt (and, by implication the debt service burden) or the recovery of the terms-of-trade, a return to solvency was unlikely. The irony here is that, particularly in the early to mid-1980s, when adjustment programs encouraged debt restructuring rather than debt reduction (thereby increasing those countries' debt burdens and exacerbating the debt overhang problem) they may have been pushing those countries further and further away from paths of external viability and internal equilibrium.[5] This would have been exacerbated by the fact that the increasing debt burden probably acted as a disincentive to honest efforts at adjustment because most of the benefit of successful adjustment would go to creditors. In short, these countries have arrived at the point of unserviceable debts and economic failure largely because the international community was unwilling or unable to recognize that what appeared to be modest debt loads in the early 1980s were, given the nature of these economies, already growth-distorting and unsustainable because of permanent changes in the global economy.

Debt, Human Development, and Growth

When most of a country's foreign debt is public and public-guaranteed debt (consisting mostly of central government debt and the debt of loss-making state-owned corporations), there are three main avenues through which it can have deleterious effects on the country's social and economic conditions. These avenues are:

(i) the budgetary process;
(ii) the external accounts;
(iii) the "debt overhang" disincentive effects.

The first two of these are directly linked to the size of (current) debt service requirements; the third relates to the size of the stock of debt (relative to expected output) and the future debt service burden that it portends.

(i) The budgetary process

There is a simple arithmetical relationship between public debt service obligations and other areas of government spending. The interest payments and principal repayments that make up debt service requirements (for public debt) must come from the government budget. Therefore, if there is no commensurate increase in revenues to match the increase in debt service requirements, meeting those requirements must imply a contraction in other areas of government spending. Even in the presence of a revenue increase, unless the growth in revenues is more than sufficient to meet new debt-related expenditure demands, the debt service burden may still have the effect of pre-empting growth in other areas of expenditure.

Increasing government revenue to generate the resources for debt repayment would appear to be the natural response to a mounting debt repayment burden. As mentioned above, if borrowing provides an impetus to economic growth in the first place, the resultant increase in revenues will naturally provide the necessary budgetary space for debt repayment. If that growth is not forthcoming, the revenues-to-income ratio has to be raised. However, most developing countries are faced with a narrow tax base, dominated by indirect (particularly trade) taxes and limited institutional

[5] Krugman (1998) describes a debt overhang as the condition where the present value of the stock of debt exceeds the present value of the future flows that it can generate to repay that debt (Krugman, 1998). A stricter, but perhaps more useful definition is one that argues that a debt overhang is the condition where the stock of debt exceeds the future flows that a country can generate to repay its debts without necessarily compromising long-term growth and poverty reduction. In the body of the text Krugman's definition will be the reference point, but the latter definition is perhaps more appropriate for addressing debt reduction in the context of the poorest countries.

infrastructure (Bird, 1990; Manuelli, 1994; Carciofi and Cetrángolo, 1994). In the absence of significant tax reform, large across-the-board tax increases are likely to be both institutionally and politically unfeasible, particularly in the face of falling terms of trade and economic stagnation.

In the absence of revenue increases, debt service obligations can be met only by contracting expenditure in other areas or by increasing the size of the government deficit. Deficit financing generally consists of some combination of inflationary finance (borrowing from the central bank) and the accumulation of domestic debt. The latter would essentially amount to exchanging one form of debt for another and will, at best, only delay the problem or put it in another guise. Inflationary finance brings with it the disruptive effect of high inflation rates on economic activity. In addition, the resulting "inflation tax" falls disproportionately on the lowest income groups. Tax incidence studies for Mexico and Argentina, for example, indicated that the inflation tax incidence was U-shaped for Mexico and definitely regressive for Argentina (Carciofi and Cetrángolo, 1994).[6] Beyond this, there is a definite limit to the resources that can be mobilized through inflationary finance: attempts to sustain that maximum will lead, inevitably, to hyperinflation.

This leaves government spending contraction as the third, and most likely, means of accommodating debt service obligations. Two areas of government spending likely to suffer the consequences of this "decrease in budgetary space" are social spending (health, education, housing, welfare, social insurance, etc.) and public investment. Social spending cuts imply a contraction in the resources available for addressing human development goals (including poverty reduction). Reduced public investment is very likely to result in lower overall investment (both because public investment is a significant proportion of total domestic investment in most developing countries and because it may be complementary to private investment). Lower overall investment means reduced potential for medium- and long-term growth.

The experience of Latin America during the debt crisis of the 1980s suggests the likely effects of high debt repayment burdens on budgetary choices, particularly with respect to health and education spending. Reimers (1990: 545) showed that in the 1970s the (unweighted) average per capita expenditure on education in Latin America grew at 3.4 % annually, but in the 1980-88 period fell by 2.4 % annually. In fact, per capita expenditure on education fell in only one of 19 countries during the 1970s but fell in 15 of the same 19 countries during 1980-88. Even more distressing, the evidence suggests that in some countries the decline in education spending was most acute at the lower levels of the system (the education most consumed by the poor). In Costa Rica, expenditure on basic (largely primary) education declined in real terms at a rate of 4.8 % per annum in the 1980-87 period, but expenditure on higher education fell by only 0.25 % during the same period (Reimers, 1990: 546).

The story of health care is similar. Cornia (1994: 44) showed that combined spending on health and education in Latin America fell from 24.4 % of the budget in 1980-81 to 18.4 % in 1985-87. In Mexico, for example, health care expenditure fell by 53 % between 1981 and 1987 (Rivero, Ascencio and Vinagre, 1994). Though the country continued to expand the coverage of health services, the quality of health service declined. That effect was apparent in the dramatic slow-down in the rate of decline of child mortality to only 4 % in the 1978-82 period. Rivero *et a*l (1991) also noted that others had observed similar effects in Brazil.

[6] A U-shaped pattern indicates that the tax falls heavily on the lowest income groups, less so on the middle income groups, and again heavily on the highest income groups.

Table 2 (see Appendix) indicates a less dramatic but significant decline in social spending in HIPC countries during periods of increasing debt. Though health and education expenditure continued to increase as a proportion of (rapidly falling) total expenditure in the 1980-96 period, it actually fell relative to GDP in the late 1980s and only increased slowly thereafter. Given the high rate of population growth in these countries (more than 2.6 % annually), per capita expenditure on both health and education services was falling. By contrast, the non-HIPC countries, though they experienced a similar contraction in health spending in the late 1980s, had more than doubled the proportion of GDP spent on health by the mid-1990s. Education spending grew consistently, both as proportion of (stable) expenditure levels and as a proportion of GDP, throughout the 1980s and into the mid-1990s.

As indicated in Table 3, the period of heavy and increasing debt for the HIPC countries coincided with a slow-down in the rate of human development (even when the war-torn countries of Angola, Liberia, Somalia, and Sudan are excepted). Even though the HIPC countries continued to record improvements in the basic indicators of human development, the rate of increase slowed perceptibly and was much lower than the corresponding figure for the non-HIPC countries. For the HIPC countries, life expectancy increased by roughly 142 days annually (0.4 of one year) in the 1970s, 113 days in the 1980-89 period, and only 80 days in the 1990s. The non-HIPC group experienced no similar decline. The average rate of annual increase rose in the 1980s and, though it fell in the 1990s, remained above the rate it had been in the 1970s for the HIPC countries.[7] Similarly, per capita calorie supply fell during the 1986-97 period after increasing between 1970 and 1986 for the HIPC group; the rate of decline in infant mortality also fell during the 1980s and 1990s; and the rate of increase in school enrolment approached zero.

While at least part of the slow-down in human development in HIPC countries can be attributed to negative per capita growth in the 1980s and 1990s—which itself may have been affected by the debt burden through the investment effect (which we will come to later)—the effect of reduced social spending should not be underestimated. Using a series of micro studies, Schultz (1998) showed that, whereas a 10.5 % increase in per capita income reduced infant mortality by 1.5 per thousand and increased male and female life expectancy by less than one year, increasing women's schooling by one year was associated with a decrease in infant mortality of 7.4 per thousand, a 1.5 year increase in female life expectancy, and a 1.1 year increase in male life expectancy. Clearly, changes in female enrolment, achievable through relatively modest increases in public spending on education, have a far more potent effect on human development indicators than does growth in income.

The budgetary effect of the debt repayment burden on public investment in particular, and total investment in general, appears to have been less direct than it was for social spending. As Table 2 indicates, in the 1980s HIPC and non-HIPC countries experienced almost identical patterns of growth in (average) public and private investment. The average rate of public investment as a percentage of GDP fell by approximately two percentage points from the early to the late 1980s. In both cases the private investment rate fell with the public investment rate, though it was, and remained, significantly higher in the non-HIPC countries.

[7] The high AIDS-incidence countries of Botswana, the Republic of Congo, Côte d'Ivoire, Kenya, Malawi, Tanzania, Togo, Uganda, Zambia, and Zimbabwe are excepted from these calculations to reduce the likelihood of misinterpretation of the data.

The 1990s turned out to be another story altogether. For the HIPC countries, public investment continued to decline at the start of the decade, but showed signs of recovery in 1995-96. The average private investment rate recovered gradually through the 1990s as growth improved somewhat. But in the non-HIPC countries, the public investment rate continued to decline throughout the 1990s although the private investment rate increased to nearly two percentage points (of GDP) higher than it had been in the early 1980s. In short, the heavily indebted countries, after experiencing sharp decreases in public investment, managed a partial recovery even in the face of declining public expenditures relative to income and mounting debt service burdens. However, what differentiates them most from the less-indebted countries is the limited responsiveness of private investment! We shall return to that issue shortly.

The relationship between investment (in physical assets) and growth is a well-established empirical—as well as theoretical—relationship in economics. Thus, the lower gross domestic investment rates in HIPC countries account, at least in part, for the lethargic performance of that group in the 1980s and 1990s. However, advances in modeling economic growth (new endogenous growth models) have contributed enormously to our understanding of the processes underlying economic growth by highlighting the importance of human capital in that process. Hence the long-term effects of per capita decreases in social spending should not be underestimated. Micro studies continue to bring that relationship into sharper focus. Schultz (1998) and Shultz and Tansel (1993) showed that health status was a strong determinant of adult wage earning capacity (and, by implication, productivity) in Ghana and Côte d'Ivoire. Husbands *et al* (1996) showed that primary schooling had a significant and positive effect on the productivity of resources in agriculture in Kenya.

In effect, the restrictions imposed on budgetary allocation by the debt burden appear to have compromised growth in the HIPC countries by causing lower rates of investment in both human and physical capital. In addition, the lower level of social spending in general has compromised human development goals. This effect is even more alarming when it is recognized that most of these countries are still not able to service all their debts and continue to build up payment arrears.

(ii) External account effects

For foreign debt obligations, the allocation of budgetary resources is but the first requirement in debt repayment. Resources must also be allocated in the external account since debt repayments are made in foreign currency. For countries blessed with substantial foreign reserves—and there is no such country within the HIPC group—this transaction is likely to have no measurable economic impact. However, for countries with limited reserves (the typical developing country), in the absence of debt refinancing, the required foreign currency must be commandeered out of current foreign exchange earning from exports, foreign direct investment, official development assistance (ODA), or private debt inflows. For the typical HIPC country, foreign direct investment and private debt inflows have been insignificant (Table 1). The foreign currency counterpart of debt service obligations must come from export earnings. In the face of decreasing or static export earnings, the net result is likely to be import compression, regardless of the exchange rate regime in effect.

Whether the foreign exchange demand imposed by debt service requirements is passed on through the price mechanism (exchange rate depreciation) or through non-price rationing (import restrictions), the effect is similar. If the country has a flexible exchange rate the currency will depreciate as the demand for foreign exchange exceeds the supply. Alternatively, a country with a fixed exchange rate might choose to devalue the currency, which has the same effect. Depreciation or devaluation of the currency can, potentially, ease the foreign exchange constraint somewhat by

inducing an increase in exports (since the depreciation/devaluation increases the domestic price of exports). However, as the experience of the last two decades has shown, for countries that export only a limited number of primary goods, the export response is neither quick nor substantial, and is often wiped out by negative terms of trade movements. In any case, currency depreciations exacerbate the budgetary choices discussed above by increasing the domestic cost of debt service obligations. The net result will thus be an increase in the price of imported intermediate inputs and capital goods, without a commensurate increase in the capacity to import, and a consequent contraction in aggregate supply and investment.

Countries that attempt to maintain a fixed exchange rate in these circumstances are forced to accommodate the increased demand for foreign exchange through restrictions on imports. The likely outcome is a reduction in the supply of imported intermediate inputs and capital goods, with similar consequences for aggregate supply and investment. In addition, the non-price restrictions create an added incentive for rent seeking activity, which in turn has an additional negative effect on output and investment.

(iii) The "debt overhang" disincentive effect

The disincentive effect of the debt ratio, sometimes referred to as the "debt overhang effect," refers to the negative savings and investment effect that can potentially be generated by a heavy debt burden. Domestic savers and investors may see a high stock of debt as an indicator of the high future tax rates that will be needed to meet debt service requirements. This acts to lower the expected (after-tax) return on savings and investment. Domestic economic agents may thus choose to invest their savings elsewhere—capital flight. Foreign investors, in addition to being similarly discouraged by the prospect of future taxes, may be discouraged by the prospect of future currency depreciations that will lower the foreign exchange value of their investment. Alternatively, they may be concerned about their ability to repatriate profits in the face of non-price rationing of foreign currency.

The extent of this "debt overhang" effect, however, remains uncertain. Fry (1989) observed a strong negative relationship between the stock of debt and the level of domestic savings for a sample of 28 developing countries. Deshpande (1997) found a similar negative relationship between debt stock and investment for a sample of 13 countries over the period 1971 to 1991. Cohen (1993) could find no such effect for a sample of 80 countries. However, he did find a strong negative relationship between current investment and debt repayment outflows—the external account effect mentioned above. In the developing-country context, the difference between those two effects may be more artificial than real. Given the limited reach of the tax system in most of these countries, it is unlikely that legislated taxes are the main concern of potential investors. The uncertainties created by ongoing pressure on the external account (with respect to the future availability and/or price of capital goods and imported intermediate inputs) may be of more immediate concern.

The figures in Table 1 clearly suggest that private investment was both lower and grew more slowly in HIPC countries than in non-HIPC countries. The lower level of investment (and indeed savings) in HIPC countries, going back to the 1970s, may likely be an indicator of more fundamental structural problems in these economies. One needs more than structure to explain the absence of significant growth in private investment over the 1980s and 1990s, however. Though the slow rate or economic growth and deteriorating terms of trade were contributing factors, it is hard to argue that the size of the debt and the ever-increasing repayment burden were not equally, if not more, important.

A related 'disincentive effect' of the debt overhang is that on policymakers. Given a debt overhang, policymakers may anticipate that the benefits from any increase in growth (increased revenues, foreign exchange etc.) due to improvement in the policy framework will accrue solely to creditors (through increases in the proportion of debt repayment obligations met). Debtor country governments may thus have limited incentive to make hard choices that improve the potential for economic growth.[8]

Structural adjustment and debt—missing the target

As described above, countries with a heavy debt burden face some hard choices. When that situation is exacerbated by a fall in the country's terms of trade and economic stagnation domestically, the country may slip into a debt overhang situation—where the debt stock exceeds the country's capacity to repay—and hard choices become impossible choices. Short-term deficit financing (of the budget) quickly becomes unsustainable, further cuts in expenditure unfeasible, and foreign reserves evaporate as export proceeds and limited foreign inflows fail to meet even contracted imports and debt repayment needs. The ensuing internal disequilibrium (high inflation, non-sustainable government deficits) and non-viability of the external sector (razor-thin reserve coverage and an export base insufficient to carry the needs of essential imports and required outflows) make exceptional financing and adjustment an imperative.

It is therefore not surprising that the current group of HIPC countries have been, since the early 1980s, the predominant users of IMF's emergency financing facilities (Standby Arrangement and Extended Fund Facilities) and the World Bank's and IMF's structural adjustment programs. In fact, between 1980 and the end of 1991, these countries agreed to approximately six IMF stabilization or IMF/World Bank structural adjustment programs on average, covering an overall period of 6.4 years. Similarly, they account for 54 of the 68 Structural Adjustment and Enhanced Structural Adjustment Facilities (SAF/ESAF) approved by the IMF up to December 1994. By contrast, the sample of selected non-HIPC countries only agreed to 2.4 programs per country, covering a total of 2.4 years between 1980 and 1991.

Regardless of the point of view one takes with regard to the efficacy of these programs, it is clear from the data that they have not, overall, produced a turnaround in those economies. While the two-decade long slide in the terms of trade is a ready target for blame, two peculiarities of that experience need to be highlighted. The first is the nearly unanimous finding of empirical studies that stabilization and adjustment programs have generally elicited a negative investment response (see, for example, Khan, 1990; Corbo and Rojas 1992; Elbadawi, 1992, Bird 1995, Killick, 1995). While that association has sometimes been attributed to a reduction in wasteful investment (increased efficiency), that argument is at odds with the fact that the source of funding for most investment in developing countries is retained earnings, and the marginal return on investment in most of these countries was, and remains, high. The second is the fact that the debt profiles of these countries did not change substantially with each program. In fact, as Table 1 indicates, the debt profile of these countries, as a group, has been worsening over time. These programs brought a temporary respite from the resource crunch these countries faced, but did not improve their net asset position.

The failure of investment to respond to these programs suggests that the fundamental problem—one of a debt overhang—was not being satisfactorily addressed. Private agents could not foresee a change in investment conditions as long as the fundamental source of present and future instability—an unsustainable debt load—remained. Countries were essentially being asked to adjust to an

[8] This, together with some of the issues mentioned above, form the basis for the debt Laffer curve.

unattainable equilibrium, one that included carrying a debt overhang. Thus the most fundamental shortcoming of adjustment over the past two decades has been the failure to recognize (until recently) that these countries' debts have been unsustainable since the early 1980s and should have been substantially reduced then!

To summarize, there is strong evidence to suggest that these countries' heavy debt burden can be directly linked to the failures to invest in both their physical and human capital—thus jeopardizing both their present and future development. It would seem to follow that significant reduction of the debt is necessary, but not sufficient, to allow for a recovery in both these areas. Sufficiency would require debt reduction that pushes the debt below the level at which it distorts macroeconomic policy and crowds out necessary social spending, and a debt reduction framework that produces the right incentives for debtor governments and private actors in those countries. It is to these issues that we now turn.

II. THE MECHANICS OF DEBT RELIEF

The evolution of debt relief mechanisms for the poorest

As already suggested, the creditor community was slow to recognize, or accept, the existence of a debt overhang in the poorest countries.[9] To be sure, it was recognized that these countries had faced severe difficulties in meeting their debt repayment obligations since the end of the 1970s. Initiatives, such as the shift from concessional to wholly grant aid by Canada and other Organisation for Economic Co-operation and Development (OECD) countries, the World Bank's Special Program of Assistance for Africa, and the IMF's SAF and ESAF arrangements, were all meant to address the problem (Sevigny, 1990). However, these initiatives treated the problem as one to which these countries could adjust in time with the right policy mix, debt-rescheduling, and new concessional financing.

The first major initiative to provide a formal framework for significant debt reduction was the Paris Club which, in 1988, introduced the "Toronto terms" as a framework for its dealings with the debt problems of low-income countries. These new terms included, along with rescheduling arrangements, debt stock reductions of up to 33 % and debt service reduction of up to 30 %.[10] As the inadequacy of the initial provisions became apparent, these terms became more generous as they evolved through the "London terms" and the "Naples terms," to the "Lyon terms" that offered up to 80 % debt and debt service reduction. This is likely to develop further to the "Cologne terms" that will offer up to 90 % debt service reduction (and 100 % in special cases) and reduce a significant proportion of ODA-related debts. Prior to negotiating its debts with the Paris Club a country is

[9] It should be pointed out that there is a significant difference between a country that faces temporary problems in servicing its debt and a country that has no hope, given expected states of the world, of repaying its debts (the former condition is one of a liquidity crisis, the second is a debt overhang problem). Taking Krugman's (1998) critique of the concept into consideration, a country can be considered to be suffering from a liquidity crisis when there still remains a significant probability that the country, given some economic policy reform, temporary assistance, and debt restructuring, will be able to generate future outflows sufficient to pay its debts. (The degree to which debtors are willing to provide new money in this circumstance will depend on their degree of risk aversion, among other factors). However, when a country faces a debt overhang problem no amount of that medicine will make the debt repayable and failure to reduce the debt to manageable levels is likely to make matters worse by creating a net disincentive effect for concerted action on the part of the debtor.

[10] These numbers tend to overstate the actual amount of debt relief available because of the use of a 'cut off date' beyond which the offer does not apply. Thus this offer would not apply to all debt outstanding at the time of negotiation but debt incurred before a particular date.

required to agree to an IMF stabilization or adjustment program—essentially linking adjustment and debt relief (Sevigny, 1990).

The second major initiative was the "Brady Plan" announced in March 1989 by the US treasury secretary, Nicholas Brady.[11] That plan enjoined commercial banks to work with developing countries and make use of a "menu of options" that included debt swaps, debt for equity conversions, refinancing, etc. to reduce the total debt of these countries. Further, IMF and World Bank resources could be used to facilitate these transactions. The IMF was no longer required to make its adjustment programs contingent on a country's prior agreement with its creditors—effectively reducing the bargaining power of the commercial banks and increasing the potential for significant debt reduction operations.

This debt relief plan had major implications for middle-income countries such as Mexico, Brazil, Argentina, Costa Rica, and Chile whose debts were owed predominantly to private commercial banks. However, as Table 4 suggests, it was of limited usefulness to the poorest countries for which commercial debt was never a substantial proportion of their total debt load. Nevertheless, some lower-income countries such as Bolivia and Mozambique did make use of that facility. More recently, the International Development Association (IDA) has used its resources to provide the necessary financing for "Brady style" reduction of commercial bank debt for many of the HIPC countries. The Brady Plan also stressed the importance of adjustment programs as an adjunct to debt reduction.

The most far-reaching initiative with respect to debt relief for the poorest countries has been the HIPC initiative introduced in 1996 and administered jointly by the World Bank and the IMF. That initiative initially offered debt relief consideration to poor countries (IDA eligible) whose debt was considered to be unsustainable even after Paris Club debt relief terms were applied to all debt other than multilateral debt.[12] Sustainable debt in this context meant a net present value of debt-to-export ratio below or in the 200-250 % range and debt service-to-exports ratios not above the 20-25 % range (the choice of an exact amount within those ranges to be determined on a case-by-case basis).[13] Alternatively, open economies with a strong fiscal stance (countries with an export-to-GDP ratio of at least 40 % and fiscal revenue to GDP of at least 20 %) could be judged according to the "fiscal criteria" which defines sustainability as a net present value of debt-to-fiscal revenue of 280 % or less (IMF, 1999).

A country became eligible for the level of debt forgiveness necessary to attain debt sustainability (i.e. it arrived at the decision point) when it had gone through three years of structural adjustment and could not attain a sustainable debt level using traditional debt relief mechanisms.[14] Debt relief, if required, was provided after a further three years of adjustment (the completion point). Debt

[11] Though the Baker Plan, by endorsing the "menu of options" approach in 1987, included the potential for debt reduction, that potential was not emphasized and was much more of an afterthought than an area of explicit focus.

[12] 'IDA eligible' means that the country is a member of the International Development Association (IDA) of the World Bank Group, rather than the International Bank for Reconstruction and Development (IBRD), because its income is below US$895, it is not sufficiently creditworthy to borrow on international capital markets, and its policy performance is considered acceptable.

[13] The Net Present Value (NPV) is determined by discounting the future stream of debt payments at a market rate of interest.

[14] Traditional debt relief mechanisms involve Paris Club terms or better on all bilateral and commercial debt (facilitated by IDA debt reduction operations on commercial debt), some forgiveness of official development assistance debt, and new financing on appropriate concessional terms.

forgiveness beyond Paris Club terms was distributed proportionally across all creditors. However, debts owed to the IMF and World Bank were not written off directly. Instead, these are paid off on behalf of the relevant country out of the ESAF facility and the HIPC trust fund respectively (IMF, 1999).[15]

At the Bank and IMF annual meetings in September 1999, the HIPC initiative became the "enhanced" HIPC initiative. This new initiative, flowing from the recommendations of the Cologne summit of the G-8, offers a more generous interpretation of debt sustainability and formally links debt reduction with efforts at poverty reduction. A sustainable debt is now defined as a Net Present Value (NPV) of debt-to-income ratio of 150 % or less. Eligibility for the fiscal criteria will require an export-to-GDP ratio of 30 % or more, and government revenue-to-GDP ratio of at least 15 %. Under those criteria, sustainability will now be defined as a NPV of debt-to-revenue ratio of no more than 250 %. In addition, the time between the decision point (when eligibility for additional debt relief, beyond traditional debt relief, is determined) and the completion point (when debt relief is actually delivered) is likely to be shortened considerably. Some relief may also be delivered before the completion point. Countries that have gone through the original HIPC initiative debt reduction procedures are also eligible for re-entry into the enhanced HIPC debt-reduction procedures.

Also of significance, debt relief in the enhanced HIPC will now be conditional on the development of a Poverty Reduction Strategy by the debtor country. In the same vein, the ESAF facility has been renamed the Poverty Reduction and Growth Facility (PRGF) to reflect the new centrality of poverty reduction in its mandate.

A critique of the current framework

This critique does not consider the Brady Plan because of its lesser relevance to the poorer countries. Though the use of market-based instruments to reduce commercial bank debt Brady-Plan style has proved effective in retiring a substantial amount of the commercial bank debt of poorer countries at significant discounts, its limitations with respect to publicly held debt are obvious. We will return to this issue shortly.

The Paris Club procedures and the HIPC initiative, which are now combined in the HIPC process, both place extreme technical and personnel demands on the governments of debtor countries. Paris Club debt reductions must be negotiated separately (and often repeatedly) with each member, a process that takes several months, at best, and requires significant technical capacity on the part of debtor-government negotiators, in addition to a great deal of time spent outside the country (Sevigny, 1990). The HIPC process is even more demanding in terms of technical capacity. Determination of what constitutes a sustainable debt load, and whether it is achievable, requires a long process of post-Paris Club negotiations. After that, the amount of debt to be forgiven by multilateral institutions must be further negotiated. These requirements are at odds with the professed intent of improving management in these countries, which already suffer from severe shortages of technically well trained public servants.

Even after expected enhancements, the adjustment process that is a prerequisite to debt relief seems chronologically misplaced. The HIPC and Enhanced HIPC initiatives place most of the economic reform requirement of debt relief *ahead* of actual debt reduction. Yet, the generally understood role of conditionality as an adjunct to debt reduction is to ensure:

[15] Although the regional development banks also avail themselves of these facilities, the arrangement is not as formalized.

(i) that the debtor country implements policy reforms that move it beyond insolvency and enhance its capacity for future growth; and
(ii) to counteract the moral hazard associated with debt reduction.[16]

At the front end, conditionality is potentially less effective because the debtor government is being asked to implement austerity measures on the promise that its case for debt relief will be duly "considered." The incentive to participate is limited by the degree to which debtor countries feel they will, in fact, obtain debt relief. Also, concessional flows under ESAF or PRGF notwithstanding, these adjustment programs are taking place within the context of a debt overhang. As was pointed out earlier, that context itself makes real adjustment impossible. The new emphasis on poverty reduction does not change that fact. Countries need to adjust to post-debt overhang conditions, not learn to live with it.

Even more perplexing, eligibility for consideration is conditional on successful completion of these programs. One presumes that success in this case is measured in terms of behaviour and not outcomes, since to make it dependent on outcomes would create an impossible hurdle. That fact is obvious even from the IMF's internal review of the ESAF facility, which concluded that "as many as half the countries reviewed have failed to make discernible progress towards external viability." This of course begs the question: What is in store for countries that fail to perform adequately under structural adjustment programs—banishment to a purgatory of over-indebtedness and economic stagnation? The underlying suggestion that debt relief is optional is fictitious. Any credible effort at addressing these countries' problems will have to begin with debt reduction.

This strong emphasis on *a priori* performance leaves the impression that debtor governments are seen as solely responsible for the policy failures that have led to the current situation. While they (and their predecessors) may not be models of public management, the shift in the debt burden from mostly bilateral to mostly multilateral debt, between the early 1980s to the 1990s (Table 4), indicates that a large part of the current debt was amassed during stabilization and adjustment programs. Thus, in addition to the effect of deteriorating terms of trade, persistent attempts at "adjustment" in the face of an existing (and uncorrected) debt overhang, under the auspices of the Bretton Woods institutions, must share responsibility for the current degree of over-indebtedness and the required level of debt forgiveness it implies.

As the evolution of the Paris Club and HIPC terms indicate, a political process and not economic rationale determine the level of debt relief offered. Essentially, issues of burden sharing, political expediency, and the like, have dominated the debt relief agenda. Thus the amount of debt relief provided has largely been determined by what could be accommodated within current political constraints with little reference to economic imperatives. Further debt relief was considered only when it was patently obvious that previous levels of debt relief were insufficient for solving debt overhang problems. The result has been that poor and heavily indebted countries have been dragged through a full decade of a protracted, incremental approach to debt reduction on the heels of nearly a full decade (1980-88) of misdiagnosis of the problem. Meanwhile, these countries continue to operate largely in a state of limbo, with continuing low investment, low growth, and reduced levels of improvement in human development.

[16] Moral hazard, in this case, comes from the fact that, once debt relief has been given, the debtor has a reduced incentive to avoid another such episode because it may feel that, if necessary, debt will again be forgiven in the future.

Conditionality and adjustment

The pronounced aim of conditionality, as practiced by the Bretton Woods institutions, is to foster "sustained policy implementation." International Monetary Fund documents define it as "the explicit commitments that members are asked to make to implement remedial measures in return for the IMF's support" (IMF, 1998). Conditionality, in this context, generally consists of a set of "prior actions," "performance criteria," and "structural benchmarks" that prospective recipient countries must fulfill before drawings can be made from relevant loan arrangements with the Fund (or Bank). Other creditors may also link disbursements to the countries' standing with the IMF, thus adding greater weight to IMF conditionality. The degree of policy implementation is judged through changes in key macroeconomic (and sometimes microeconomic, social, or governance related) variables associated with the policy objectives. Conditionality has had a long history with the Bretton Woods institutions (particularly the IMF) and, over the years, has expanded in scope and reach as these institutions have extended their mandates in response both to perceived changes in the nature of the problems facing developing countries and the evolving global context.

As long as it has existed, the efficacy of conditionality and its conduct has been a subject of debate, both within and outside the Bretton Woods institutions. More recently, the ESAF facility and its related conditionality have come in for some criticism. While it is hard to prove causation between conditionality and any of the effects (or lack thereof) of adjustment programs, the low rate of program completion (see Killick 1995, IMF 1997) suggests that conditionality, whether in conception, implementation, or monitoring, remains an area of concern. There are four aspects of current conditionality that can be identified as problematic:

(i) **The nature of conditionality:** The conditionality practiced by the international financial institutions has been overwhelmingly of the negative type—countries risk losing access to funds if they fail to meet certain pre-arranged conditions. While it can be argued that this form of conditionality creates a disincentive for countries to renege on agreements, it does have several disadvantages that include:

(a) **The potential for antagonism:** Because this approach involves the threat of sanction on the part of the sponsoring agency (usually the Fund or Bank) to the implementing agency (the debtor government) it creates an inherent potential for antagonism between the two sides. This antagonism, if it materializes, can reduce the level of cooperation between those agencies even when there is no substantive disagreement on objectives.

(b) **The cost of premature program termination**: In most cases the withdrawal of funding in response to failure to satisfy pre-arranged conditions means premature program termination. This is costly for the debtor country because the benefits from pre-termination reform may be lost as a result of the lack of follow through, yet the country must still bear the cost of repaying disbursed amounts. In addition, the credibility of both the government and the sponsoring institution suffers in the eyes of other economic agents, such as investors.

(c) **The requirement of *ex-ante* negotiations and agreement:** Because such conditionality is necessarily *ex ante* (it must be agreed by both parties sometime before implementation), it requires substantial negotiation before program implementation (and, sometimes, additional negotiation during implementation). These negotiations are demanding in terms of technical expertise and carry a cost (in addition to the opportunity cost of technical staff involvement) in terms of delayed implementation.

(ii) **The degree of conditionality:** As the range of issues addressed within structural adjustment programs have increased, so has the number of conditions attached to these programs. However, the larger the number of conditions attached to each program, the greater the likelihood that some conditions will be breached (referred to as policy slippage), resulting in an increased likelihood of premature termination of programs. Even if, as argued by the internal review of the ESAF (IMF, 1997), this does not increase the likelihood of premature program termination, it is likely to require that some conditionalities be given more importance than others—lending an air of arbitrariness to the whole exercise that compromises credibility.

(iii) **The reach of conditionality**: Adjustment programs are meant to reduce the possibility of countries returning to the crisis (or non-sustainable) conditions that usually precede the institution of these facilities. However, differentiating *required* from *desired* reforms is necessary for providing governments with the policy space needed to engender ownership of these programs without reducing the potential for successful adjustment. The argument that adjustment programs, such as the ESAF facility, are more than a little coloured by the free market orthodoxy of the Fund—and to a lesser extent the Bank—is not without merit. For example, professed aims such as "reducing the 'extent' of government intervention into the economy" implies a rather specific 'less is better' approach in an area where a wide range of opinion is known to exist among governments, economists, and policymakers. Yet it cannot be defended purely on economic or historical grounds. Outside the extreme interventions of pure command economies, the *degree* of intervention exercised in an economy is not, by itself, a very powerful determinant of the probability of success (Summers and Thomas, 1993). Conditionalities that limit the policy space within such ideologically narrow confines unnecessarily increase the likelihood of conflict and reduce the potential for country ownership of these programs without necessarily increasing the likelihood of successful adjustment, even for completed programs.

The problem of "ownership" created by differences in perspective between implementing agencies and sponsoring institutions is clearly articulated by the external review of the ESAF facility (Botchwey *et al*, 1998). The internal review of the ESAF also noted that the areas of greatest resistance to reform were in public enterprise reform and financial reform and the determination of exchange rate regimes (IMF, 1997). These are some of the areas most likely to be affected by differing ideological perspectives. Yet, ownership is clearly crucial to program success. For example, an analysis by Johnson and Wasty (1993) of 81 World Bank programs indicates that, out of 16 programs rated as having very high country ownership, 15 were considered to have had satisfactory or highly satisfactory outcomes. On the other hand, out of 17 with low country ownership, only 3 had satisfactory outcomes and none were highly satisfactory.

There are other forms of conditionality that may have some usefulness in the context of debt reduction. These include:

Positive Conditionality: In this case countries gain rewards for implementing certain policies rather than pay a price for not doing so. This form of conditionality carries a lesser potential for conflict and requires few *ex ante* negotiations since prior agreement is not needed. Programs with a high proportion of positive conditionality may carry a higher potential for ownership because countries can make decisions as the program evolves, without requiring the prior agreement of all parties. However, for the implementing agency such conditionality would

mean giving up some of the leverage that comes with holding the purse strings because a minimum level of funding would have to be guaranteed (with countries choosing to increase funding by meeting certain prescribed conditions). Such conditionality also carries some risk of policy incoherence because countries may choose to implement some aspects of a program and forego others that are necessary for overall coherence.

Third Party Reviews: This form of conditionality is similar to negative conditionality in that it requires *ex ante* agreement with regards to conditionality and involves the threat of sanctions. However, it reduces the antagonistic nature of the relationship between funding and implementing agencies—and (it is hoped) the likelihood of premature termination—by bringing in a third party who contributes to both the determination of the conditions and the assessment of adherence to those conditions. Ideally such a third party should have some interest in the results of these programs that overlaps with that of both parties, thus creating an element of impartiality. Obvious third party candidates include: civil society organizations, UN agencies, and other multilateral institutions.[17] (The similarity of this approach to the World Bank's Comprehensive Development Framework (CDF) is not accidental—it derives from the same principle of broad consensus).

Alternative instruments for debt relief

The HIPC initiative provides debt stock and flow reductions largely through off-market, third-party arrangements. HIPC bilateral debts, for instance, (owed mostly to export credit agencies) are generally not directly written down but extinguished through compensatory payments from (creditor) government budgets. Multilateral debt reduction takes place through similar compensatory payments from the ESAF facility (in the case of the IMF) and the HIPC Trust Fund (in the case of the World Bank and the regional lending institutions). The preponderance of these off-market transactions derives largely from the fact (as noted earlier) that most HIPC debt is owed to public bilateral and multilateral agencies that do not allow their debt to be sold on secondary markets.

On the other hand much of the debt owed to private creditors has already been reduced through market-based operations. In particular, the IDA has provided (as an adjunct to adjustment programs) Debt Service Reduction Loans to HIPC countries for market-based debt reduction operations. These loans provide debtor countries with funds that can be used to engage in market-based debt buy-back and debt conversion operations (*à la* Brady Plan) with respect to external commercial bank debt. In essence, these countries exchange their expensive private debts for smaller amounts of highly concessional IDA debts.

The absence of a secondary market for the debts of public sector institutions does, in fact, limit—but not altogether remove—the potential use of market based instruments for reducing the debt owed to public sector institutions. Market based operations can be grouped into four categories:[18]

[17] The NGO community has suggested other developing countries as potential third parties; however, it is hard to imagine that other countries, no matter how friendly, would be seen to be impartial. Further, as Helleiner (1998) has argued, because the record of cooperation between developing countries is abysmal, the likelihood that they would be able to participate at this level seems remote.

[18] There are several categorizations of debt relief in the literature that are not coincident; the categorization is an extension of that by Bowe and Dean (1997).

Debt Buybacks: Debtor repurchasing of its debts on the secondary market at a discount. This operation generally requires the approval of creditor institutions.

Exit Bonds: New bonds issued and exchanged for old debt at a discount. These bonds must be either collateralized or made senior to the old debt instruments in order to raise their value relative to that of the old debt instruments (and thus justify the discount).

Debt-Equity Swaps: An exchange of foreign debt for (local currency denominated) claims on the equity of an enterprise within the debtor country.

Other (non-Equity) Debt Swaps: This involves the exchange of foreign debt for local currency commitments other than claims on domestic enterprises.

The first two operations are unlikely to be contemplated by bilateral and multilateral agencies because they involve explicit write-downs (or discounting) of existing debt, whether based on secondary market prices or arbitrated). The third approach is even less attractive to these agencies because, as public agencies, they are unlikely to have any interest in owning the shares of private or public enterprises in developing countries. However, the fourth operation does hold much promise for the poorest developing countries.

There is a myriad of possible operations that fall under the general generic heading of (non-equity) debt swaps. In fact, in the past few years developing-country debts have been exchanged for spending commitments in the areas of health, education, family planning, AIDS prevention, and environmental conservation; for land; and for NGO funding. In the typical transaction, a third party (purchaser) buys public or public guaranteed foreign debt on the secondary market, usually at a substantial discount; in exchange for extinguishing that debt the government allocates the equivalent in domestic currency to the particular cause that interests the purchaser. The creditor, thus bypassing the need for a purchaser, can also initiate this operation.

The advantage to purchasers is that they are able to obtain a domestic currency funding commitment that is significantly larger than the exchange rate equivalent of what is spent buying the debt. The advantage to debtor governments is the saving on foreign exchange that comes from being able to make payments in the domestic currency (they may also obtain a discount from the purchaser). However, significant amounts of such swaps hold the risk of inflation if they induce the government to print large amounts of money to pay for the local currency equivalent of the debt over a short period of time.

Though these debt swaps have traditionally required the approval of relevant creditors and/or the existence of a secondary market for the debt, neither is absolutely necessary. Trust funds and escrow accounts can be used to bypass that requirement. In this case a third party, instead of purchasing the debt directly, can make the foreign exchange equivalent available to the debtor government through a fund or escrow account. In response the debtor government can commit to spending the equivalent in domestic currency on the desired activity and can then draw on that fund or account to pay down its debts. We shall come back to this operation later.

Defining adequate debt relief

We have noted that the level of debt relief has, thus far, been inadequate and determined more by political than economic logic. It is worth considering what level of debt relief would be necessary to address the significant problems these countries face, as well as be in the interest of their creditors. There is no simple answer to that question because:

(i) the actual size of the debt overhang is difficult to measure in any precise manner because it requires an estimation of future potential based on current information; and

(ii) the appropriate definition of what constitutes a debt "overhang" must be related to the objectives of the original debt flows and current debt relief.

If creditors simply wish to obtain the best rate of return on capital, the intent would be to maximize the net present value of the debt that is repaid relative to the present value of outlays (including new debt flows).[19] If, on the other hand, the intent is to promote growth in the debtor country, then more generous debt relief may be necessary to allow sufficient breathing space to unleash the growth potential thwarted by the debt repayment burden and other disincentive effects of the debt. However, given that the debt relief through the Enhanced HIPC initiative is expressly aimed at poverty reduction (or, more broadly, human development), even more generous terms are required. More directly, Krugman's (1998) definition of the debt overhang as simply that part of the debt that cannot conceivably be repaid will not suffice. Instead, a stricter definition that considers the debt overhang to be that part of the debt that compromises the potential for poverty reduction and growth is more appropriate in the context of the Enhanced HIPC initiative.[20]

Taking poverty reduction (with growth) as the relevant framework, one can readily think of three benchmarks that can be used to determine a minimum level of debt relief. These are:

(a) the current level of debt repayment;

(b) the discount rate on private debt;

(c) a model-based estimation of the level of the maximum non-distortional debt burden.

These shall be reviewed separately.

(a) **The current level of debt repayment:** As Table 5 indicates, the HIPC countries as a group were able to meet (on average) only about 40 % of their scheduled debt service payments in the period 1990 to 1994. This occurred even as these countries received significant amounts of concessional resource flows and underwent various level of "adjustment." There is a clear argument to be made that this represents (at the very least) the upper limit of the net debt outflows that these countries can bear. A lower-bound interpretation of the debt overhang can, therefore, be: "that part of the debt that requires debt service payments above current levels." Roughly, taking current levels to be 40 % of scheduled payments and assuming a one-to-one relationship between debt service levels and the debt stock (and ignoring the timeline of the debt), this would constitute 60 % of the current stock of debt.

However, when it is recognized that even that level of debt servicing was achieved at the cost of reduced levels of human development and growth, debt reduction would have to be significantly more than 60 % of the current stock of debt if debt relief dividends that can be applied to poverty reduction and human development are to be obtained. To put it differently, post-relief debt service payments would have to *be significantly lower than actual (rather*

[19] This amount is not as easily calculated as it seems. As Krugman (1998) has shown, that amount depends on what the expectations are for the country and its anticipated behavior in those circumstances, factors that are not easily predicted.

[20] See footnote No. 5 above.

than scheduled) levels of debt servicing if debt reduction is to provide the necessary budgetary space for poverty reduction.

(b) **The discount rate on private debt:** Although the proportion of the total debt owed by HIPC countries that was private commercial bank debt has always been relatively small, many of these countries carried some commercial bank debts at relatively high interest rates. The IDA Debt Reduction Facility has been used to help these countries deal with that portion of their debt stock by providing funds that allowed them to buy back much of that debt on the secondary market, Brady Plan style. One can argue that the price of these countries' debt on the secondary market is the markets' "rational" assessment of the proportion of the debt the country would have reasonably been expected to repay."[21] In other words, the implied discount on the secondary market indicates the part of the debt that the private market, unhindered by humanitarian considerations, treats as a debt overhang and is willing to forgive.[22] Public debt should, therefore, be willing at least to come close the discount rate of the private market.

The average value of the private debt of the HIPC countries (that had used the IDA Debt Reduction Facility) on the secondary market was 15 cents on the dollar.[23] This represents a discount, or level of debt forgiveness, of 85 %. Thus, if public entities were subject to the discipline of the secondary markets as commercial banks are, they would have to contemplate a level of forgiveness of at least 85 %. Note also that this amount would provide ample budgetary space for new spending on poverty reduction in debtor countries.

(c) **A model-based estimation of the level of the maximum non-distortional debt burden:** A significant body of work in applied economics has attempted to discern the effects of a country's relative debt stock (or debt service obligations) on its rate of growth. Some of these studies have tried to estimate the ratio of public debt to GDP that is growth maximizing (i.e. the debt ratio that is consistent with a maximum level of economic growth). The estimates of that "optimal" debt ratio (for public debt) for the US ranges from 38.4 % (Smyth and Hsing, 1994) to 47.1 % (Eisner, 1992). Given that the HIPC countries are much weaker economies than the US, it would seem to follow that their debt carrying capacity is much lower than that of the United States. However, the significant level of concessionality in HIPC debt can, to some degree, compensate for that difference. Using the above result as a benchmark, one can, therefore, suggest that to be growth maximizing—and therefore potentially poverty decreasing—these countries' public sector debts should not exceed 40 % of GDP. Given an estimated average public indebtedness ratio of 143 % for the HIPC countries, it would require an average forgiveness rate of approximately 72 % of these countries' debts to achieve this.[24]

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[21] The word "rational" is used here in the spirit of rational expectations, which argue that the unhindered, private economic agents will, on average, use available information optimally in making judgements about the likely movements of economic variables.

[22] It should, of course, be noted that the private market's position is colored by the fact that this debt is *de facto* (and, in the case of the IMF, *de jure*) junior to the multilateral debt. That reduces its value further because it is anticipated that this debt would be paid only after the multilateral institutions' debt had been paid.

[23] Calculated from data provided by the World Banks, Global Development Finance 1999.

[24] Estimates are derived from Global Development Finance 1999 (CD ROM version), with short-termed debt assumed to be mostly public debt.

While the above estimates are hypothetical, they are at least based on some basic economic criteria. What is common to all these estimates is that they propose a level of debt forgiveness that is almost certain to exceed what is offered by even the enhanced HIPC initiative for most countries. To compare, the enhanced HIPC initiative proposes to reduce from US$130 billion to US$60 billion the (1998) net present value of the debt of 33 of the countries likely to gain from the initiative. This implies an average forgiveness rate of 54 %.[25] This level of debt reduction would not meet any of the criteria mentioned above and would fail to provide any debt forgiveness dividend (on average). Yet if debt relief does not completely eliminate the debt overhang, further losses in poverty reduction and growth can be expected.

III. THE COST OF DEBT RELIEF

Multilateral debt

The public nature of the debt has made debt forgiveness a far more complex accounting transaction than it would have been for purely private institutions. The IMF has argued that a straightforward write-down of the debts of HIPC countries would compromise the risk value of its general fund (which is part of the reserves of its members) and would therefore be both unfair and compromise the trust of its members. The World Bank and regional banks have argued that similar write-downs would jeopardize their (triple A) credit rating, making it more expensive to borrow in capital markets and forcing them to pass that cost to non-HIPC borrowers.[26]

Many observers are not convinced, particularly for the larger Bretton Woods institutions whose exposure to HIPC countries is very small relative their total capital/subscriptions (Hardy, 1996). Be that as it may, the enjoinder against direct write-downs has been instituted within the HIPC initiative. This, in no small measure, creates a binding constraint on the amount of debt relief that can be offered because all multilateral debts must be covered in full from other sources. Some of the sources of funds are within those institutions themselves, but those sources are limited and must, ultimately, be supplemented by funds from bilateral creditors who themselves must find funds to pay off the debts owed to their export credit and aid agencies. This rather complex arrangement is part of the reason for the sluggish progress in debt relief over the years.

As of September 1999, estimates of the enhanced HIPC initiative put the cost of debt reduction for these institutions at US$13.3 billion. The World Bank will carry at least $5.1 billion of that cost, the IMF $2.3 billion, the African Development Bank $2.0 billion, the Inter-American Development Bank $1.0 billion, and $2.9 billion will be distributed among other multilateral creditors. It is anticipated that the IMF will meet its share of the cost by investing the proceeds derived from revaluing some of its gold stock, which is severely under-priced, then liquefying and investing that value.[27] The World Bank and the regional banks are expected to pay for debt reduction partly out of their own resources and partly from the HIPC Trust Fund. That fund is replenished by contributions from member countries and International Bank for Reconstruction and Development (IBRD) profits.

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[25] There remains the possibility of a further $20 billion reduction of ODA debt that would bring the debt reduction rate closer to 70 % but this remains strictly voluntary and not part of the initiative.

[26] Though this does not apply to IDA credits, since IDA funds are not raised on world capital markets, the World Bank still argues that the cost would have to be passed on to IBRD borrowers, resulting in the same net effect.

[27] This will be accomplished by selling the gold to central banks owing money to the IMF at market price and allowing those banks to use that gold to pay the amounts owed to the IMF. The proceeds are then invested and the profits used to fund debt relief through the ESAF/PRGF facility.

While the IMF's gold revaluation exercise is likely to provide the resources required to cover the IMF's portion of debt reduction under the Enhanced HIPC initiative, the financing of debt reduction by the World Bank and regional banks remain an unresolved issue. Despite suggesting significant increases in the amount of debt relief offered, the Cologne Initiative made no counterpart commitment of resources for these institutions. Instead, there was vague language such as a "call for proportional burden sharing" among donors, and "innovative approaches" by the multilateral banks to mobilize internal resources for debt reduction. The language of the *Joint Statement by Chairmen* (of the Interim and Development Committees) after endorsement of the proposed enhancements to the HIPC initiative, similarly side-stepped that funding issue by committing merely to "maintaining the financial integrity of multilateral financial institutions" and "cost sharing on an equitable basis."[28]

This obfuscatory approach clearly suggests that the funding of multilateral debt reduction remains unresolved. Despite several new commitments in September 1999, the total announced contributions to the HIPC Trust Fund remained well below what would be required to cover more than a small proportion of the debt reduction costs of the regional banks and the World Bank. This issue may not be critical for the World Bank (debt reduction costs would amount to less than 2 % of the combined capital of the IBRD and IDA) but it could be critical for regional lending institutions such as the African Development Banks (whose potential debt reduction commitment is close to 10 % of its capital base). Clearly, to maintain their financial integrity many of these institutions will have to draw on substantial external resources that have, thus far, not been committed. Thus the problems of burden -haring among creditor agencies and governments that have plagued the debt reduction process throughout, remain. It might yet serve to delay or even undermine the Enhanced HIPC Initiative.

Bilateral debt relief

There are, potentially, three approaches that creditor governments can take to reduce bilateral debt (which is owed largely to export credit agencies and aid agencies). These are:

(i) asking those agencies to simply write the debt off their books;
(ii) compensating those agencies for the estimated repayment (or market) value of the debt;
(iii) compensating those agencies for the original (or uncorrected) value of the debt.

The first option is potentially the least costly (with respect to creditor government budgets) but, depending on the size of debt stocks, it could endanger the health of agencies not directly funded by relevant governments. The second option, though slightly more costly than the first, would not endanger any institution that was not already technically insolvent. The third option is by far the most expensive because, in economic terms, the funds transferred contain a direct capital transfer in addition to the value of the debt extinguished. It is not clear how many countries use the first two options, but some countries do in fact use the third option—resulting in an exaggeration of the cost of debt reduction.

Canada, for example, uses the third option with respect to the debt owed to the Export Development Corporation (EDC). In Canada, of the (roughly) C$1.02 billion of bilateral debt owed by HIPC countries, more than $900 million is owed to the EDC. When Canada provides debt relief, the EDC is compensated in full by the government of Canada for removing debtor-country loans from its books. Ostensibly, the cost to the Canadian government (and ultimately the Canadian taxpayer) of writing down EDC debt is the full value of the unpaid portion of the loan, including arrears. However, this overstates the actual costs.

[28] IMF Communiqué, September 26, 1999.

The EDC, as a matter of course, makes explicit allowance for expected losses on loans based on risk profiles. The corporation thus writes down the value of high risk or impaired loans (loans that are not performing adequately) to reflect the lowered expectation of repayment. For impaired loans, the allowance averaged 40 % for sovereign loans and 88 % for commercial loans on the corporation's 1998 balance sheet.[29] Thus, loans to HIPC countries, a significant proportion of which are already "impaired," are not valued at their original negotiated value but at some proportion of that value. This is good business practice by the EDC, but it also means that when the organization is paid the unamortized portion of the original value of the loan (plus unpaid interest), part of the repayment is a windfall, because the corporation had already made allowances for loan losses. In other words, the payment made to EDC is a combination of two things:

(i) loan repayment on behalf of the debtor country based on EDC's valuation of that loan; and
(ii) a net transfer to EDC (equal to loan loss provisions) that can be added to its capital stock or repaid to the government as dividends.

There seems to be very little reason for this overly generous arrangement since payment of debt as valued by the corporation holds no potential risk to the corporation. Debt reduction through the second approach suggested above would be equivalent (in financial terms) to a realization of the firm's expectations regarding loan performance and would cost the government a great deal less. Most importantly, the current arrangements tend to place artificial budgetary limits on debt reduction by exaggerating its cost.

Debt relief and official development assistance

The fact that funds for debt relief are, in essence, directed at dealing with problems of the developing world may encourage the view that it is essentially part of the general program of official development assistance (ODA) and that funding for debt relief should naturally come out of the ODA budget. That perception is incorrect. Two crucial differences between debt relief and ODA make them non-substitutable:

(1) ODA is a consistent flow of funds that developed countries, such as Canada, commit in support of their international development agenda. Its continuity at fairly predictable levels is almost as important as its size. It is only in so doing that these countries can implement multi-year programs, maintain a core of expertise in that area, and sustain a reputation for consistency and dependability. In "Shaping the 21st. Century: The Contribution of Development Co-operation" (DAC/OECD, 1996) the OECD countries committed themselves to a 50 % reduction in global poverty by the year 2015. If ODA is to have any chance of performing that task, current flows must be maintained *above and beyond additional flows for debt relief.*

(2) Replacing ODA by (pre overhang) debt relief is almost certain to result in a reduction in net flows to poorer countries. Some figures may help clarify that point. In 1997 Cameroon received ODA equivalent to 5.9 % of its GNP. Cameroon's debt service obligation in that year was roughly 12.3 % of its GNP, of which it was able to meet 49 % (or 6.0 % of GNP). If aid to Cameroon was reduced by 50 % to help pay for a 60 % debt and debt service reduction in that year, the net effect would have been a reduction in debt service obligations to 4.9 % of GNP, and a reduction in aid equivalent to 3 % of GNP. The net effect would have been lower net

[29] If, for example, all of the HIPC debt constituted impaired loans, the $900 million dollar HIPC debt would be valued at $540 million (or 60 cents on the dollar). However, not all of the HIPC debt is, in fact, impaired so the real valuation would be higher though still significantly less than $900 million.

inflows of 1.9 % of GNP (3 % lost ODA minus 1.1 % saving from debt service reduction). Thus, even if that ODA had been only half as effective as the debt relief dividends, the net effect would have been negative for the country in that year. This is so because a large part of debt forgiveness will have no discernable impact on resource flows since it will go to pay off debts that were not being serviced.

However, these arguments are not necessarily applicable to the post-overhang condition. If debt reduction succeeds in removing the debt overhang, it is possible that the substitutability between ODA and debt reduction will be more closely related to the relative effectiveness of *further* debt relief (i.e. enlarging the debt relief dividends) versus aid. We shall return to this issue shortly.

Options for poverty focused debt reduction

While poverty focused debt reduction is a laudable goal, both poverty reduction and debt reduction can be compromised if the basic requirements for success in achieving either become lost in the larger shuffle.

Poverty can be considered to have two aspects that hold different (and sometimes contradictory challenges) to policymakers. First, there is the day-to-day experience of economic deprivation (the challenge of living with limited functionings); second, there are the structural aspects, or persistent realities, that tend to perpetuate poverty (the limited creation of *capabilities*). The first aspect can and should be addressed, with all haste, to alleviate suffering, but it is only by addressing the structural aspects of poverty that this condition can be permanently eradicated.[30]

Poverty is most often found within a context of inadequate command of factors of production (human capital, physical capital, land, etc.) or limited means of utilizing that capacity (lack of employment, and the absence of physical and institutional infrastructure necessary for productive activity and the full realization of human potential). These attributes already describe a wide range of areas in which actions and intervention may be necessary to eradicate poverty. These include:

(i) improvements in education, health, nutrition, etc.;
(ii) increased public and private investment;
(iii) greater equity in the distribution of land and other assets;
(iv) the development of the relevant institutions (banking, legal, etc.) that form the superstructure within which economic activity can take place.

None of this is new, but it does beg the question: how does debt relief fit into this equation? The first part of this paper was devoted to illustrating the manner in which the debt overhang has delayed poverty reduction by reducing the rate of improvement in human capital, physical capital (investment), and growth (production). However, it does not follow that debt relief will automatically result in improvements in these measures. If positive results are to be forthcoming, such debt relief should meet at least the following three criteria:

(i) Adequacy: It is not true that any amount of debt reduction will have a significant positive effect. If debt reduction is not sufficient to remove the debt overhang there may be no net benefit to debt reduction (in terms of poverty reduction or otherwise). A smaller debt overhang can have precisely the same effect as the current overhang in terms of reducing the budgetary

[30] Having said this, it should be recognized, however, that there is a great deal of overlap between those two aspects. For instance, improved health, access to clean water and food, etc. also provide people with greater productive capacity and this in turn can lead to long-term improvements in their economic circumstances.

space for governments, producing a foreign exchange crunch, and providing a disincentive for investment and reform. Therefore, the first requirement for poverty focused debt reduction must be *sufficient debt relief to remove the debt overhang.*

(ii) Additional financing for both debt relief and poverty reduction:
The enhanced HIPC facility, even if it does remove the debt overhang (a still doubtful prospect as we have shown) is not likely to provide a substantial dividend for use in poverty reduction. In any case, the remaining debt burden, though smaller, may still be large enough to impair growth through some of the mechanisms discussed earlier (lower investment, etc.). New instruments and procedures should be used to improve both these conditions.

For example, exchanging debt for spending on poverty reduction can be used to simultaneously help debtor governments further reduce the debt load (or at least cover service obligations) while encouraging them to spend on poverty related areas. As described earlier, payments can be made to a special fund or escrow account denominated in foreign currency that can be drawn on by debtor governments for debt service payments in return for spending prescribed amounts in domestic currency (perhaps above some benchmark level) on health, education, or other area of poverty related spending, or contributing to a Poverty Reduction Fund such as that used in Uganda.

However, it is important that this funding is *additional* to other initiatives such as the Enhanced HIPC initiative because the net effect would be minimal if it served simply as part of the debt overhang reduction exercise. Another advantage is that, if it replaces a pre-existing commitment (i.e. debt was previously being serviced) the problems of overload and limited absorption noted by Foster *et al* (1999) are not likely to be relevant. Such funding (again only if it is additional to removal of the debt overhang) can be a legitimate and fruitful use of ODA if poverty action plans are indeed acted upon. Part of the advantage is that such funding is directed through the government budget in a manner that much of ODA is not. In the particular case of poverty reduction, the centrality of government action in providing the institutional capacity, legislative power, coverage, and continuity in the delivery of services and management and the provision of public goods is undeniable.

(iii) Constructive arrangements for monitoring and funding poverty reduction and growth:
The conditionality attached to debt reduction must be conducive to constructive and coherent policies, and to general ownership of these policies by debtor country governments and peoples. In that regard it is necessary that adjustment programs avoid the problems of conditionality overload, narrowing of the policy space due to ideological rigidity, and the excessive dependence on negative conditionality for which the ESAF facility has developed a reputation, deserved or otherwise.

The framework proposed by the World Bank (1999) does go some way in that direction by proposing a participatory process within the CDF and along the lines of the third-party approach noted above. While this approach is useful as a broad framework, it may be unwieldy with respect to short-term assessment of country performance. This can however be achieved through a country rating system (not unlike the credit worthiness criteria) managed by one or both of the Bretton Woods institutions or a UN agency. Through such a system, countries' efforts and effectiveness at poverty reduction and general economic policy can be rated based on an agreed scale and criteria (focused on management-related issues such as transparency, accountability, efficiency in the use of funds, etc., rather than on the level of achievement).

Potential donors could use this rating system to determine the level and nature of contributions to a country's poverty reduction strategy, thus avoiding the stop-start-stop process of current adjustment-related funding. Such a rating system could also act as a means of utilizing positive conditionalities—countries' eligibility for certain types of funding assistance, etc. can be related to their rating.[31]

IV. CONCLUSION

This paper has tried to describe the nature of the debt problem facing the heavily indebted poor countries and their creditors. It has argued that the profile of the debtor countries and the overwhelmingly public nature of the debt create both constraints and opportunities for its resolution. The weaknesses in those economies and pervasive poverty have meant that the existences of a debt overhang problem, and its persistence, have compromised both human development and growth in these countries. Removal of the debt burden will, if nothing else, reduce the slow-down in the pace of human development that has been the legacy of debt. However, partial removal of the debt overhang will not suffice and would likely have no discernable effect. Thus far, creditors' niggling approach to debt reduction has already meant persistent underachievement in that area, at a high price to the debtor countries and increasing cost to creditors.

However, removing the debt overhang is a necessary but not sufficient condition for significant poverty reduction in the short and medium term. Additional debt reduction and other funding will be necessary to provide a real debt relief dividend that can be directed at the structural aspects of poverty. In addition, the post-relief adjustment regime must be one that actively fosters ownership, reduces the potential for conflict, and broadens the nature of conditionality even as it reduces the conditionality burden.

While enhancements to the HIPC initiative are to be commended, with respect to removing the debt overhang it is too early to conclude that the deed is done. To our knowledge there has been no explicit attempt to estimate the actual size of the debt overhang. Though a formal attempt to do so is beyond the scope of this paper, rule of thumb tests using various approaches suggest that the debt overhang is almost certainly above 60 % of current debt (on average) and possibly as high as 85 %. Thus, current attempts at debt relief may not, in fact, be sufficient.

The approach to debt relief, as we have mentioned, has been niggardly largely because creditors have not been subject to the discipline of a secondary market and because funding has been largely through reimbursement rather than direct write-downs. This has meant that debt reduction costs have become part of government budgets even as these governments attempt to hold the line on expenditures. At the same time, debt relief has seemed to lack a compelling quantitative benchmark. But delay has only increased that cost for all sides. The cheapest option is sufficient and immediate debt relief.

However, with respect to the best mechanics for debt reduction, the relationship between debt reduction and poverty, and the appropriate regime for development finance in the post-debt reduction era, there is still much that remains unexplored. In this paper we have addressed some general issues with regard to the true cost of the debt burden and possible approaches to, and effects of, debt

[31] In such a system, however, it becomes even more crucial that performance criteria not be strongly endogenous—affected by non policy-related variables—since that would automatically put certain countries at an unfair disadvantage.

reduction, but the specific country perspectives remain unexplored. What, for example, were the specific country experiences relating to the heavy debt burden? What do different domestic participants perceive as the most appropriate modalities for debt and poverty reduction. What are their expectations for the post-debt reduction period? These are issues that need to be more closely explored if debt reduction is to be better tailored to the needs of debtor countries.

The manner in which debt reduction can and should be related to poverty reduction still remains unclear. In that respect both specific country experiences and larger explorations of the mechanics of debt relief *vis à vis* poverty reduction is necessary. Similarly, if the potential for future debt crises is to be minimized, the development finance regime that follows debt reduction needs to be carefully considered. In that regard, the role of the regional banks (including their current role in debt reduction), the nature of resource flows, and other related issues must be subject to further study and deliberation.

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APPENDIX

TABLE 1

SOME FIVE-YEAR ECONOMIC AGGREGATES

Economic Aggregates (Unweighted Averages)	HIPC Countries					Selected Non-HI		
	1975-79	1980-84	1985-89	1990-94	1995-97	1975-79	1980-84	1985
Total External Debt								
(Billions of $US)	32.8	72.8	134.5	201.6	212.8	45.9	98.0	170
(as a % of GNP)	42.6	79.3	136.8	185.9	168.9	25.8	42.6	59
Debt Service Payments								
(as a % of Govt. Revenue)	13.8	17.5	21.1	21.6	23.2	6.6	12.2	16.
Debt Service Payments								
(as a % of Exports)	11.5	21.2	27.6	21.8	19.9	8.3	11.8	14.
Terms of Trade multiplied by the Export Ratio	28.1	24.5	23.7	22.6	25.6	30.5	34.4	34.
Total Exports								
(as a % of GDP)	26.4	24.0	21.6	22.9	28.6	29.2	32.6	35.
Foreign Direct Investment[33]								
(as a % of GDP)	0.8	0.5	0.4	1.6	1.5	1.4	0.9	2.8
Official Development Assistance (as a % of GDP)	9.7	12.2	17.2	23.6	20.9	10.1	12.5	13.

Sources: World Development Indicators (World Bank); Global Development Finance (World Bank).

[32] The group of countries defined as "selected non-HIPC" are those countries (for which data was generally available) that were def
Global Development Finance 1999 as moderately or less indebted; whose income (in $PPP) was less than $2000 in 1980 (and are t
group whose maximum per capita income ($PPP) was slightly higher than $1500); and were not included in the Jubilee 2000 choic
countries. The two exceptions to that rule were China, which was not included because of its size and unique conditions, and the D
included even though it's per capita income was 2070 ($PPP) in 1980 (see The World Bank's World Development Indicators). The
group are: Belize, Botswana, cape Verde, Comoros, Dominica, Dominican Republic, Egypt, El Salvador, Gambia, Grenada, India,
Nepal, Pakistan, Solomon Islands, Sri Lanka, St. Kitts and Nevis, St. Vincent, Swaziland, Thailand, Zimbabwe.

[33] Equatorial Guinea was excepted because of extremely high inflows in 1995 of over 77% of GDP, due to new investment in the m
period average.

TABLE 2

Some Pubic Expenditure Related Aggregates (Averages)

Economic Aggregates	HIPC Countries				Selected Non-	
	1980-84	1985-89	1990-94	1995-96	1980-84	1985-89
Government Revenue, Excluding Grants (% GDP)	18.73	17.65	14.65	16.04	22.37	23.30
Health Expenditure, Public (% of GDP)	1.26	1.17	1.67	1.68	1.22	1.13
(% of Govt. Expenditure)	4.48	4.78	7.33	8.14	4.50	4.23
Public Spending on Education (% of GNP)	4.16	3.75	4.09	4.32	3.77	4.25
(% of Govt. Expenditure)	14.74	15.25	17.92	20.95	13.84	15.93
PPG Debt Service (% of Govt. Revenue)	18.85	21.97	22.26	28.65	15.55	23.21
Military Expenditure (% of GNP)	..	2.99	3.23	2.26	..	3.61
Government Expenditure, Total (% of GDP)[34]	28.21	24.60	22.84	20.62	27.23	26.68
Gross Domestic Investment (% of GDP)	16.15	15.43	15.85	17.46	28.14	25.50
Public Investment (% of GDP)	8.98	6.85	6.78	7.77	9.74	7.61
Private Investment (% of GDP)	9.23	7.83	8.68	9.55	15.42	14.76

Sources: World Development Indicators 1999 (World Bank) Ebel, Beth, "Patterns of Government Expenditure in Develop
1980s: The Impact on Social Services," UNICEF, I*nnocenti Occasional Papers*, Florence, Italy, July 1991.

[34] The country coverage for gross domestic investment is more complete than the coverage for public and private investment, hence

TABLE 3

Performance Comparison of HIPC and Selected Non-HIPC Countries[35]

CRITERIA	HIPC Countries			Non-HIP	
	1970-79	1980-89	1990-97	1970-79	19
Average annual growth of GDP (%)	3.1	2.3	1.7	5.7	
Average annual growth of GDP per capita (%)	0.3	-0.6	-1.0	2.9	
Average annual increase in (average) life expectancy (years)	0.40	0.27	0.18	0.46	
Average annual increase in (per capita) calorie supply	6.3(1)		-2.0(2)	17.6(1)	
Average annual decrease in infant mortality rate (per 1000)	2.3	1.7	1.3	2.4	
Average annual increase in gross primary school enrollment (%)	2.0	0.0	0.7(3)	2.0	

(1) 1971-86
(2) 1987-96
(3) 1990 to the latest year in the period 1994-96
Sources: World Development Indicators 1999 (World Bank),
Global Development Finance 1999 (World Bank).

[35] Data coverage was not complete for the variables estimated here but was above 50% in all cases. To avoid the bias creased by situation countries such as Angola, Liberia, Somalia, and Sudan were excluded from the data set.

TABLE 4

Distribution of Public (and Public Guaranteed) Debt among Creditors
For the 41 HIPC countries

Year	Public and Public Guaranteed (Long Term) Debt/GNP	Multilateral (% of Total PPG)	Bilateral (% of Total PPG)	Private (% of Total PPG)
1980	48.52	25.36	48.33	26.31
1985	87.39	30.88	49.33	19.80
1990	143.83	39.21	49.37	11.42
1995	163.59	46.05	46.21	7.74
1997	126.80	48.92	43.93	7.15

Source: Global Development Finance 1999 (World Bank)

TABLE 5

Debt Servicing Ratios

YEAR	Average Ratio of Scheduled Debt Service to GNP	Average Ratio of Actual Debt Service to GNP	Average proportion of Debt Paid [36]
	(Unweighted Average)	(Unweighted Average)	(Unweighted Average)
1990	17.6	4.1	47.7
1991	15.6	5.0	47.4
1992	19.2	4.9	40.8
1993	16.2	4.6	42.8
1994	17.6	6.2	43.6

Source: "Debt Relief for Low-Income Countries: The HIPC Initiative," *IMF Pamphlet Series No. 51*, Washington DC: The International Monetary Fund.

[36] The apparent mismatch between this ratio and the implied ratio from the two previous columns comes from the fact that those countries whose scheduled service ratios were low relative to GNP tended to have high repayment rates while those who had high ratios relative to GNP had low repayment rates. Thus this is an average of two extremes