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Report to Congressional Committees

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DEVELOPING COUNTRIES

Debt Relief Initiative for Poor Countries Faces Challenges

GAO

Accountability * Integrity * Reliability

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Abbreviations

GDP	Gross domestic product
HIPC	Heavily indebted poor country
IMF	International Monetary Fund
OECD	Organization for Economic Cooperation and Development
OMB	Office of Management and Budget
SDR	Special Drawing Right

United States General Accounting Office
Washington, D.C. 20548

National Security and
International Affairs Division

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June 29, 2000

The Honorable James A. Leach
Chairman
The Honorable John J. LaFalce
Ranking Member
Committee on Banking and Financial Services
House of Representatives

The Honorable Spencer Bachus
Chairman
The Honorable Maxine Waters
Ranking Member
Subcommittee on Domestic and International
Monetary Policy
Committee on Banking and Financial Services
House of Representatives

This report responds to your request that we (1) assess whether the enhanced Heavily Indebted Poor Countries Initiative is likely to free up resources for poverty reduction and achieve the goal of debt sustainability, (2) describe the strategy to strengthen the link between debt relief and poverty reduction and how this strategy is to be implemented, and (3) describe the challenges creditors face in fully funding the enhanced initiative.

We are sending copies of the report to the Honorable Lawrence H. Summers, Secretary of the Treasury; the Honorable Madeleine K. Albright, Secretary of State; the Honorable James D. Wolfensohn, President of the World Bank; and the Honorable Horst Köhler, Managing Director of the International Monetary Fund; and other interested parties. Copies will also be made available to others on request.

Please contact Harold J. Johnson, Associate Director, International Relations and Trade Issues, at (202) 512-4128 if you or your staff have any questions concerning the report. An additional GAO contact and staff acknowledgments are listed in appendix XV.

Henry L. Hinton, Jr.
Assistant Comptroller General

Executive Summary

Purpose

In 1996, the World Bank and the International Monetary Fund[1] agreed to undertake a comprehensive approach, called the Heavily Indebted Poor Countries Initiative, for providing debt relief to the poorest and most indebted countries in the world. In September 1999, in response to concerns about the continuing vulnerability of these countries, the World Bank and the Fund agreed to enhance this initiative.[2] The enhancements more than doubled the estimated amount of debt relief, from $12.5 billion for 29 countries to over $28 billion for 32 countries, and added the central goal of reducing poverty in the poorest countries.[3] Creditors expected to provide debt relief under the initiative include governments, the World Bank, the Fund, other international financial institutions, and commercial creditors. This debt relief is to (1) lower countries' debt-service payments significantly, (2) free up resources that will be spent on poverty reduction, and (3) provide a lasting exit from debt problems. To qualify for debt relief, countries must undertake economic and social reforms. After receiving debt relief, it is assumed that countries will have a sustainable level of debt (reach "debt sustainability"), meaning they will be able to make their future debt payments on time using internal and external resources, and without the need for further debt relief. In order for countries to remain debt sustainable, the World Bank and the Fund assume that countries will achieve continuous, strong economic performance, supported by their effectively using their resources and donors continuing to provide assistance for 20 years or more following debt relief. Over the last 2 years, the U.S. Treasury has requested more than $1 billion from Congress to fund U.S. participation in the initiative, mostly to help finance the participation of some multilateral institutions.

[1]The World Bank, supported by its 181 member governments, promotes economic growth and the development of market economies by providing financing on reasonable terms to countries that have difficulty obtaining capital. The Fund promotes international monetary cooperation and exchange rate stability and provides lending to member countries that experience balance-of-payments difficulties. For poor countries, the Fund also provides medium-term (10-year) loans on concessional (below market) terms. One hundred eighty-two governments are members of the Fund.

[2]For information on the original initiative, see *Developing Countries: Status of the Heavily Indebted Poor Countries Debt Relief Initiative* (GAO/NSIAD-98-229, Sept. 30, 1998).

[3]The amount of debt relief is estimated using a "net present value" calculation that captures the concessional terms that underlie most of these countries' loans. The face, or nominal, value of the debt for these countries is significantly greater than the net present value.

Recognizing that previous efforts did not resolve the debt problems of poor countries, the Chairmen and the Ranking Members of the House Committee on Banking and Financial Services and its Subcommittee on Domestic and International Monetary Policy asked GAO to review the enhanced initiative. In response, GAO (1) assessed whether the enhanced initiative is likely to free up resources for poverty reduction and achieve the goal of debt sustainability, (2) described the strategy to strengthen the link between debt relief and poverty reduction and how this strategy is to be implemented, and (3) described the challenges creditors face in fully funding the enhanced initiative.

Results in Brief

The enhanced Heavily Indebted Poor Countries Initiative will provide significant debt relief to recipient countries, with the debt for six of the seven countries GAO analyzed projected to be reduced by one-third or more. However, given the continued fragility of these countries, the initiative is not likely to provide recipients with a lasting exit from their debt problems, unless they achieve strong, sustained economic growth. GAO's analysis shows that the decline in debt service for the seven countries will only "free up" resources for additional poverty reduction if countries continue to borrow at the same level and concessional terms as in the years prior to their qualifying for debt relief.[4] This occurs because countries previously borrowed for several reasons including debt payments, and they will need to continue borrowing after receiving debt relief in order to meet their remaining debt payments and to increase spending on poverty reduction. Furthermore, in order for countries to service their debt after receiving debt relief, World Bank and Fund staffs assume that countries will achieve sustained, strong economic performance. For example, the World Bank and the Fund assume that export earnings will grow an annual average of over 9 percent for 20 years in four of the seven countries GAO analyzed. GAO's analysis indicated that this assumption may be optimistic, since these countries rely on primary commodities, such as coffee, for much of their export revenue, and the prices of such commodities have fluctuated over time, with export earnings in fact declining in certain years. Failure to achieve the projected levels of

[4]Such borrowing will be on concessional loan terms, which include a grace period of about 5 to 10 years and fees and charges of 2 percent or less. In concluding that all of these resources will be borrowed, GAO's analysis has accounted for the amount of grants (money that does not have to be repaid) that donors are expected to provide and the recipients' own revenue.

economic growth could lead, once again, to these countries having difficulty repaying their debt.

Debt relief under the initiative is to be linked to recipient countries' preparation of a comprehensive strategy focused on reducing poverty that integrates numerous policies, such as achieving rapid, sustainable growth and improving health care systems. However, linking debt relief and poverty reduction creates tension between quick debt relief and preparing such strategies. Preparing a comprehensive, "country owned" poverty reduction strategy can be complicated and resource intensive. In 1999, World Bank and Fund staffs estimated that it could take countries up to 2 years to prepare such a strategy. However, Uganda, which the staffs consider at the forefront of these efforts, has been working on a strategy for about 5 years. Uganda has prepared a comprehensive strategy, but, according to the staffs, it still needs to provide additional estimates of the cost of poverty reduction programs and strengthen the links between expenditures and poverty indicators. Many actions are required to prepare and implement a poverty reduction strategy, including gaining the support of key stakeholders, such as political leaders with the power to affect change, and collecting and analyzing necessary data, such as data on the extent and major causes of poverty. However, weaknesses in countries' ability to collect and analyze these data and other challenges may limit these efforts. According to officials from some nongovernmental organizations, such as Catholic Relief Services and Jubilee 2000, the desire to receive debt relief quickly may cause some countries to quickly prepare the strategies, which could diminish the strategies' quality, or the level of civil society participation, at least in the short term. The World Bank, the Fund, and the U.S. Treasury said that these concerns are mitigated because some countries do not have to prepare a full poverty reduction strategy in order to qualify for debt relief, some countries will receive a significant share of their debt relief after they qualify for the initiative, and because debt relief can be an incentive for countries to prepare the strategies.

Financing the initiative has proven to be a challenge for many creditors, with some multilateral and smaller bilateral creditors reporting that they are facing difficulties in providing their full share of debt relief and need external funding. For example, some smaller bilateral creditors, such as Tanzania, are themselves potential debt relief recipients and may find it difficult to absorb the costs of forgiving other countries' debts. For multilateral and smaller bilateral creditors, difficulties in financing their shares stem from legal, technical, and financial restrictions.[5] For instance, the African Development Bank has stated that it is unable to finance its share of debt relief under the initiative solely through its own resources and at the same time maintain an adequate level of reserves and its commitment to future concessional lending. Difficulties in fully financing the initiative could undermine the success of the initiative, since debt relief is supposed to be additional to the assistance that donors and creditors would otherwise provide to low-income countries.

The uncertainties over whether the initiative provides a lasting exit from debt problems, the tension between quick debt relief and preparing poverty reduction strategies, and the difficulties in financing the initiative should not be seen, however, as a reason to abandon efforts to provide debt relief to eligible countries. Heavily indebted poor countries continue to carry unsustainable debt burdens that are unlikely to be lessened without debt relief, but participants and observers may need to have a more realistic expectation of what the initiative may ultimately achieve.

Background

The World Bank and the Fund have classified 40 countries as heavily indebted and poor.[6] Thirty-two of these countries are in sub-Saharan Africa.

[5]Creditors' shares of debt relief are determined using a "proportional approach," under which bilateral and multilateral creditors would provide debt relief together and provide equal percentage reductions of debt owed them after the full use of existing debt relief mechanisms. The World Bank and the Fund in collaboration with government authorities estimate the amount of debt relief the bilateral and multilateral creditors, as a group, are to provide a particular country.

[6]In 1996, the World Bank and the Fund classified 41 countries as heavily indebted poor countries. This included, for analytical purposes, 32 countries with a 1993 gross national product per capita of $695 or less and 1993 present value of debt to exports higher than 220 percent or present value of debt to gross national product higher than 80 percent. Also included were nine countries that received, or were eligible for, concessional debt rescheduling from bilateral creditors. In 1998, Nigeria no longer met the criteria, and Malawi was added. In 1999, the number of countries was reduced to 40 because Equatorial Guinea no longer met the criteria for "low income" or "heavily indebted."

The United Nations classified 27 of the 40 countries as being in its lowest category of human development, based on life expectancy, literacy, and per capita national income. (See app. I for a list of the human development indicators for 38 of 40 countries. Data were not available for Liberia and Somalia.) Most receive substantial amounts of development assistance from governments, multilateral organizations, and nongovernmental organizations. Some, such as Rwanda and Sierra Leone, are engaged in or have recently emerged from civil strife or external conflict.

The debt problems of many of these countries continue to be a concern for the international community. In 1996, in response to concerns that even after receiving debt relief from bilateral creditors through existing means some poor countries will have debt burdens that remain too large relative to their ability to pay, creditors agreed to the Heavily Indebted Poor Countries Initiative. The initiative—the first comprehensive effort to include bilateral and multilateral creditors—provided full debt relief to four countries. Nongovernmental organizations and some governments criticized this initiative as providing too little relief too slowly. In September 1999, the creditors agreed to provide increased debt relief more quickly to more eligible countries. They also called for a strong link between debt relief and poverty alleviation and said that debt relief should free resources for spending on priority poverty reduction areas. These changes were contingent on creditors providing sufficient financing so that, among other things, normal aid flows would not be reduced.

Under the enhanced initiative, the debt levels of eligible countries are expected to be lowered to a point that is considered sustainable; that is, countries will continue to be able to meet their future debt obligations on time without the need for further debt relief. The staffs of the World Bank and the Fund assume that this point (debt sustainability) is reached when the ratio of the net present value of a country's debt level to its exports is 150 percent or less. After calculating the amount of debt relief a country needs to reach this level, the staffs of the two institutions together with the recipient government project the factors supporting continued debt sustainability, including estimates of future debt levels, exports, income, tax revenue, and donor assistance for the 20-year projection period. The staffs assume that donor assistance will be an important source of external flows for these countries and may help finance any future gaps that countries experience in meeting their debt obligations.

According to the World Bank and the Fund, for debt relief under the initiative to be effective, it must be integrated into a country's overall

strategy for reducing poverty. The recipient country prepares the strategy. The World Bank, the Fund, and others may help. The strategy is to (1) address a broad array of policies, including those aimed at increasing economic growth and improving living conditions; (2) be developed with the participation of civil society and donors; and (3) reflect the country's unique circumstances. The strategy is to be developed in an iterative process and updated about every 3 years. In recognition that the preparation of such comprehensive strategies could delay debt relief for countries that were progressing in their efforts to qualify under the original initiative and the calls for hastening the qualification for the enhanced initiative, the World Bank and the Fund agreed that countries could qualify for debt relief based on an "interim" poverty reduction strategy, a less detailed and relatively brief document.

Principal Findings

Unless Strong, Sustained Economic Growth Is Achieved, the Initiative Is Not Likely to Provide a Lasting Exit From Debt Problems

Enhanced Initiative Provides Significant Debt Relief

The enhanced Heavily Indebted Poor Countries Initiative provides significant debt relief for all seven of the countries GAO analyzed: Bolivia, Honduras, Mauritania, Mozambique, Nicaragua, Tanzania, and Uganda.[7] This analysis showed that the total amount of debt for these countries is projected to fall, following debt relief, by more than one-third in most cases and by one-half or more for five countries—Mauritania, Mozambique, Nicaragua, Tanzania, and Uganda. Furthermore, all seven countries' scheduled debt service is also expected to fall considerably, with reductions ranging from more than a 12-percent drop for Honduras to more than 50 percent for Mozambique and Uganda.

[7]GAO's analysis focused on seven of the eight countries in which a debt sustainability analysis from the World Bank and the Fund was available to GAO to analyze. Due to the limitations of time, GAO was unable to review the final country, Guinea.

To Fund Additional Spending for Poverty Reduction, Countries Must Continue to Borrow

GAO's analysis shows that the seven countries' debt levels will again rise following the receipt of debt relief under the initiative. This occurs because in order to have the funds that are expected to be spent on poverty reduction, these countries must continue to borrow—at the same level and concessional terms as in the years prior to qualifying for debt relief under the initiative—given each country's projected amount of grants, loans, and revenue. Countries previously borrowed for several reasons, including debt payments, and they will need to continue borrowing after receiving debt relief in order to meet their remaining debt payments and to increase spending on poverty reduction. Thus, these countries cannot both increase their spending on poverty reduction and reduce their annual borrowing by the amount that their debt service was lowered.

Ability to Repay Debt in the Future Hinges on the Assumption of Strong Economic Growth

Countries' ability to repay debt depends on the assumption that countries will achieve strong, sustained economic growth. One underpinning of this assumption is that countries will use their borrowed resources effectively. Some argue that borrowing may be in the best interest of each country because governments can spend the borrowed resources on priority areas, such as poverty reduction, rather than to pay creditors. However, this involves deficit financing, meaning that countries have to borrow in order to increase their current spending. The need for debt relief is due in part to previous lending programs that did not sufficiently increase recipients' ability to pay their debt obligations. The initiative contains an implicit assumption that the process of preparing and implementing a poverty reduction strategy will result in a more effective and productive use of resources, leading to both economic growth and poverty reduction. However, such strategies are relatively new and untested. Failure to effectively use their resources could jeopardize countries' future ability to repay debt.

Maintaining debt sustainability also depends on recipient countries' achieving continuous, strong economic growth. Most recipient countries that GAO has analyzed are projected by World Bank and Fund staffs to have robust growth in export earnings, with the projected growth for four of these countries—Honduras, Nicaragua, Tanzania, and Uganda—expected to average at least 9.1 percent a year over 20 years. The staffs also assume strong growth in gross domestic product and government revenue for most of the recipient countries that GAO has analyzed. The average annual growth (in nominal dollars) of these two factors was assumed to be greater than 6 percent in all cases and to exceed 9 percent for Honduras, Mozambique, Tanzania, and Uganda in one or both of those factors. Growth in exports, gross domestic product, and government revenue are presumed

to contribute considerably to these countries' ability to meet their future debt obligations. Although such growth levels are generally consistent with the growth levels since 1990, sustaining such levels over a 20-year period may be difficult. For example, these countries rely on a small number of primary commodities, such as coffee, for a majority of their export earnings, and the prices of these commodities tend to fluctuate over time, with export earnings in fact declining in certain years.

Shortfalls in these growth projections will lower the amount of revenue these countries will be able to contribute toward their future debt service or poverty reduction. If these countries are to remain debt sustainable, continue to alleviate poverty, and maintain growth, this shortfall could be made up through increased donor assistance.[8] Without such assistance, countries may no longer be debt sustainable and may require additional debt relief, or they may accumulate arrears. For example, if Tanzania's actual average annual export growth is about 20 percent less than projected, if Tanzania will be unlikely to repay its debt obligations unless donor flows (both concessional loans and grants) increase by about 30 percent. As a result, Tanzania's debt -to-export ratio could more than double over what was originally forecast for the projection period.

Linking Debt Relief and Poverty Reduction Creates Tension Between Quick Debt Relief and Comprehensive Strategies

The initiative calls for countries to prepare a comprehensive, "country owned" poverty reduction strategy before completing the initiative. However, accomplishing this task poses many challenges.

Preparing Strategies Is Complicated and Resource Intensive

In 1999, World Bank and Fund staffs estimated that most countries should be able to prepare a poverty reduction strategy within 2 years. However, Uganda, which the staffs consider at the forefront of these efforts, has been

[8]The shortfall in export earnings is assumed to be made up through an increase in grants and concessional loans so that imports and domestic spending, including poverty reduction activities, remain the same as in the original projections. This additional concessional borrowing results in higher levels of debt and debt ratios, while preserving fairly robust economic growth levels and poverty reduction. If instead policymakers choose to adjust to these lower levels of export earnings by reducing imports, lowering domestic spending, raising tax revenue, or a combination of these approaches, they could avoid incurring such high debt ratios, although it would likely result in lower economic growth and lower expenditures on poverty reduction.

working on a strategy for about 5 years. Uganda has prepared a comprehensive strategy, but according to the staffs, it still needs to provide additional estimates of the cost of poverty reduction programs and strengthen the links between expenditures and poverty indicators. Many actions are needed to reduce poverty, given the high incidence and numerous and diverse causes of poverty. These actions include rapid sustainable growth, sound macroeconomic policies, measures targeted at the specific causes of poverty, good governance, and active civil society participation. The coordination of so many activities is challenging and time consuming, but GAO found that for poor countries the preparation of a poverty strategy can tax already limited government resources. Preparing a strategy depends on collecting and analyzing an extensive amount of data, which take time, resources, and expertise. For example, countries are to collect and analyze data that describe the nature, extent, and major causes of poverty in ways that can be used later to monitor progress. In the four countries GAO visited—Bolivia, Nicaragua, Tanzania, and Uganda—government officials, with technical and financial support from donors and others, were undertaking actions to improve their ability to gather and analyze data and monitor indicators. However, existing weaknesses in countries' capacity may limit their effort to collect and analyze data. The World Bank and the Fund are strongly encouraging donors to increase their technical and financial support in this area. Furthermore, there is limited evidence showing which actions have the greatest impact for achieving poverty reduction goals.

Country Ownership and Donor Support of the Strategy Can Be Difficult to Achieve

The effective preparation and implementation of the poverty reduction strategy requires countries to take ownership of the strategies, involve civil society, and receive donor support, according to the World Bank, the Fund, and some nongovernmental organizations. Nonetheless, there is a tension between the time needed to satisfy these requirements and the desire for quick debt relief. The World Bank and the Fund Executive Boards have said the strategies should reflect countries' unique circumstances and capacities and therefore have not defined specific criteria for judging key aspects of the strategies. Although countries are to define their own strategies, the World Bank and the Fund Boards must endorse the strategies in order for countries to receive debt relief and future loans from the Bank and the Fund. Thus, recipient countries need to determine how they will (1) define or achieve ownership (that is, reflect the outcome of an open participatory process involving governments, civil society, and relevant international institutions and donors); (2) address challenges to effective civil society participation; and (3) ensure that the donors will align their funding with the priorities outlined in these strategies. Officials

from some donor governments, multilateral organizations, and nongovernmental organizations, such as Catholic Relief Services and Jubilee 2000, said they were concerned that countries' desire to receive debt relief under the initiative as soon as possible could adversely affect the degree of countries' ownership and the level, quality, and impact of civil society participation in the development of a poverty reduction strategy.

Additionally, the strategy needs the support of key stakeholders such as political leaders. In a document on increasing participation, World Bank staff reported that attempts to bypass powerful stakeholders often resulted in their opposition, which usually compounded the problem of getting anything useful accomplished.[9] Absence of the full range of stakeholders, especially politicians with the power to affect change, limits effectiveness. The effectiveness of the strategies is also influenced by the extent to which donors agree with and are willing to align their contributions with the countries' priorities. Field representatives of donors may support the concept of a recipient-led strategy but may not be able to reallocate their aid to fund the recipients' priorities due to the earmarking of spending by their governments.

Differing Views on Whether to Directly Link Debt Relief to Poverty Reduction Strategies

Given the vulnerabilities and debt problems of poor countries, some creditor governments, the U.N. Secretary General, and nongovernmental organizations have urged creditors to quickly provide debt relief under the initiative. Some representatives said that delaying debt relief adversely impacts countries' growth by diverting scarce resources from development needs to debt payments. They are also concerned that the conditions (such as some economic reforms) countries must meet in order to receive debt relief under the initiative will delay debt relief and, in some cases, hurt rather than help the country. However, the World Bank and the Fund argue that these concerns are mitigated because countries begin to receive significant debt relief when they qualify for the initiative and that conditions are needed to ensure that governments undertake reforms and use resources effectively.

Because recipient countries will be highly dependent on concessional financing and will be monitored under World Bank- and Fund-supported programs for the foreseeable future, some nongovernmental organizations have said that debt relief under the initiative should not be linked directly to the preparation of poverty reduction strategies. They said they want to

[9] *The World Bank Participation Sourcebook* (Washington, D.C.: World Bank, 1996).

ensure that the strategies are of high quality and the level of civil society participation is not compromised simply to meet the initiative's time frames. Also, countries may have the incentive to quickly complete the initiative because debt relief only becomes irrevocable at that point. Prior to that, creditors may revoke debt relief due to recipients' unsatisfactory performance. On the other hand, the World Bank, the Fund, and the U.S Treasury argue that these concerns are mitigated because some countries do not have to prepare a full poverty reduction strategy in order to qualify for debt relief, and countries will begin receiving debt relief after they qualify for the initiative. World Bank and Fund staffs estimated that for four countries—Mauritania, Mozambique, Tanzania, and Uganda—the reduction in debt service expected during the interim period is at least 70 percent of the debt service reduction expected with full debt relief. Moreover, the World Bank and the Fund see the receipt of debt relief under the initiative as a catalyst that should motivate countries to undertake difficult reforms and begin preparing the poverty reduction strategies. According to World Bank and Fund staffs, creditors agreed in 1999 to increase the amount of debt relief if the link between debt relief and poverty reduction were strengthened and thus may resist weakening this link.

Bilateral and Multilateral Creditors Face Financing Challenges

As a group, bilateral and multilateral creditors are expected to provide roughly equal shares of debt relief under the initiative that is estimated to total over $28 billion (in net present value terms);[10] however, many creditors, especially the multilateral and smaller bilateral creditors, report that they are having difficulty identifying their share of the necessary financing from their own resources due to budgetary and other constraints. For example, an underlying premise of the initiative is that debt relief is supposed to be additional to the assistance that donors and creditors would otherwise provide to low-income countries. Difficulties in financing the initiative could delay debt relief and ultimately undermine the success of the initiative.

Bilateral Creditors Are Important to Success of the Initiative

Although bilateral creditors are expected to provide about $13 billion (in net present value terms) of debt relief under the initiative, the estimated cost of providing this relief varies among creditors, and some report that they have not secured the full financing to fund their obligations. GAO's

[10]Of the $28 billion, multilateral creditors are expected to provide about $14 billion, bilateral creditors to provide about $13.2 billion, and commercial creditors to provide about $0.8 billion.

review of the seven leading industrial countries[11] indicates that providing debt relief results in additional budget costs for each country. However, the impact on their budgets in providing debt relief varies based on five key factors: the amount of outstanding loans, the method used to value loans, the method used to budget for debt relief, the options used to provide debt relief, and the constraints imposed by certain legal requirements. GAO's analysis indicates that, for four of the seven leading industrial countries (France, Germany, Italy, and Japan), the budgetary cost of providing debt relief is close to the face, or nominal, value of the debt. For the other countries, including the United States, the budgetary cost of debt relief is less than the face value of the debt because the value of the debt has been discounted, or reduced, in recognition of the risk that these loans may not be repaid. For example, according to U.S. Treasury officials, the budgetary cost to the United States is about $346 million (in net present value terms) to forgive about $3.8 billion in debt (in nominal terms) owed by 22 countries under the enhanced initiative. In addition to funding the direct costs of debt relief, large bilateral creditors are also expected to provide continued aid flows and contribute to help multilateral and smaller bilateral creditors meet their share of debt relief under the initiative. Bilateral creditors have pledged over $2.5 billion to assist multilateral creditors.

[11]These seven countries are Canada, France, Germany, Italy, Japan, the United Kingdom, and the United States. They are expected to provide about 50 percent of the debt relief anticipated from bilateral creditors.

Three of the Four Largest Multilateral Creditors Face Considerable Financing Gaps

Although most multilateral institutions have expressed support for the overall goal of the initiative, many have yet to overcome serious difficulties in being able to provide their full share (about $14 billion in net present value terms) of debt relief. Collectively, the four major multilateral institutions—the World Bank, the International Monetary Fund, the African Development Bank, and the Inter-American Development Bank—are expected to provide about $12 billion (net present value terms) in debt relief. Of these four institutions, all but the Fund have large financing gaps that they are working to fill from internal and external sources.[12] Creditors' difficulties in financing their shares stem from legal, technical, and financial restrictions. For example, the African Development Bank has stated that it is unable to finance its share of debt relief solely through its own resources and at the same time maintain an adequate level of reserves and its commitment to future concessional lending. Also, some smaller multilateral institutions have raised the concern that providing debt relief under the initiative threatens their financial integrity.

Observations

The Heavily Indebted Poor Countries Initiative represents a step forward in the international community's efforts to relieve poor countries of their heavy debt burdens, and it does so by seeking to include all creditors and providing significant debt relief to recipient countries. Elements of the current initiative—especially its goals and financing—have required and continue to require much negotiation among the various creditors and recipients; however, unless strong, sustained economic growth is achieved, the initiative will not likely provide recipient countries with a lasting exit from their debt problems. Furthermore, as long as the initiative links debt relief to poverty reduction strategies, the tension between quick debt relief and comprehensive country-owned strategies is likely to continue. These issues should not be seen, however, as a reason to abandon efforts to provide debt relief to eligible countries. Heavily indebted poor countries continue to carry unsustainable debt burdens that are unlikely to be lessened without debt relief, but participants and observers may need to have a more realistic expectation of what the initiative may ultimately achieve.

[12]According to the Fund, full financing will be realized if the members provide the resources they pledged and the U.S. Congress grants the Fund the authority to use the full earnings from the investment of profits from off-market gold sales. Therefore, unlike the other major multilateral creditors, the Fund has a clearly identified means for closing its remaining financing gap.

Agency Comments and GAO's Evaluation

GAO received written comments on this report from the Department of the Treasury, the International Monetary Fund, and the World Bank. These comments and GAO's evaluation of them are reprinted in appendixes XII-XIV. The organizations also separately provided technical comments that GAO discussed with relevant officials and included in the text of the report, where appropriate.

The Treasury stated that it agrees with the report's main conclusions, including that there is tension between the objective to provide debt relief quickly and the need to develop quality poverty reduction strategies. The Treasury said that in its view, there is no degree of debt reduction that can by itself provide a definitive exit from debt problems and ensure adequate growth in these countries. The Treasury stated the report provides useful information and raises pertinent questions that will continue to be considered as implementation moves forward on this important initiative.

Both the Treasury and the Fund commented on the fact that future borrowing will occur at below market loan terms. The Treasury stated that GAO's report is misleading when it argues that the initiative does not free up resources for increased spending for poverty reduction because GAO implies that the interest rates at which these countries borrow are unsustainable. Similarly, the Fund said that the report does not emphasize sufficiently that the borrowing to increase spending on poverty reduction is at rates that are substantially below market and that a larger share of aid is now in the form of grants, which do not have to be paid back. GAO disagrees with the Treasury's and the Fund's characterizations. GAO's analysis assumed, consistent with Fund and World Bank assumptions, that future borrowing would be at the same level and below market terms as in the years just prior to qualifying for debt relief. GAO's analysis of countries' future debt burdens also incorporates the level of grants and lending projected by World Bank and Fund staffs.

The Treasury and the Fund also commented that if countries experience lower growth in exports than projected and debt sustainability is threatened, it would be reasonable to expect that adjustments would be made in countries' borrowing and expenditure plans. This implies that good debt management practices will be utilized. GAO agrees with this point. However, GAO notes that although efforts are being undertaken to improve debt management, there has not been a history of strong management in this area. Moreover, GAO believes that if policymakers adjust to the lower levels of export earnings by reducing imports, lowering

domestic spending, raising tax revenue, or using a combination of these approaches, this would likely result in lower economic growth and lower expenditures on poverty reduction.

The World Bank said the report provides much useful information and underscores important aspects of the Heavily Indebted Poor Countries Initiative that the partners will be able to take into account as they move forward with the initiative's implementation. The Bank strongly agreed with the need for countries to pursue prudent debt management policies and for lenders to follow responsible lending policies, if debt problems are to be avoided over the long term. Otherwise, the benefits of the initiative could be eroded, as GAO's report indicates. According to the World Bank, a durable exit from unsustainable debt remains a central objective of the initiative.

Introduction

The debt problems of many of the world's heavily indebted poor countries continue to be a concern for the international community. Most of these countries' debt is owed to official creditors consisting of other governments (bilateral) and international financial institutions (multilateral). In 1996, the World Bank and the International Monetary Fund (IMF)[1] launched the Heavily Indebted Poor Countries (HIPC) Initiative.[2] The initiative—the first comprehensive effort to include all creditors in addressing poor countries' debt problems—responded to concerns that even after receiving bilateral debt relief through existing means, some poor countries would still have debt burdens that remain too large relative to their ability to pay. While recognizing that this first initiative was a positive step forward, nongovernmental organizations, U.N. organizations, and some borrower governments criticized the initiative as providing too little relief too slowly. In response to these concerns and the likelihood that changes to the initiative would be discussed by leaders from industrialized countries, in February 1999 the World Bank and the IMF launched a broad review of the HIPC Initiative that included suggestions from the public, governments, nongovernmental organizations, and international organizations. In April 1999, the Interim and Development Committees endorsed efforts to provide increased debt relief under the initiative and to strengthen the link between debt relief and poverty

[1]The World Bank, supported by its 181 member governments, promotes economic growth and the development of market economies by providing financing on reasonable terms to countries that have difficulty obtaining capital. The Bank is the world's single largest official source of investment capital for developing countries. The IMF promotes international monetary cooperation and exchange rate stability and provides short-term lending to member countries that experience balance-of-payments difficulties. For poor countries, the IMF also provides medium-term (10-year) loans on concessional (below market interest rate) terms under its Poverty Reduction and Growth Facility, the successor to its Enhanced Structural Adjustment Facility. One hundred eighty-two governments are members of the IMF.

The Development Committee, which is composed of 24 members who are usually ministers of finance or development, advises the World Bank's and IMF's Boards of Governors. The International Monetary and Financial Committee of the IMF (formerly the Interim Committee) is an advisory body made up of IMF governors or government ministers. The World Bank and the IMF operate under the authority of the Boards of Governors, the highest decision-making authorities. General operations of the World Bank and the IMF are delegated to smaller groups of representatives, the Boards of Executive Directors, who are responsible for making policy decisions and approving loans. Each Board comprises 24 Executive Directors who are appointed or elected by one or more member countries.

[2]For more information on the original HIPC Initiative, see *Developing Countries: Status of the Heavily Indebted Poor Countries Debt Relief Initiative* (GAO/NSIAD-98-229, Sept. 30, 1998).

reduction. The committees stated that the debt relief should provide a clear exit from unsustainable debt burdens, meaning that recipients will be able to make their debt payments on time and without the need for future debt relief. In June 1999, the leaders of the seven major industrialized countries (Canada, France, Germany, Italy, Japan, the United Kingdom, and the United States) plus Russia called for an enhanced HIPC Initiative that would provide increased debt relief more quickly to more countries. However, the leaders reiterated the need for conditions to ensure that governments undertake reforms and use resources effectively. They said that to receive debt relief, countries must demonstrate a commitment to reform and poverty alleviation. They called for a strong link between debt relief and poverty alleviation and said that debt relief should free resources for spending on priority poverty reduction areas. In September 1999, the World Bank and the IMF endorsed these changes to the HIPC Initiative, subject to the availability of adequate financing.

Poor Countries' Debt Burdens

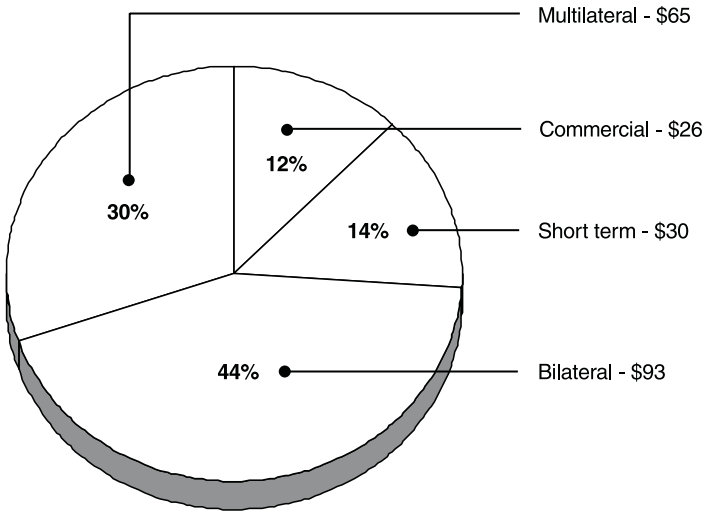
The World Bank and the IMF have classified 40 countries as potentially eligible for HIPC debt relief.[3] Thirty-two of these countries are in sub-Saharan Africa. The United Nations classified 27 of the 40 countries as being in its lowest category of human development, based on life expectancy, literacy, and annual per capita national income. (See app. I for a list of countries, their per capita income, and their human development indicators. These data are available for 38 of the 40 potential HIPC recipients. Data were not available for Liberia and Somalia.) Most receive substantial amounts of development assistance from governments, multilateral organizations, and nongovernmental organizations. Some, such as Rwanda and Sierra Leone, are engaged in or have recently emerged from civil strife or external conflict.

The total external debt of the 40 countries was over $200 billion in nominal, or face value, terms, as of the end of 1997. As shown in figure 1, most of this

[3]In 1996, the World Bank and the IMF classified 41 countries as heavily indebted poor countries. This included, for analytical purposes, 32 countries with a 1993 gross national product per capita of $695 or less and 1993 net present value of debt to exports higher than 220 percent or net present value of debt to gross national product higher than 80 percent. Also included were nine countries that received, or were eligible for, concessional debt rescheduling from bilateral creditors. In 1998, Nigeria no longer met the criteria, and Malawi was added. In 1999, the number of countries was reduced to 40 because Equatorial Guinea no longer met the criteria for "low income" or "heavily indebted."

debt is owed to official creditors; that is, governments and multilateral institutions.

Figure 1: Composition of External Debt for 40 Heavily Indebted Poor Countries, 1995-97 (Nominal value, in billions of U.S. dollars)



Note: Total debt includes short-, medium-, and long-term debt. Short-term debt can be owed to either official or commercial creditors. It includes loans with maturities of less than 1 year (often trade financing) and interest arrears.

Source: GAO analysis based on World Bank data.

About $93 billion, or 44 percent, was medium- and long-term debt owed to bilateral (government) creditors, and about $65 billion, or 30 percent, was owed to multilateral creditors. Poor countries incur two major types of debt: concessional (below market interest rates) and nonconcessional (market-based interest rates). (See app. II for information on the types of debt incurred by poor countries and app. III for information on the amount and type of debt that potential HIPC recipients owe to the United States.)

Causes of Poor Countries' Debt Problems

According to a 1999 IMF staff paper, the debt problems of poor countries originated in borrower countries' weak macroeconomic policies and debt management, adverse trade shocks, and official creditors' willingness to take risks unacceptable to private lenders.[4] During the 1970s and 1980s, many low-income countries experienced a sharp increase in their external borrowing. Most of these countries had limited access to private finance and were more often borrowing directly from other governments or their export credit agencies, or through private loans that export credit agencies guaranteed would be repaid.[5] This lending was primarily on nonconcessional terms. The 1999 IMF staff paper stated that this lending was, by definition, a highly risky business, with a real possibility that eventually much of the debt would not be repaid. This paper further stated that creditor governments lent this money in order to increase their domestic exports and the associated benefits of protecting or creating domestic employment, as well as to strengthen diplomatic relations with the borrower countries. According to a 1997 IMF staff paper, the commodity boom of the 1970s may have done more harm than good by contributing to optimistic export growth projections on the part of developing countries, encouraging them to overborrow.[6] Much of the lending was not used effectively, and the debt continued to grow, according to the 1999 staff paper.

In addition to the willingness of official creditors to lend and the debtors to borrow, several other factors contributed to borrower countries' debt burdens. These included adverse shocks in the terms of trade (that is, the prices of their exports fell or the prices of their imports increased); a lack of sustained economic reform by governments; weak debt management practices; and political factors, such as war and social strife. The World Bank reported that, by the early 1980s, interest payments became an increasing burden for indebted countries, and the share of new borrowing used for debt payments increased sharply. According to the 1999 IMF staff

[4]Christina Daseking and Robert Powell, *From Toronto Terms to the HIPC Initiative: A Brief History of Debt Relief for Low Income Countries*, IMF Working Paper 99/142 (Washington, D.C.: IMF, 1999).

[5]According to the 1999 IMF staff paper, the role of the export credit agencies has largely been to support domestic exports by providing loans to developing countries in the context of the unwillingness of the private sector to accept certain risks, especially political risks arising from uncertain conditions in borrower countries.

[6]Abdelhak Senhadji, *Sources of Debt Accumulation in a Small Open Economy*, IMF Working Paper 97/146 (Washington, D.C.: IMF, 1997).

paper, by this time, many low-income countries had been brought to the point of collapse by years of economic mismanagement.

According to a 1998 IMF staff paper, by the mid-1980s, the bulk of new loan financing to low-income countries was concessional financing from the multilaterals, particularly in countries where debt-service problems arose and private creditors no longer viewed these countries as creditworthy.[7] According to an academic study, the consequence of the switch from nonconcessional to concessional financing was a dramatic rise in the share of debt and debt service owed to the multilateral development banks.[8] Although the lending by the multilateral institutions became increasingly concessional during the 1980s, according to the 1998 IMF staff paper, in some cases such lending was inconsistent with these countries' debt-servicing capacity, particularly for countries that already faced very high debt levels.

Prior Debt Relief Efforts Did Not Significantly Lower Countries' Debt Burdens

Much of the debt owed by the heavily indebted poor countries cannot be fully paid using their own resources and is either paid through the support of donors or not paid at all. This has been true since the 1980s. Debt relief efforts since that time have been undertaken primarily by bilateral and commercial creditors. Multilateral creditors had generally not rescheduled or reduced debt owed them because of their belief that forgiving or reducing debt would diminish assurances of repayment on new lending and, in some cases, hurt their credit rating. Although bilateral creditors have reduced debt individually, they most commonly have worked together to offer debt relief on increasingly concessional terms through the Paris Club, an informal group of creditors that meets, as needed, to negotiate debt rescheduling and relief efforts for public or publicly guaranteed loans.

In September 1996, in response to concerns that, even after receiving debt relief through these efforts, some poor countries will still have debt burdens that remain too large relative to their ability to pay, the World Bank and the IMF launched the HIPC Initiative. The initiative was the first comprehensive effort to include all creditors in addressing poor countries'

[7]Ray Brooks et al., *External Debt Histories of Ten Low-Income Developing Countries: Lessons from Their Experience*, IMF Working Paper 98/72 (Washington, D.C.: IMF, 1998).

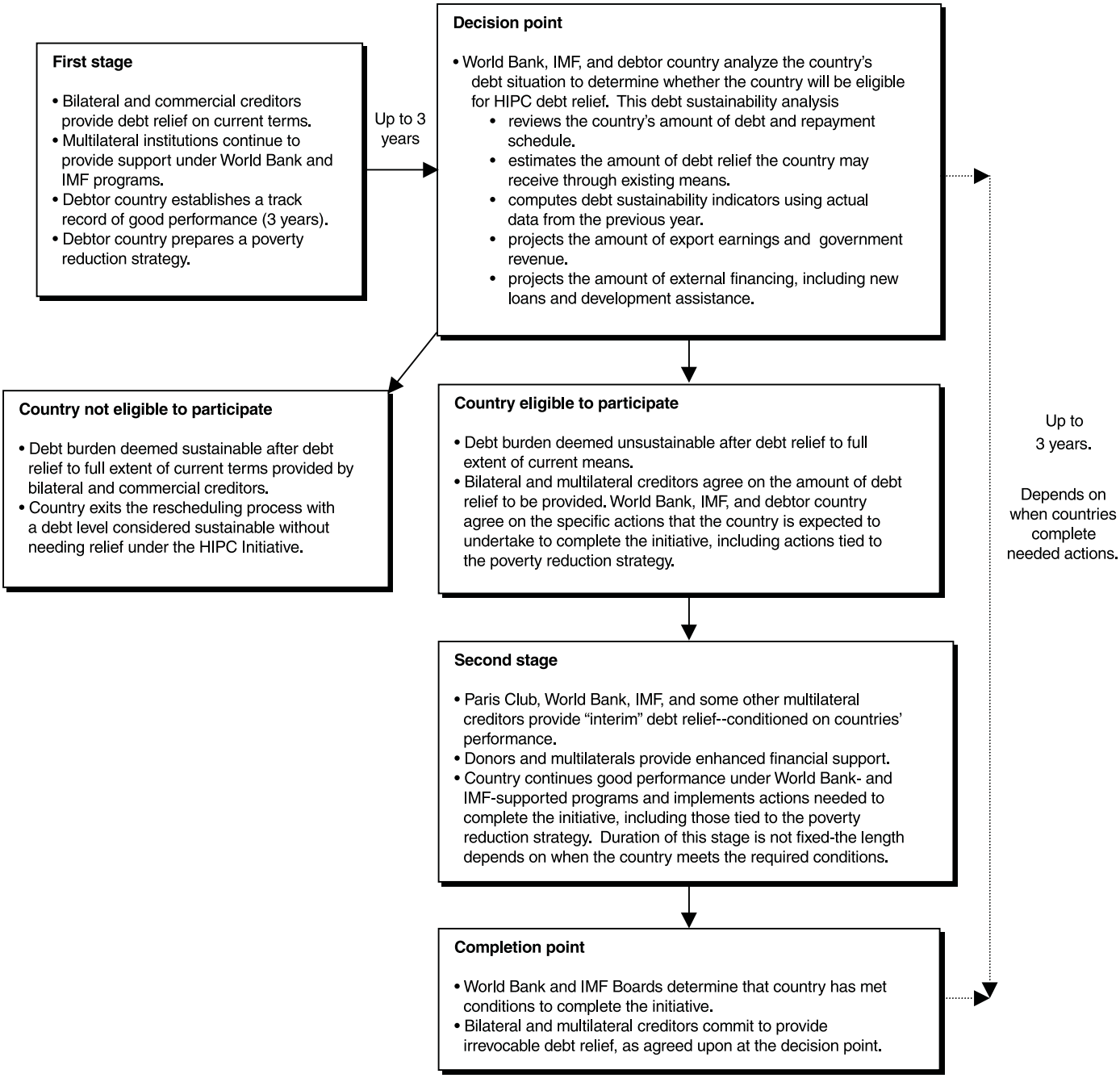
[8]Percy S. Mistry, *Resolving Africa's Multilateral Debt Problem* (The Hague, the Netherlands: The Forum on Debt and Development, 1996).

debt problems. Participating creditors include governments; major multilateral creditors such as the World Bank, the IMF, and the African Development Bank; commercial creditors; and over 20 other multilateral organizations, including the International Fund for Agricultural Development. (See app. IV for a list of participating multilateral organizations.) Under the original initiative, seven countries qualified for debt relief, and four of these countries—Bolivia, Guyana, Mozambique, and Uganda—received full debt relief, as of May 1, 2000. However, while acknowledging that this first initiative was a positive step forward, nongovernmental organizations, U.N. organizations, some borrower governments, and some creditor governments criticized the original HIPC Initiative as providing too little relief too slowly. In response to these concerns and the likelihood that changes to the initiative would be discussed by leaders from industrialized countries, in February 1999 the World Bank and the IMF launched a broad review of the HIPC Initiative that included suggestions from the public, governments, nongovernmental organizations, and international organizations. In April 1999, the Interim and Development Committees endorsed efforts to provide increased debt relief under the initiative and to strengthen the link between debt relief and poverty reduction. The committees stated that the debt relief should provide a clear exit from unsustainable debt burdens.

Enhanced HIPC Initiative

In September 1999, the Interim and Development Committees approved changes to the HIPC Initiative that are to provide faster, broader, and deeper debt relief with the central goal of reducing poverty in the poorest countries in the world. The committees stressed the need to ensure that debt relief will result in poverty reduction while recognizing that debt relief is only one part of a larger effort to reduce poverty. HIPC debt relief, together with forgiveness of debts arising from official development assistance, is to lower countries' debt-service burdens significantly and free resources for priority social spending. The committees endorsed the proposals, subject to the availability of financing. Like the original initiative, the enhanced initiative is to be implemented in two stages. (See fig. 2.)

Figure 2: Process for Implementing the Enhanced HIPC Initiative



Sources: World Bank and IMF documents.

- During stage one, a country must carry out economic and social reforms under World Bank- and IMF-supported programs, after which eligibility for HIPC debt relief is assessed. At that time, called the "decision point," the World Bank and IMF Executive Boards determine whether (1) existing debt relief mechanisms[9] are sufficient to lower a country's debt to a point they consider sustainable or (2) the country requires additional relief. In making this determination, they decide whether the ratio of a country's debt (in net present value terms) to the value of its exports is more than 150 percent.[10] If existing means are not enough to make debt levels sustainable and creditors are willing to support HIPC debt relief with pledges of financing, the country is considered eligible to enter the second stage of the initiative. At this time, the World Bank and IMF staffs together with recipient governments calculate the amount of debt relief creditors are to provide when countries complete this stage. Official creditors have agreed to share the costs of HIPC relief by providing equal percentage reductions of debt owed them after the full use of existing debt relief means. During this stage, the country receives some debt relief from the Paris Club, the World Bank, the IMF, and possibly other multilateral creditors. The World Bank, the IMF, and the recipient country agree on the specific actions to be taken or indicators to be monitored under World Bank and IMF programs that the countries are expected to meet in order to complete the initiative.

[9]Existing, or current, mechanisms refer to debt relief offered prior to the HIPC Initiative, including the terms offered by the Paris Club and other bilateral and commercial creditors. Under "Naples terms" (the terms that existed just prior to the initiative), countries could receive up to a 67-percent reduction in eligible debt under a stock-of-debt operation. This operation refers to the total refinancing of the outstanding balance of a country's eligible debt. The stock of eligible debt will be reduced, and the remainder will be rescheduled. The Paris Club generally limits the debt that is eligible to be rescheduled to nonconcessional debt, such as loans to support exports from the lending country and loans that were incurred before an agreed-upon cutoff date. This date corresponds to the first time that a country requests debt rescheduling/relief from the Paris Club. For many potential HIPC recipients, this date occurred in the 1980s and thus eligible debt was contracted before this time.

[10]Under certain conditions, for countries with economies very open to international trade and strong efforts to generate fiscal revenues, the target may be based on the ratio of debt (in net present value terms) to government revenue. The target ratio is now 250 percent, down from 280 percent under the original initiative. The eligibility thresholds were also reduced from 40 percent to 30 percent for exports to gross domestic product and from 20 percent to 15 percent for government revenue to gross domestic product. Much of the debt of poor countries is contracted on concessional terms. The net present value of debt is a measure that takes into account the degree of concessionality.

- During the second stage, the country receives some debt relief, implements economic and social reforms agreed to with the World Bank and the IMF, and adopts and implements a strategy to reduce poverty. Once the country implements the reforms, it receives irrevocable debt relief. For a country to reach the completion point, the World Bank and IMF Executive Boards must determine that the country has met the specific actions that they agreed to at the decision point. As such, the completion point is to be based on countries' outcomes rather than the length of their track records, as was done under the original initiative. At the completion point, bilateral and multilateral creditors commit to provide an equal percentage of debt reduction.

In 1999, World Bank and IMF staffs estimated that 36 of the 40 countries might eventually receive relief based on the initiative's specific criteria concerning income, indebtedness, and reform efforts.[11] The reforms are to help ensure that debt relief is put to effective use. In 1999, World Bank and IMF staffs estimated that the enhanced HIPC Initiative could provide about $28 billion in debt relief (1999 net present value terms) to 32 countries.[12] Table 1 shows that, as of May 2000, specific eligibility decisions had been made for five countries—Bolivia, Mauritania, Mozambique, Tanzania, and Uganda—under the enhanced initiative.

[11]The four countries not expected to qualify were Angola, Kenya, Vietnam, and Yemen.

[12]These estimates do not include relief for Ghana, which indicated that it may not request HIPC debt relief, and for Liberia, Somalia, and Sudan because of the relatively poor data and uncertainty regarding the treatment of their large arrears. For Ghana, the estimated amount of debt relief was about $1 billion in net present value terms. Adding Liberia, Somalia, and Sudan increases the estimated amount of relief to about $36 billion in net present value terms.

Table 1: Status of Implementation of the HIPC Initiative, Countries Grouped by Milestone Reached, as of May 3, 2000 (Debt expressed in net present value terms unless otherwise noted)

Millions of U.S. dollars

				Amount of debt relief[a]						
Country	**Decision point**	**Completion point**	**Debt-to-export target (in percent)**	**Total**	**Bilateral**	**Multilateral**	**IMF**	**World Bank**	**Reduction in debt[b] (in percent)**	**Estimated total debt service relief (nominal, millions of U.S. dollars)**
Decision point reached under enhanced initiative										
Bolivia				**$1,302**	**$425**	**$876**	**$84**	**$194**	**30**	**$2,060**
Original	Sept. 1997	Sept. 1998	225	448	157	291	29	53		
Enhanced	Feb. 2000	Floating	150	854	268	585	55	141		
Mauritania	Feb. 2000	Floating	137[c]	622	261	361	47	100	50	**1,200**
Mozambique				**1,970**	**1,235**	**736**	**141**	**434**	**72**	**4,300**
Original	Apr. 1998	June 1999	200	1,716	1,076	641	125	381		
Enhanced	Apr. 2000	Floating	150	254	159	95	16	53		
Tanzania	Apr. 2000	Floating	150	2,026	1,006	1,020	120	695	54	**3,000**
Uganda				**1,003**	**183**	**820**	**160**	**517**	**40**	**1,950**
Original	Apr. 1997	Apr. 1998	202	347	73	274	69	160		
Enhanced	Feb. 2000	May 2000	150	656	110	546	91	357		
Completion point reached under original initiative										
Guyana	Dec. 1997	May 1999	107[c]	256	91	165	35	27	24	**410**
Decision point reached under original initiative										
Burkina Faso	Sept. 1997	Apr. 2000[d]	205	115	21	94	10	44	14	**200**
Côte d'Ivoire	Mar. 1998	Mar. 2001[d]	141[c]	345	163	182	23	91	6[e]	**800**
Mali	Sept. 1998	Spring 2000[d]	200	128	37	90	14	44	10	**250**
Total assistance provided/committed				**$7,767**	**$3,422**	**$4,344**	**$634[f]**	**$2,146**		**$14,170**
Preliminary HIPC document issued[g]										
Ethiopia	-	-	200	$636	$225	$411	$22	$214	$23	**$1,300**
Guinea	-	-	150	638	256	383	37	173	34	**1,148**
Guinea-Bissau	-	-	200	300	148	153	8	73	73	**600**
Honduras	-	-	137[c]	569	208	361	18	85	18	**1,024**

(Continued From Previous Page)

Millions of U.S. dollars

				Amount of debt relief[a]						
Country	**Decision point**	**Completion point**	**Debt-to-export target (in percent)**	**Total**	**Bilateral**	**Multilateral**	**IMF**	**World Bank**	**Reduction in debt[b] (in percent)**	**Estimated total debt service relief (nominal, millions of U.S. dollars)**
Nicaragua	-	-	150	2,507	1,416	1,091	32	188	66	**5,000**
No assistance required under original initiative – eligibility to be reassessed under enhanced initiative[h]										
Benin	July 1997									
Senegal	Apr. 1998									

[a]Assistance levels are at countries' respective decision or completion points, as applicable.

[b]In percent of the net present value of debt at decision or completion point (as applicable), after the full use of traditional debt relief mechanisms.

[c]Eligible under fiscal/openness criteria; figures provided show the ratios of debt-to-exports that correspond to the targeted debt-to-revenue ratio. For Guyana and Côte d'Ivoire, a 280 percent debt (net present value)-to-revenue ratio was targeted at the completion point; for Honduras and Mauritania, a 250 percent ratio was targeted at the decision point.

[d]Completion points projected at the decision points.

[e]Nonreschedulable debt to non-Paris Club official bilateral creditors and the London Club of commercial creditors, which was already subject to a highly concessional restructuring, is excluded from the net present value of debt at the completion point in the calculation of this ratio.

[f]Equivalent to Special Drawing Rights (the international reserve asset created by the IMF) of 374 million at a Special Drawing Right exchange rate to U.S. dollars of 0.744.

[g]Figures are based on preliminary assessments at the time of the issuance of the preliminary HIPC document and are subject to change. Assistance levels for Ethiopia and Guinea-Bissau were based on the original initiative and applied at the completion point. For Guinea, Honduras, and Nicaragua, targets are based on the enhanced initiative, and assistance levels are at the decision point.

[h]Deemed to have a sustainable level of debt.

Sources: IMF and World Bank.

Three of these countries—Bolivia, Mozambique, and Uganda—completed the first HIPC Initiative. (See app. V for information on the specific conditions that eight countries are expected to meet in order to reach their HIPC decision and completion points.)

Government Actions Needed

According to World Bank and IMF staffs and the former Managing Director of the IMF, to be effective, an enhanced HIPC Initiative needs to be supported by actions of both borrower and creditor countries, including the following:

The major bilateral donors must be willing and able to (1) finance traditional debt relief measures (Paris Club) and HIPC debt relief, continued aid flows (especially grants), and multilateral concessional lending facilities; (2) reduce trade restrictions on the exports of low-income countries—which are mainly primary commodities such as raw materials and agricultural products;[13] and restrain government-guaranteed commercial export credit lending to recipients, with no such loans for military purposes.

The Managing Director also urged bilateral donors to contribute funds to enable some multilateral and smaller bilateral creditors to provide debt relief under the initiative.

The recipient, or borrower, countries must be willing and able to

- maintain a stable macroeconomic environment as called for under IMF-supported programs and
- implement reforms that promote growth, sustainable development, and poverty reduction—including lower military spending and higher social spending; these include reforms outlined under World Bank- and IMF-supported programs.

[13]In February 2000, the then-Managing Director of the IMF emphasized the importance of increased exports for poor countries' economic growth by stating that "[T]he fact is that the international community is giving with one hand, but is taking away with the other. Governments have made the far-reaching decision—in the framework of the Bretton Woods institutions—to reduce by about one-half the debt of 35 or 40 heavily indebted poor countries through our HIPC Initiative. But those same governments have failed—in the framework of WTO [the World Trade Organization]—to launch a trade round, or even to take the very modest step of eliminating trade barriers to the exports of the poorest countries, especially HIPCs. And it is the latter measure that has the greater long-term potential, through its effects on export-led growth and income generation, for lifting the poor out of poverty. This failure, unless quickly reversed, would make a mockery of a decision on debt that is, otherwise, of historic dimensions."

According to World Bank and IMF staffs, in the future, more disciplined lending and borrowing practices, greater provision of grant financing within a multiyear framework, and the development of country-owned poverty reduction strategies hold out the prospect for increasing the effectiveness of external assistance—including debt relief—within a more coherent framework for achieving poverty reduction in low-income countries.[14]

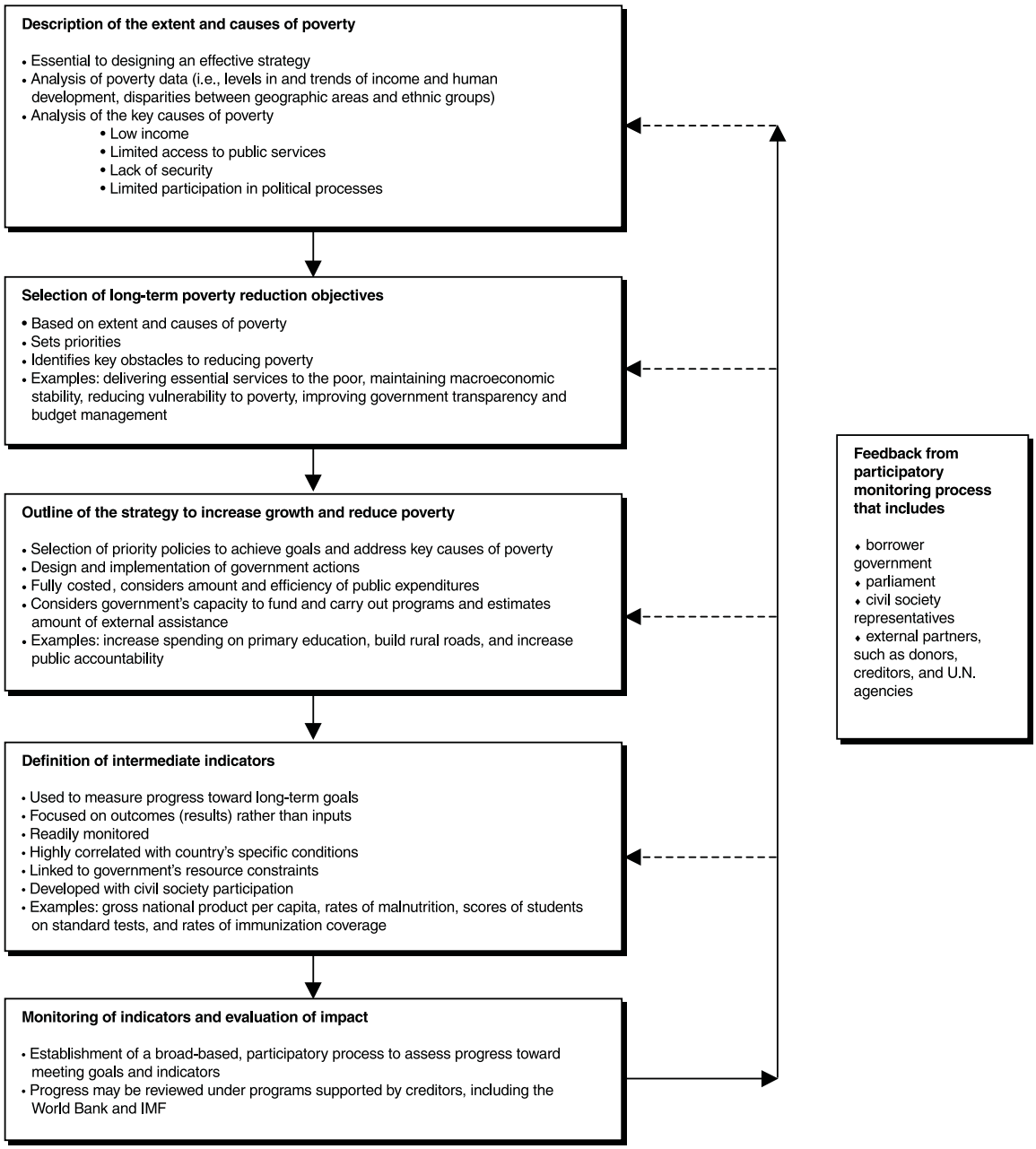
Comprehensive Strategies Link Debt Relief to Poverty Reduction

According to the World Bank and the IMF, for HIPC debt relief to be effective, it must be integrated into a country's overall strategy for reducing poverty, called a "poverty reduction strategy paper." The recipient country prepares the strategy in a participatory process involving civil society and donors. The World Bank, the IMF, and others are available to help. The strategy is to be developed in an iterative process and updated about every 3 years to reflect experience gained in implementing the strategy. The World Bank and the IMF have not outlined a "blueprint" for the poverty reduction strategy because they want the strategy to be country owned. In general, as shown in figure 3, the strategy is to describe the

- extent, nature, and causes of poverty;
- key obstacles to reducing poverty;
- long-term poverty reduction goals and outcomes;
- policies and reforms for achieving these goals and their expected costs;
- way the strategy is integrated into the country's macroeconomic framework;
- intermediate indicators that will measure progress toward achieving long-term goals;
- process for involving civil society and others; and
- participatory process for assessing progress.

[14]According to the World Bank and the IMF, to be effective and meet the expectations underlying the poverty reduction strategy approach, the strategies must be genuinely country owned and reflect the outcome of an open participatory process involving governments, civil society, and relevant international institutions and donors. See *Poverty Reduction Strategy Papers—Status and Next Steps* (Washington, D.C.: IMF and World Bank, Nov. 1999). "Civil society" refers to the nongovernmental segment of society and includes churches, community groups, trade unions, business associations, and organizations that advocate for specific causes, such as human rights and environmental protection.

Figure 3: Key Elements of the Poverty Reduction Strategy as Described in World Bank and IMF Documents



Source: GAO analysis of World Bank and IMF documents.

The strategy is to (1) address a broad array of policies, including those aimed at increasing economic growth and improving living conditions, (2) be developed with the participation of civil society and donors, and (3) reflect the country's unique circumstances. The causes of poverty are multifaceted and include limited access to social services, limited access to markets for selling goods, and restrictions on the ownership of property. Thus, efforts to reduce poverty are long term; complex; and cover a wide range of activities, including increased economic growth, higher immunization rates, improved water quality, and better roads. The HIPC Initiative may contribute to the financing of the strategy, such as spending on health and education programs, as well as monitor progress in implementing the strategy. This strategy is to provide the basis for all future World Bank and IMF concessional lending to low-income countries. World Bank and IMF staffs estimated that, for most countries, it could take up to 2 years to develop an initial poverty reduction strategy.

In recognition that the preparation of such comprehensive strategies could delay debt relief for countries that were progressing in their efforts to qualify under the original initiative and that the committees called for hastening the qualification for the HIPC Initiative, the World Bank and IMF Boards agreed that some countries could qualify for their decision points, and the start of debt relief, on the basis of "interim" poverty reduction strategies. The interim strategies could be less detailed and relatively brief, but would need to be followed by comprehensive and completed poverty reduction strategies prior to the completion point. During the year 2000, 28 countries are expected to prepare an interim strategy.

The poverty reduction strategy is to establish a framework that all creditors and donors can use to guide their activities. Ideally, according to the World Bank and IMF staffs, all donors and multilateral development institutions will support countries by contributing to the poverty reduction strategy's design and consultative processes, identifying their specific participation, and making up-front commitments regarding their participation. Some countries have noted that donors may need to consider new patterns of assistance consistent with poverty reduction priorities, such as longer–term support aligned with the long-term horizon of the strategies.

Objectives, Scope, and Methodology

The Chairman and the Ranking Member of the House Committee on Banking and Financial Services, as well as the Chairman and the Ranking Member of the Committee's Subcommittee on Domestic and International Monetary Policy, asked us to conduct a review of the enhanced HIPC

Initiative. In response, we (1) assessed whether the enhanced initiative is likely to free up resources for poverty reduction and achieve the goal of debt sustainability, (2) described the strategy to strengthen the link between debt relief and poverty reduction and how this strategy is to be implemented, and (3) described the challenges creditors face in fully funding the enhanced initiative.

For our first objective, we examined the World Bank's and the Fund's debt sustainability analyses of Bolivia, Honduras, Mauritania, Mozambique, Nicaragua, Tanzania, and Uganda. Our analysis focused on seven of the eight countries in which a debt sustainability analysis from the World Bank and the IMF was available to us to analyze. Due to the limitations of time, we were unable to review the final country, Guinea. In our analysis, we examined the basis for the IMF and World Bank projections for key economic variables including debt stock, gross domestic product (GDP), government revenue, donor assistance, and exports from 1999 through 2018. We supplemented this work with data from the IMF *(International Financial Statistics)*, the World Bank *(Global Development Finance)*, the Organization for Economic Cooperation and Development (OECD), and the United Nations. We held meetings with IMF and World Bank officials to review the underlying methodology of the debt sustainability analyses and to clarify areas of ambiguity. (See app. VI for a technical description of the economic methodologies used in this report.)

We met with officials from the U.S. Treasury and nongovernmental organizations in the United States, and officials from the host government, donor organizations, and nongovernmental organizations in four recipient countries—Bolivia, Nicaragua, Tanzania, and Uganda—to discuss their understanding of "freed-up resources" and how this was applied under the HIPC Initiative. We also discussed with government officials in the four recipient countries their expectations of the impact of HIPC debt relief on their budgets and their ability to increase spending on priority poverty areas.

For our second objective, we met with and obtained information on the strategy for strengthening the link between debt relief and poverty reduction and on how this strategy is being implemented from government officials of the United States, HIPC recipient countries, and other creditor countries; and officials from multilateral organizations and nongovernmental organizations. We met with and obtained documents discussing the strategy and countries' efforts to reduce poverty from officials at the U.S. Department of the Treasury, the Department of State,

the U.S. Agency for International Development, the United Nations, the World Bank, the IMF, and the Inter-American Development Bank.

We also met with and/or reviewed documents from nongovernmental organizations, including churches, in the United States and abroad, such as ActionAid, Action for Development, AIDS Support Organization, ANGOZA (umbrella organization for nongovernmental organizations on Zanzibar in Tanzania), Bread for the World, Bretton Woods Project, Catholic Relief Services, Center of Concern, Christian Aid, Civil Coordinator for the Emergency and Reconstruction, Cooperative for Assistance and Relief Everywhere, Debt Relief International, Development Group for Alternative Policies, Episcopal Church, European Network on Debt and Development, 50 Years is Enough, Foundation for International Community Assistance, *Grupo Propositivo de Cabildeo*, Heritage Foundation, Inti Raymi Foundation, Jubilee 2000, Women Against AIDS in Kilimanjaro, MaaSae Girls Lutheran Secondary School, National Council of the Churches of Christ in the USA/Church World Service, Overseas Development Institute, Oxfam, Presbyterian Church, St. Anne Kkonge School, TACOSODE (umbrella organization for nongovernmental organizations in Tanzania), Tanzania Association of Nongovernmental Organizations, Tanzania Coalition on Debt and Development, Tanzania Ecumenical Dialogue Group, Tanzania Social Economic Trust, Tanzania Educational Network, Uganda Debt Network, Uganda Microfinance Union, Ugandan Women's Efforts to Save Orphans, Ugandan Women's Finance Trust, United States Catholic Conference, and World Vision.

To obtain information from recipient countries about the implementation of the HIPC Initiative, we interviewed government and other officials in Bolivia, Nicaragua, Tanzania, and Uganda. We selected recipient countries likely to represent a range of experiences under the HIPC Initiative and at different stages of the process. Within the recipient countries, we discussed efforts to reduce poverty, including the preparation of their poverty reduction strategies, with officials of relevant government bodies (such as HIPC implementation units and/or the ministries of finance, planning, health, and education); World Bank and IMF field staff; U.S. embassy and U.S. Agency for International Development officials; local representatives of other donor countries, the European Union, and the U.N. Development Program; local academics; and nongovernmental organizations, including those previously listed. We reviewed relevant documents on efforts to reduce poverty from these organizations.

To determine the challenges faced by creditors in fully funding the initiative, we focused primarily on the seven major industrialized countries (Canada, France, Germany, Italy, Japan, the United Kingdom, and the United States) and four major multilateral institutions (the African Development Bank, the Inter-American Development Bank, the International Monetary Fund, and the World Bank). These countries and financial institutions account for the majority of the outstanding claims against the heavily indebted poor countries and thus are expected to provide most of the debt relief under the HIPC Initiative. Specifically, we spoke to officials from these seven countries and reviewed and analyzed information to determine the extent of their financial exposure to the heavily indebted poor countries; the types of accounting, budgetary, and legal constraints they face in providing debt relief; and their estimated total costs to provide HIPC debt relief. Our analysis of foreign legal constraints is based largely, but not entirely, on interviews and other secondary sources.

To describe the challenges facing the four major multilateral institutions, we interviewed senior officials and reviewed documents from each organization. Specifically, we focused on the identified financing and the funding needed to provide each institution's estimated share of debt relief, as well as the budgetary and administrative constraints each institution faces in identifying additional internal resources. We did not independently verify the amount of internal resources each institution reports as available to fund its share of HIPC debt relief.

We performed our review from August 1999 through April 2000 in accordance with generally accepted government accounting standards.

Unless Strong, Sustained Economic Growth Is Achieved, the Initiative Is Not Likely to Provide a Lasting Exit From Debt Problems

The enhanced Heavily Indebted Poor Countries Initiative will provide significant debt relief to recipient countries, with the debt for six of the seven countries we analyzed projected to be reduced by one-third or more. However, given the continued fragility of these countries, the initiative is not likely to provide recipients with a lasting exit from their debt problems, unless they achieve strong, sustained economic growth. Our analysis of the World Bank, IMF, and host country projections contained within the HIPC documents[1] shows that the decline in debt service for the seven countries will only "free up" resources for additional poverty reduction if countries continue to borrow at the same level and concessional terms as in the years prior to their qualifying for debt relief.[2] As such, recipients' debt levels will rise faster than they would without borrowing for increased spending on poverty reduction. Although such borrowing would increase each country's future debt levels, it would be appropriate if the money contributes to economic growth. However, the need for debt relief is due in part to previous lending activities that did not sufficiently increase recipients' economic capacity, enabling them to pay their debt obligations. In order for countries to remain debt sustainable, World Bank and Fund staffs assume that countries will achieve sustained, strong economic performance, supported by countries effectively using their resources and donors continuing to provide assistance for 20 years or more following debt relief. Our analysis found that the assumption of sustained, strong economic growth might be optimistic since these countries rely on primary commodities, such as coffee, for much of their export revenue, and the prices of such commodities have fluctuated over time, with export earnings in fact declining in certain years. Failure to achieve the projected levels of economic growth could lead, once again, to these countries having difficulty repaying their debt.

[1]These projections are referred to within HIPC documents as the "debt sustainability analysis."

[2]Such borrowing will be on what are considered concessional loan terms, which include a grace period of about 5 to 10 years and fees and charges of 2 percent or less. In concluding that all of these resources will be borrowed, GAO's analysis has accounted for the amount of grants (money that does not have to be repaid) that donors are expected to provide and the recipients' own revenue.

Enhanced HIPC Initiative Provides Significant Debt Relief

The enhanced HIPC Initiative provides significant debt relief for all seven of the countries we have analyzed, as shown in table 2.

Table 2: Estimated Debt Reduction for Seven Countries Under the HIPC Initiative

Country	Debt reduction[a] (in percent, net present value)	Reduction in scheduled debt service[b] (in percent)	Reduction in actual debt service[c] (in percent)
Bolivia[d]	38.3	24.9	37.5
Honduras[e]	18.1	12.2	45.6
Mauritania	50.0	36.1	36.2
Mozambique[d]	72.1	63.7	60.5
Nicaragua[e]	64.0	44.6	55.6
Tanzania	53.8	32.8	30.7
Uganda[d]	52.1	54.4	62.0

Note: “Debt” refers to the total amount of debt that a country owes at a given point in time. “Debt service” refers to the periodic payments countries make to repay their debt.

[a]Percentage reduction in debt stock (in net present value terms) due to HIPC debt relief is calculated as the ratio of HIPC debt relief (in net present value terms) to the initial debt total (in net present value terms), either at the completion point or at the decision point (whichever is applicable), after traditional debt relief and before HIPC debt relief is delivered.

[b]Percent change in scheduled debt service (in net present value terms) before HIPC, but after traditional forms of debt relief, over the projection period (2000-2018), compared to estimated scheduled debt service (in net present value terms) after enhanced HIPC Initiative relief, over the same projection period.

[c]Comparison of the annual average amount of debt service paid during 1995-97 with the average amount of debt service scheduled, 2001-2003, following HIPC relief.

[d]Includes debt relief under both the first and enhanced HIPC Initiatives.

[e]Information based on preliminary HIPC documents.

Source: GAO analysis of IMF and World Bank data.

According to our analysis of HIPC documents, after the provision of HIPC debt relief, the total amount of debt for these countries is projected to fall by more than one-third in all but one country and by one-half or more for five countries—Mauritania, Mozambique, Nicaragua, Tanzania, and Uganda. Furthermore, all countries' scheduled debt service is also projected to fall considerably, with reductions ranging from 12 percent in the case of Honduras to more than 63 percent for Mozambique. In five of the seven countries, the drop in scheduled debt service was one-third or more. In many cases, recipient countries could not fully service their debt in the years prior to receiving HIPC debt relief, accumulating arrears or rescheduling debt payments as a result. For that reason, a comparison of actual debt service paid pre-HIPC with the scheduled debt service to be paid post-HIPC provides a more meaningful indicator of the impact of debt relief on the amount of debt service countries actually pay. In all but one country, the reduction in actual debt service paid by recipients is projected to be at least one-third and more than one-half for three of the seven countries whose HIPC documents we have analyzed. These substantial reductions in actual debt service paid are much larger than those in the original HIPC Initiative.[3]

To Fund Additional Spending for Poverty Reduction, Countries Must Continue to Borrow

According to our analysis, all seven countries' net present value debt levels will rise following the receipt of debt relief, in part because countries would need to continue borrowing concessionally—at the same level as the years prior to qualifying for debt relief—in order to free up the resources that are expected to be spent on additional poverty reduction activities. This occurs because countries borrowed prior to debt relief for several reasons, including debt payments, and they will need to continue borrowing after receiving debt relief in order to meet their remaining debt payments and to increase spending on poverty reduction. Thus, countries cannot both increase their spending on poverty reduction and reduce their annual borrowing by the amount that their debt service was lowered. If

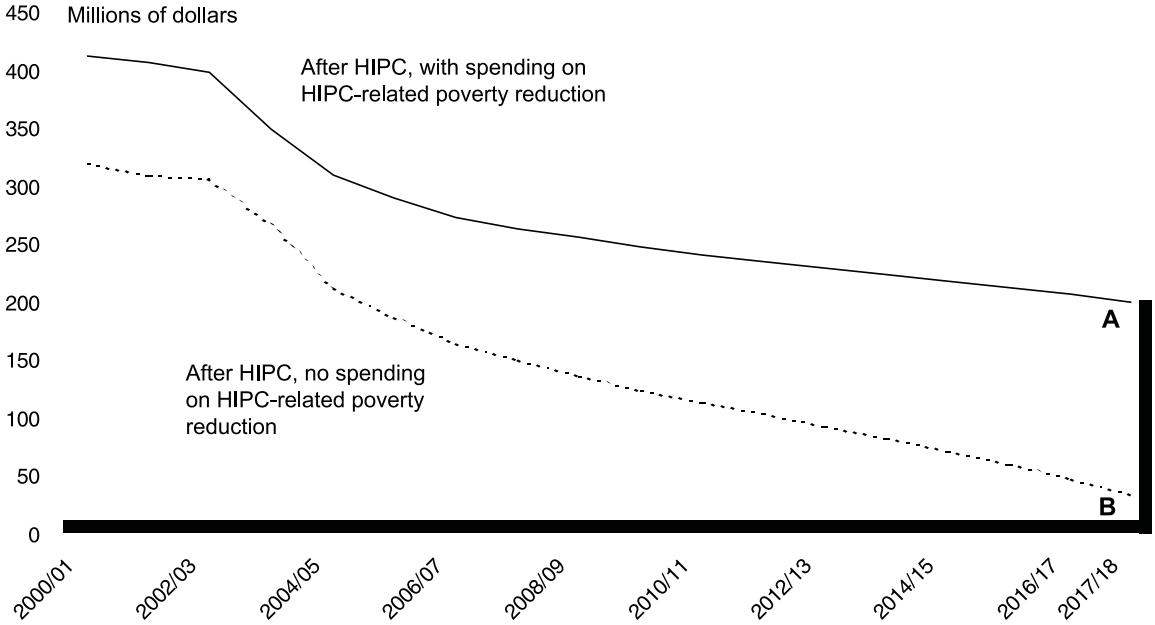
[3]See *Developing Countries: Status of the Heavily Indebted Poor Countries Debt Relief Initiative*. For example, as we reported, although Mozambique's debt stock was projected to fall by as much as half, the effect of this reduction on its actual debt service was expected to be less than 15 percent.

donors were to increase the amount of grant assistance they give recipients over what is currently projected, countries would need to borrow less.[4]

For example, in the case of Tanzania, the HIPC documents we have analyzed indicate that debt relief is expected to lower Tanzania's debt service requirements by approximately $100 million per year in the initial years of the initiative (see fig. 4). This is represented by the gap between lines A and B, during the first 5 years of the initiative.

[4]In June 1999, the leaders of the seven leading industrial countries and Russia said they will strive gradually to increase the volume of official development assistance and to put special emphasis on countries best positioned to use it effectively. To ease future debt burdens and facilitate sustainable development, they agreed to increase the share of grant-based financing in the assistance they provide to the least-developed countries.

Figure 4: Tanzania's Required Balance-of-Payments Financing With and Without HIPC-related Spending for Poverty Reduction, 2000/01-2017/18



Note 1: A country's balance of payments summarizes its financial dealings with the outside world.

Note 2: Line A represents Tanzania's required external financing needs, after subtracting out its export earnings, loans, and grants for project assistance, and private transfers and capital inflows. Line B represents the level of external financing (with the same subtractions as line A) if there are no additional spending and borrowing for HIPC-related poverty reduction activities and the additional financial cost savings derived from not borrowing the HIPC debt service relief. Line A is also equivalent to Tanzania's external financing needs without HIPC assistance.

Source: GAO analysis of World Bank and IMF documents.

However, any increase in spending on poverty reduction would need to be funded by borrowing all or part of this $100 million. IMF and World Bank staff projections assume that Tanzania and other HIPC recipients will borrow all of this money to increase spending on HIPC-related poverty reduction. Borrowing all of these resources would result in Tanzania's maintaining a post-HIPC need for financing (to meet its external requirements such as the remaining foreign debt service and trade deficits) that is identical to the need that existed prior to HIPC debt relief (line A). In other words, Tanzania's pre- and post-HIPC financing profile would be unchanged if it were to borrow all of the $100 million for spending on poverty reduction. If instead the decision were made that Tanzania would not borrow these resources for spending on HIPC-related poverty

reduction, its post-HIPC external financing requirements would be substantially lower. This situation is represented by line B of figure 4.[5]

Even without borrowing the $100 million per year, Tanzania is projected to continue to need a substantial amount of concessional donor financing to cover its remaining external debt obligations.[6] This is represented by the area below line B in figure 4. Thus, although Tanzania would be considered debt sustainable following HIPC relief, it would not be "externally viable" because it would continue to require some external balance-of-payments assistance to close its financing gap.[7] Achieving external viability is considered important because it indicates that the country is no longer dependent on concessional financing to meet its debt obligations. According to the IMF, a country is "externally viable" if it is able to pay its external obligations with its own resources (tax revenues, external account surpluses, and nonconcessional borrowing), without recourse to donor assistance. Without such assistance, Tanzania and the other HIPC recipients will not have sufficient resources to continue to meet their debt payments in the future. If, after receiving HIPC debt relief, all seven countries fully borrow the "freed-up" resources, they all will need donor assistance to continue to help pay their debt obligations.

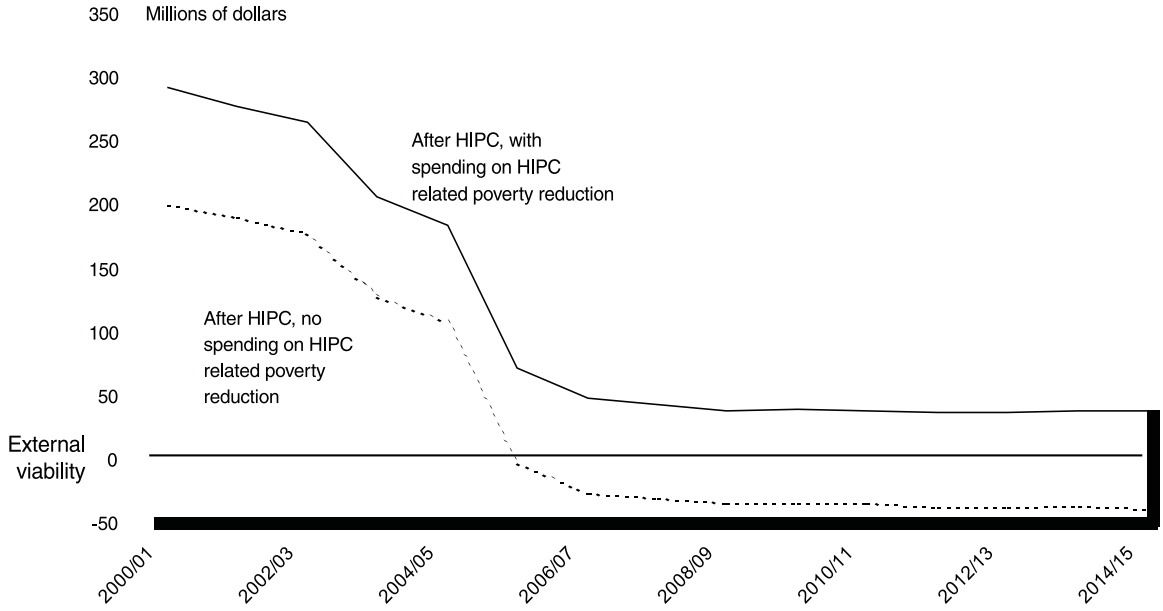
In the case of Uganda, as shown in figure 5, if the decision is made not to borrow the amount of resources (equivalent to debt relief) for spending on poverty reduction, based on our analysis of the projections contained in Uganda's HIPC documents, Uganda would become externally viable within 5 years of receiving the enhanced HIPC debt relief and is projected to remain externally viable for the remainder of the projection period.

[5]Since new borrowing is assumed to be concessional, with a 10-year grace period on principal repayment, the savings in financing requirements increase more rapidly after the time period covered by the World Bank and IMF staffs' debt sustainability analysis.

[6]Our analysis of the World Bank's and the IMF's projections have already accounted for the resources that the recipient country is expected to provide on its own behalf toward its external obligations. See appendix VI for a description of the assumptions used in our analysis.

[7]Such financing is considered "exceptional financing" by the IMF. The original goal of the IMF's program for low-income countries was to allow countries to end their need for such financing within 3 years of getting assistance. IMF staff said that in the mid-1990s this objective was modified to encourage low-income countries receiving their assistance to move toward external viability over time.

Figure 5: Uganda's Required Balance-of-Payments Financing With and Without HIPC-related Spending for Poverty Reduction, 2000/01-2014/15



Source: GAO analysis of World Bank and IMF documents.

External viability is represented by the point in which the lower line crosses the zero axis and remains below it. In contrast, the decision to borrow these resources for poverty reduction results in Uganda never achieving external viability over the projection period. This is represented by the top line, which is above the zero axis over the entire period. This means that Uganda will remain dependent on donor assistance to help meet its external debt obligations for the foreseeable future.

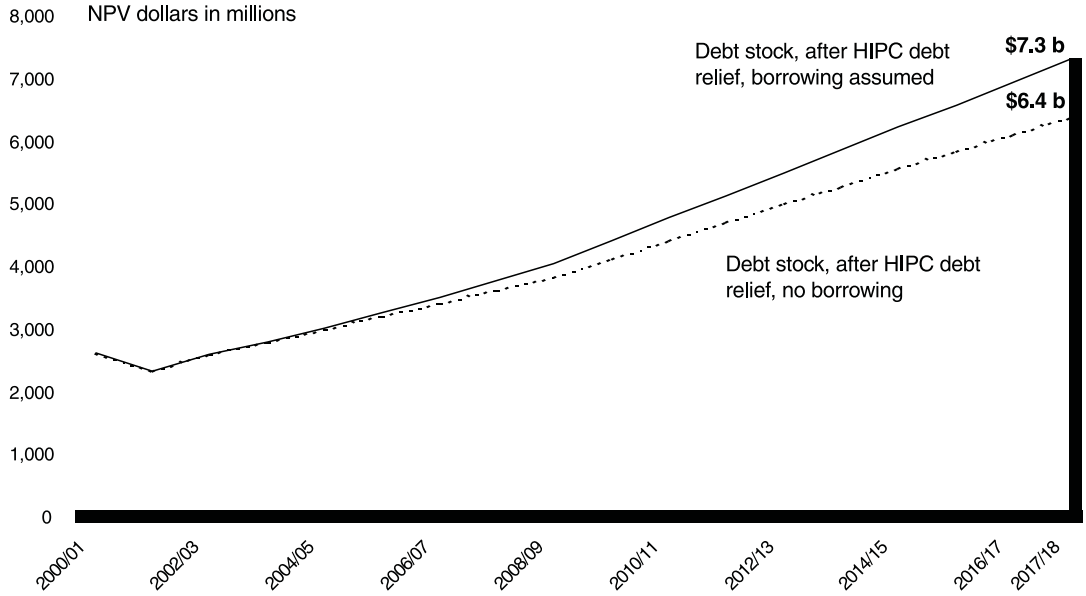
Ability to Repay Debt in the Future Hinges on the Assumption of Strong Economic Growth

Effective Use of Resources

According to projections by World Bank and IMF staffs, countries maintain debt sustainability by keeping their future borrowing in line with the growth in their capacity to repay. One underpinning of these projections is that countries will use their borrowed resources effectively. Although the borrowing previously described would increase future debt levels, it would be appropriate if the borrowed money is spent effectively and contributes to economic growth. The initiative contains an implicit assumption that the process of preparing and implementing a poverty reduction strategy will result in a more effective and productive use of resources, leading to both economic growth and poverty reduction. However, such strategies are relatively new and untested.

Some argue that such borrowing may be in the best interest of each country, because governments are to spend the borrowed resources to reduce poverty rather than to pay creditors. However, this situation would involve deficit financing, meaning that countries have to borrow in order to increase their current spending. The more resources that countries borrow for poverty reduction, the greater the poverty reduction presumably would be, but also the greater the future debt levels would be. In the case of Tanzania, its total debt stock is projected to steadily rise in the period following debt relief whether it borrows these resources or not; however, the rise is even greater if it borrows these additional resources (see fig. 6).

Figure 6: Tanzania's Total Debt With and Without Borrowing for Poverty Reduction, 2000/01-2017/18



Legend

NPV = net present value

Note: Debt in net present value terms.

Source: GAO analysis of World Bank and IMF documents.

Our analysis of the projections in Tanzania's HIPC documents indicate that Tanzania's total debt will rise because Tanzania is assumed to have significant requirements for borrowing after debt relief, to use for development purposes and for its remaining external financing needs. However, the decision to borrow these resources will add considerably to its total debt, with the total debt levels approximately $900 million higher (in net present value terms) at the end of the projection period than if Tanzania chooses not to borrow these resources. This gap will continue to widen in the years following the end of the 20-year projection period, if these trends continue.

Although the loans for poverty reduction are expected to have concessional terms, poor countries have had difficulties in repaying their loans in the past, as evidenced by the accumulation of arrears, debt reschedulings, and other prior debt relief efforts. As discussed later, the ability to repay these loans in the future depends on these countries achieving sustained, strong economic performance, supported by their

effectively using their resources and donors continuing to provide assistance for 20 years or more following debt relief. The need for debt relief is due in part to previous lending programs that did not sufficiently increase recipients' ability to pay their debt obligations. The enhanced HIPC Initiative contains an implicit assumption that the process of preparing and implementing a poverty reduction strategy will result in a more effective and productive use of resources, leading to both economic growth and poverty reduction. However, the preparation of such strategies is relatively new, and there is little evidence as of yet to support this assumption. Failure to effectively use these resources could jeopardize countries' future ability to pay.

Economic Growth

As mentioned previously, according to projections by World Bank and IMF staffs, maintaining debt sustainability depends on recipient countries' achieving sustained, strong economic performance. Most recipient countries that we have analyzed are projected by World Bank and IMF staffs to have robust growth in export earnings, with the projected growth in U.S. dollar terms for four of these countries expected to average at least 9.1 percent a year over 20 years. (See table 3.)

Table 3: Key Economic Indicators for Seven Countries (Projected and Historic, Using Nominal Dollar Values)

In percent

Country	Projected growth in export earnings[a]	Historic growth in export earnings[b]	Projected gross domestic product growth[a]	Historic gross national product growth[b,c]	Projected government revenue growth[a]	Historic government revenue growth[d]
Bolivia	7.5	7.3	7.0	7.5	7.4	15.8
Honduras	9.3	12.4	8.4	7.0	9.9	7.3
Mauritania	5.4	0.6	6.9	0.3	6.2	3.9
Mozambique	8.5	9.0	9.2	4.3	12.3	N/A
Nicaragua	9.1	15.6	7.6	7.4	7.8	13.1
Tanzania	9.2	17.4	8.1	8.2	9.3	7.6
Uganda	9.5	26.0[e]	9.8	10.7	11.0	20.0

Legend

N/A = Not available

Note: Real growth rates could not be calculated for the projection period because the country debt sustainability analysis documents do not include price deflators. Annual amounts are reported in nominal dollars. Growth rates are calculated in U.S. dollar terms.

[a]As calculated from each country's debt sustainability analysis.

[b]In nominal U.S. dollar terms as reported in the World Bank's *Global Development Finance* data, 1990-97.

[c]*Global Development Finance* reports gross national product but not gross domestic product.

[d]IMF's *International Financial Statistics Yearbook 1999* and World Bank's *Global Development Finance*.

[e]Does not include information from 1998 and 1999, in which export earnings significantly declined.

Sources: GAO analysis of IMF and World Bank data.

The assumption of strong, sustained growth in export earnings is important for the projection of continued debt sustainability, since the income from exports is presumed to contribute considerably to these countries' ability to meet their external obligations. Although these levels of export growth are consistent with the experience of these countries in the recent past,[8] as we discussed in our previous report,[9] these countries tend to rely on a small number of primary commodities for a majority of their export earnings. The prices of such commodities tend to fluctuate, and in the case of Uganda in 1998 and 1999, the large fall in the price of coffee resulted in a decline in its export earnings in those 2 years, following a period of substantial export growth in the early and mid-1990s. As a result, Uganda's debt-to-export ratio rose considerably, despite Uganda's having received a reduction in debt under the first HIPC Initiative. Due to continued weakness in Uganda's export sector, in April 2000 the World Bank and the IMF reduced the projected growth of Uganda's export revenues for 2001-2003 by more than 16 percent from what was projected in January 2000.

[8]An examination of the average annual growth rates of export earnings and gross national product of these seven countries for the period prior to debt relief (1978-97) shows a substantially lower level of growth for both factors. All of the export growth values are below 6 percent, and all of the gross national product growth values (nominal U.S. dollars) are below 8 percent, with two of those growth levels negative over the 20-year period.

[9]See *Developing Countries: Status of the Heavily Indebted Poor Countries Debt Relief Initiative*.

The World Bank and IMF staffs also assume strong growth in GDP and government revenue for most of the recipient countries that we have analyzed. A criticism by some nongovernmental organizations and academics of the first HIPC Initiative, including the external evaluators of the Enhanced Structural Adjustment Facility, was that it focused too heavily on exports as a proxy for a country's ability to pay its external obligations. Rapid growth in exports does not always translate into more resources for the government to use to pay its obligations.[10] The new initiative has placed a greater level of attention on the recipient economy's ability to generate its own resources, as measured by GDP and government revenue. Robust increases in both factors are also considered important contributors to a country's ability to remain debt sustainable. Based on our analysis of HIPC documents, the projected average annual growth (in nominal dollars) of GDP and government revenue is greater than 6 percent for all seven countries and exceeds 9 percent in several instances (see table 3). Although these projected growth levels are generally consistent with the growth levels of the recent past, sustaining such levels over a 20-year period may be difficult. For example, Uganda recently had to lower its GDP growth projection for the year 2000 because of a drought and continued weakness in coffee prices.

Donor Assistance

According to our analysis of World Bank and IMF staff projections of donor assistance (both project and program aid), such assistance is expected to be at levels generally comparable to the assistance provided in the recent past.[11] Continued donor assistance is necessary for countries to remain debt sustainable, since recipient countries will continue to rely on donor assistance to meet their future debt payments, separate from the resources they need for development purposes. Although the assumption that donor

[10]In the case of Tanzania, its export revenues are expected to rise rapidly over the next several years due to the recent exploitation of its gold resources. However, given the capital-intensive nature of the industry, the government of Tanzania will realize very little revenue from these increased exports for a considerable period. In order to attract investment in this sector, the government of Tanzania agreed to receive relatively low revenue while foreign investors are recouping their investment costs.

[11]According to our review of the debt sustainability analyses' projections of donor assistance for HIPC recipients, such assistance is expected to be on the low side of the donor assistance provided between 1990 and 1997 for five countries (Bolivia, Mauritania, Mozambique, Nicaragua, and Uganda), and in the middle and high range for Honduras and Tanzania, respectively. These projections do not assume IMF lending beyond the current program. Inclusion of IMF resources would raise the projected debt levels for the recipient countries.

assistance will be at levels generally consistent with the past seems reasonable, the full amount of donor assistance that is required for continued debt sustainability might be optimistic. First, if the key economic factors of recipient countries do not grow as quickly as projected, their need for donor resources will likely increase in order to counter this shortfall. Otherwise, countries may not be able to meet their future debt payments. This is discussed in greater detail later in the report. Second, considering the substantial amount of donor resources required for the full financing of the initiative (as discussed in ch. 4), maintaining existing levels of assistance may be difficult, because the large bilateral donors will also be expected to provide a substantial amount of new funding to support the participation of the multilateral institutions and smaller bilateral creditors. If these additional resources for the multilaterals and smaller bilateral creditors (including other developing countries) are not forthcoming, then the future aid from these sources may be compromised, which could lower the amount of total donor resources provided to the HIPC recipients.

Relationship Between Economic Growth and Donor Assistance

As discussed, the enhanced HIPC Initiative assumes strong economic growth projections for most countries that receive debt relief. Shortfalls in these growth projections will lower the amount of revenue these countries will be able to contribute toward their future debt service. If these countries are to remain debt sustainable, this shortfall will need to be made up through increased donor assistance or other means of adjustment. Without such adjustment, countries will no longer be debt sustainable, requiring additional debt relief, or accumulation of arrears. For illustrative purposes, we analyze the effect of a shortfall in projected export earnings that is made up through an increase in grants and concessional loans so that imports and domestic spending, including poverty reduction activities, remain the same as in the original HIPC projections. We consider this to be a reasonable assumption because, although this additional concessional borrowing results in higher levels of debt and debt ratios, it will preserve fairly robust economic growth levels and poverty reduction for the recipient country. If instead, policymakers choose to adjust to these lower levels of export earnings by reducing imports, lowering domestic spending, raising tax revenue, or using a combination of these approaches, they could avoid incurring debt ratios that will rise as much, although this choice would likely result in lower economic growth and lower expenditures on poverty reduction. The relationship between a decline in export growth and an increase in donor assistance for Tanzania is highlighted in table 4.

Table 4: Relationship Between a Decline in Export Earnings and Increases in Aid Flows – Tanzania

In millions of U.S. dollars

	New assistance – loans and grants			New assistance – loans only		
	Assistance	Debt/export in 2017/18 (percent)	Debt	Assistance	Debt/export in 2017/18 (percent)	Debt
Base case[a]	$19,767	137	$7,333	$19,767	137	$7,333
With 1 percentage point export decrease	22,864	200	9,365	23,013	236	11,013
With 2 percentage point export decrease	25,648	280	11,178	25,935	358	14,298

Note: Assistance is in millions of 1999 net present value dollars, and debt is in millions of 2017/18 net present value dollars.

[a]The "base case" refers to the data contained in the projections made by the IMF and the World Bank.

Source: GAO analysis of IMF and World Bank data.

According to Tanzania's debt sustainability analysis, its export earnings are projected to grow by 9.2 percent a year on average for 19 years, after receiving debt relief. At the end of that projection period, its debt-to-export ratio (in net present value terms) will be about 137 percent, and donors were assumed to have provided almost $20 billion in assistance. However, if the growth in Tanzania's export earnings were to be 1 percentage point lower over this period (to an average increase of 8.2 percent a year), donor assistance would have to grow by almost 16 percent over the period, or an additional $3.1 billion, for Tanzania to maintain debt sustainability. As shown in table 4, the impact of this assistance on Tanzania's future debt levels is substantial, reaching a debt-to-export ratio of 200 percent by the end of the projection period.

The additional assistance may be provided as concessional loans or a combination of concessional loans and grants. The left side of the table assumes that the new assistance is provided using the relative proportions between loans and grants, assumed within Tanzania's base case. The right side of table 4 assumes that the additional assistance would be all concessional lending. The assumption of all lending may be more realistic. For example, in response to a decline in export earnings during 1998, Uganda increased its borrowing, mainly from multilateral institutions, to avoid a financing gap in its balance of payments. In both cases, Tanzania's

total debt ratios will rise, with the increase 36 percentage points greater when the assistance is assumed to be all lending.

The impact of a 2-percentage point decrease in export earnings (to an average increase of 7.2 percent a year) is even more substantial. Under such a scenario, donors will be expected to provide about $5.9 billion in additional assistance to Tanzania. Under the assumption that the additional assistance would be a mix of loans and grants, Tanzania's debt-to-export ratio is projected to more than double over the base case projection. If the additional assistance were to be all loans, this ratio would be more than 2.6 times greater than the base case and would be at a level that would exceed Tanzania's debt-to-export ratio (324) prior to receiving HIPC assistance.

Linking Debt Relief and Poverty Reduction Creates Tension Between Quick Debt Relief and Comprehensive Strategies

In order to receive full debt relief under the enhanced HIPC Initiative, countries are expected to prepare comprehensive strategies for reducing poverty; however, the preparation of these strategies is time consuming, with their success dependent on countries reaching widespread agreement on sensitive and complex issues. Nongovernmental organizations and some donor governments raised the concern that, in order to receive debt relief quickly, countries may "shortcut the quality" of their strategies and limit the extent of participation, especially from the civil society of the country. To counter these concerns, some recipients and nongovernmental organizations have suggested separating the link between the timing of debt relief and the preparation of these strategies, recognizing that recipient countries are likely to be monitored under World Bank and IMF programs for many years. However, the World Bank, the IMF, and the U.S. Treasury argue that these concerns are mitigated because some countries do not have to prepare a full poverty reduction strategy in order to qualify for debt relief, and countries will receive a significant amount of interim debt relief after they qualify for the initiative.

Preparing Strategies Is Complicated and Resource Intensive

We found that preparing a comprehensive, "country-owned" poverty reduction strategy poses many challenges for recipient countries, particularly when preparing them within the relatively short time frames of the initiative. Preparing the poverty reduction strategy is costly and time consuming because it (1) addresses numerous social and economic policies, (2) is to show the impact of government programs on poverty, and (3) depends on collecting and analyzing an extensive amount of data. In September 1999, the World Bank reported that no country had fully and systematically applied a strategy focused on achieving poverty outcomes. In May 2000, a Bank official said that such a strategy is untested. World Bank and IMF staffs guidance says that most countries should be able to prepare a poverty reduction strategy within 2 years. However, although Uganda is considered by the staffs to be at the forefront of these efforts and has prepared a comprehensive strategy and progress report, it has been working on a strategy for about 5 years. Moreover, according to the staffs, to prepare a full poverty reduction strategy in line with their guidance, Uganda needs to provide additional estimates of the cost of poverty reduction programs and strengthen the links between expenditures on poverty reduction and indicators of poverty.

Numerous, Diverse Actions Needed to Address Poverty

Tackling the numerous and complex factors that cause poverty is difficult because it involves many economic and social policies. We found that coordinating all of these policies is particularly challenging within short time frames. Poverty is complex and defined broadly because of the following:

- Poverty stems from many social and economic problems such as weak economic growth, low education levels, limited access to health services, limited property rights that restrict the ability of the poor to gain physical and financial assets, and social exclusion.
- Poverty affects a significant number of people. According to their interim poverty reduction strategies, 50 percent or more of the populations of Bolivia, Tanzania, and Mozambique are estimated to live below each country's poverty line.
- Poverty varies based on factors such as gender, geographic area, and indigenous group and thus reflects inequality in economic opportunity and income distribution. According to the interim poverty reduction strategies from three countries—Bolivia, Mozambique, and Uganda—poverty levels were higher in rural areas than in urban areas and higher among women than men.[1]
- Poverty is influenced by factors that may be connected and mutually reinforcing. For example, Uganda's participatory poverty assessment describes the following cycle of poverty: Poor health leads to decreased household income due to spending on health care and reduced productivity due to the inability to work. This in turn leads to lower food availability, poor nutrition, further poor health, low income and productivity, and worsening poverty. Also, some factors, such as theft and other forms of insecurity, may be both a cause and a result of poverty.

According to World Bank and IMF documents, such as progress reports and Executive Board minutes, a multifaceted approach is needed to reduce poverty, given the high incidence and the numerous and diverse causes of poverty. According to these documents, reducing poverty requires the following:

[1]In 1998, the United Nations reported that poverty in Bolivia is primarily rural and concentrated in indigenous groups. In rural areas, 94 percent of the households live in poverty, in comparison to about 51 percent of the households in urban areas. In addition, in 1999, the U.S. Agency for International Development reported that 88 percent of the poor in Bolivia are indigenous peoples.

- *Rapid, sustainable growth that includes the poor.* According to the U.N. Economic Commission for Africa, for sub-Saharan Africa to cut poverty in half by 2015, average (real) annual GDP growth of at least 8 percent is required.[2]
- *Actions targeted at the specific causes of poverty.* The interim strategies developed by five countries (Bolivia, Mauritania, Mozambique, Tanzania, and Uganda) for use in HIPC decision-making address numerous economic and social actions that are intended to generate growth and contribute to poverty reduction. The coordination of so many activities and the preparation of the poverty strategies can tax already limited government resources. For example, in Tanzania, donor officials told us that preparing such a comprehensive strategy along with other documents required by donors has involved numerous key government officials who also have many other concurrent responsibilities.[3]
- *Good governance.* According to World Bank and IMF documents, good governance requires responsive, transparent (open), and accountable institutions as well as sound management of public resources. However, many poor countries have weak, inefficient, and sometimes corrupt institutions that resist reform. Redressing these problems continues to involve reforms to reduce corruption and improve countries' judicial systems, revenue collection, and financial management.
- *Active civil society participation.* World Bank and IMF staffs, nongovernmental organizations such as Oxfam and World Vision, the U.N. Development Program, and some governments see the participation of civil society, especially the poor, as a way to identify the needs of the poor and monitor government activities. However, this participation also presents operational challenges, such as determining who will represent civil society, that take time to resolve.

[2]*The Economic Commission for Africa and Africa: Accelerating a Continent's Development* (Addis Ababa, Ethiopia: U.N. Economic Commission for Africa, May 1999).

[3]For example, in addition to preparing the poverty reduction strategy, the government of Tanzania helps to prepare documents for internal planning purposes and donors, such as public expenditure reviews; strategies for bilateral and multilateral assistance programs and projects; and sector-specific strategies focused on health, education, civil service reform, and other areas.

Showing the Impact of Government Actions on Poverty Is Difficult

The World Bank and IMF staffs' guidance calls on recipients to describe in their poverty reduction strategies how their public actions will affect poverty goals, but the impacts are not clearly established in many areas either by the donors or the recipients nor are they described in the guidance. While such connections are considered key elements of the poverty reduction strategy, World Bank and IMF staffs recognize there are wide disparities in the cost-effectiveness of government expenditures for poverty reduction efforts in developing countries. In addition, World Bank and IMF staffs have reported that there are little country-specific data demonstrating how rapidly the indicators for some key social sectors can be expected to change. Furthermore, there is limited evidence showing which actions have the greatest impact for achieving poverty reduction goals. Determining which activities to prioritize and the expected time frames for reducing specific causes of poverty can thus take a considerable amount of dialogue and analysis.

A 1999 IMF staff study found that there is little empirical evidence to show that public spending alone improves health and education indicators, or outcomes.[4] However, this study showed that the allocation of spending within the subsectors of health and education could successfully contribute to positive outcomes. For example, shifting spending toward primary and secondary education improves enrollment and retention rates through grade 4. Furthermore, shifting health spending toward primary care has a favorable effect on infant and child mortality rates.

[4]Sanjeev Gupta, et al., "Does Higher Government Spending Buy Better Results in Education and Health Care?" IMF Working Paper 99/21 (Washington, D.C.: IMF, Feb. 1999).

Strategies Depend on Data

According to the World Bank and IMF staffs' guidance, preparing credible poverty reduction strategies depends on collecting and analyzing data; however, this takes time, resources, and expertise. For example, a poverty assessment relies on collecting and analyzing an extensive amount of data to describe the nature, extent, and major causes of poverty in ways that can be used later to monitor progress. World Bank and IMF staffs consider success in this first step as essential to ensure the development of an effective poverty reduction strategy. However, such an exercise takes resources and expertise, and weaknesses in poor countries' capacity to collect and analyze data may limit this effort. In 1999, the World Bank reported that, in Mozambique, it took 2 years after the national household surveys to get results and that lags of this nature are not uncommon.[5] In September 1999, the IMF's Executive Board noted that the poor quality of data on social spending and indicators has inhibited the design and implementation of effective social programs.[6] The Board saw an urgent need for country authorities to identify weaknesses in data and data collection and to make data improvements in collaboration with the World Bank, other international agencies, and civil society. The World Bank and the IMF are strongly encouraging donors to increase their technical and financial support in this area. In November 1999, a group of developing countries and donor agencies said that global efforts to fight poverty and promote better lives for millions of the world's poor would be more effective if developing countries had better statistics and that the HIPC Initiative was hastening the need for good quality statistical information.[7] They said that too often, outdated, missing, or unreliable information led to badly informed decisions, which waste resources and incur high financial and human costs. They agreed to launch a strategy to ensure adequate funding and support for national statistical systems.

[5]*Building Poverty Reduction Strategies in Developing Countries* (Washington, D.C.: World Bank, Sept. 1999).

[6]*Concluding Remarks by the Chairman—Review of Social Issues and Policies in IMF-supported Programs; HIPC Initiative-Strengthening the Link between Debt Relief and Poverty Reduction; and Transforming the Enhanced Structural Adjustment Facility* (Washington, D.C.: IMF, Sept. 1999).

[7]The strategy, called the "Partnerships in Statistics for Development in the 21st Century," is designed to improve the statistics in poor countries and initiate programs to improve the statistical capacity of countries that qualify for HIPC debt relief by the end of the year 2000. See *IMF, OECD, UN and World Bank Experts Call for Better Statistics to Fight Poverty*, IMF Press Release 99/55 (Washington, D.C.: IMF, Nov. 19, 1999).

In the four countries we visited—Bolivia, Nicaragua, Tanzania, and Uganda—government officials, with technical and financial support from donors and others, were undertaking actions to improve their capacity to gather and analyze data and monitor indicators. Uganda—which is considered ahead of most countries in this effort—is trying to gather information directly from the poor to develop a broader set of indicators to define poverty, such as physical and social isolation and powerlessness, in all of its 45 districts. Thus far, with donor technical and financial support, Uganda has collected data from nine districts. Tanzania is currently planning to undertake a household budget and labor force survey–the survey is estimated to cost $1.5 million and take approximately 1 year.

Country Ownership and Donor Support of the Strategy Can Be Difficult to Achieve

Having countries take ownership of the strategies with the support of donors is considered by the World Bank, the IMF, and nongovernmental organizations such as Oxfam to be critical to the effective preparation and implementation of the poverty reduction strategy; however, there is a tension between the time needed to build country ownership and to prepare a poverty reduction strategy within the initiative's deadlines. Moreover, operational issues take time to resolve. For example, it is not clear how to define or achieve ownership at the country level, to define the amount and nature of civil society participation, or to ensure that the donors will align their funding with the priorities outlined in these strategies. The point at which "ownership" is achieved is not clearly defined because it reflects country- and context-specific circumstances and can be built slowly over time through an iterative process of increasing levels of participation. Although the World Bank and the IMF expect civil society participation in developing the strategies, they have not set criteria for determining a sufficient or effective level and quality of civil society participation. They want the strategies to be owned by the countries and therefore want each country to determine a sufficient level of participation. Nonetheless, officials from some donor governments, multilateral organizations, and nongovernmental organizations told us they were concerned that countries' desire to receive debt relief as soon as possible could affect the level, quality, and impact of civil society participation. Several representatives from nongovernmental organizations such as Catholic Relief Services and Jubilee 2000 told us that they want meaningful, widespread civil society participation but are concerned that this could delay debt relief.

While difficult to measure, participation is increasingly seen as important for greater effectiveness. According to a World Bank staff paper, the absence of sufficient "commitment" in many of the projects the Bank finances occurs because stakeholders (including civil society) do not understand fully the commitment they are being asked to make.[8] If stakeholders who must implement and sustain the project do not fully understand what is expected of them, little will be accomplished. Moreover, the paper reported that attempts to bypass powerful stakeholders, such as political leaders, often resulted in opposition from them; this opposition usually compounded the problem of getting anything useful accomplished. For example, the paper stated that the main reason for not making more progress in resolving problems in project implementation in Mozambique was the failure to engage the ministers (the political level) in the participatory process. Absence of the full range of stakeholders, especially politicians with the power to affect change, limits effectiveness.

Challenges to Effective Civil Society Participation

The World Bank sourcebook defines participation as "a process through which stakeholders influence and share control over development initiatives and the decisions and resources which affect them." Stakeholders include those directly affected by the project or strategy, such as the poor, as well as those who are indirectly affected, such as the borrower governments at the national and local level, nongovernmental organizations, private sector organizations, and donors. However, we found that countries face challenges in determining which groups should represent civil society. This can be especially difficult in countries that lack a democratic or representative tradition and thus have few existing means for getting citizen or nongovernmental organizations' input or for electing representatives. These concerns are magnified when the process is to involve the poor or groups that have traditionally been excluded, such as women and indigenous populations. There is also concern that government officials will not support a participatory process if it is perceived as diluting their power, alienating influential constituencies, or done simply to get HIPC debt relief.

[8] *The World Bank Participation Sourcebook* (Washington, D.C.: World Bank, 1996).

If these issues are overcome and civil society representatives are to participate in developing the poverty reduction strategy, a process for getting their input within the initiative's time frames must be established. According to the World Bank staff paper, some of the poorest people live in countries characterized by weak governments and civil strife. Others also said that in order to involve the poor, representatives and governments must overcome deficiencies in communication and high illiteracy rates.[9] Furthermore, to involve the poor who live in rural and outlying areas, representatives must also overcome poor roads. Moreover, efforts must be made to educate civil society and their representatives about important issues and build their organizational and financial capacity to participate. In Tanzania, nongovernmental organizations historically delivered services by, for example, funding schools or health clinics. They are now beginning to focus on advocacy and have organized themselves into working groups that study specific issues related to poverty and provide input to the government.

Determining the Level of Civil Society Participation

It is also challenging and potentially controversial to determine a sufficient and effective level of participation by civil society in the process. For example, in 1997 the government of Bolivia conducted a "national dialogue" to involve civil society in its effort to build support for its new economic and social priorities. Although government officials said they considered that effort to have been quite worthwhile, some nongovernmental organizations and donors that we talked with disagreed. They told us the dialogue consisted of a 1-day meeting in which the government selected whom to invite, involved little regional participation, gave little advance notice regarding the agenda to the invitees, provided little background information, and used the meeting to present its views. One nongovernmental organization representative characterized this effort as having been more a "regional monologue than a national dialogue." In 1998, the United Nations reported that, according to a recent survey, 70 percent of Bolivians felt that their opinions did not count at all in the political system's decision-making process.[10] Additionally, according to the

[9]World Bank staff estimated that a thorough process of participatory consultation, such as that conducted for a participatory country assistance strategy or poverty assessment, could cost between $50,000 and $500,000.

[10]*UNDP: Country Cooperation Frameworks and Related Matters – First Country Cooperation Framework for Bolivia (1998-2002)* (New York: U.N. Development Program, DP/CCF/BOL/1, Feb. 2, 1998).

Bolivian government and nongovernmental organizations, there was little follow-up after the national dialogue to ensure that actions were undertaken. In light of this experience, the public met with some suspicion the government's plans for a new dialogue as part of the HIPC Initiative. To overcome the previous criticisms and involve civil society in preparing its poverty reduction strategy, the government is convening a second national dialogue that is to involve more participants and regions, provide extensive background papers prepared by the government and others, and establish a mechanism to follow up on commitments made during the dialogue. The process is to culminate in a poverty reduction strategy. (See app. VIII for additional information on Bolivia's national dialogue.)

Consultation Versus Consensus

Consulting with civil society increases civil society's awareness of government strategies, can change resource allocations, and can alert the government to the priorities of the poor; however, it does not guarantee consensus. According to World Bank and IMF staffs, the results of Uganda's consultation with the poor had a direct effect on budget allocations. In response to the high priority placed by poor communities on the availability of safe water, the government has significantly shifted its spending toward improving water quality. Uganda's consultation with the poor also brought to the government's attention factors related to poverty that the government previously had not considered, such as the poor's physical and social isolation, sense of powerlessness, and concerns regarding security. However, reasonable people can disagree on the best use of the resources for reducing poverty, given their individual circumstances. Thus, the evidence is not clear as to what extent consultation increases country ownership of, or widespread agreement on, the strategy. The involvement of civil society in the process does not ensure that (1) consensus on priorities can be reached quickly, easily, or at all; or (2) that the government will accept civil society's views. Stakeholders have different levels of power and conflicting priorities; how these are resolved affects how people view the strategy. Given the countries' high levels of poverty, we believe that civil society, government, and donors can probably reach agreement on broad poverty reduction goals such as improved health, education, and economic growth. However, the challenge will be reaching agreement on how to allocate the limited available resources among these goals, all of which have large financing requirements. For example, to reduce rural poverty, some may advocate funding agricultural extension services, whereas others may wish to increase spending on education or health care. The challenge of reaching agreement on resource

allocations is further complicated by the disparities in income levels and living conditions that exist between regions and sectors of society.

The effectiveness of the strategies is also influenced by the extent to which donors agree with and are willing to align their contributions with the countries' priorities. Field representatives of donors may support the concept of a recipient-led strategy but may not be able to reallocate their aid to fund the recipients' priorities due to the earmarking of spending by their governments. While some donors may expect that resources from debt relief will be spent mainly on certain social needs such as health and education, recipients may prioritize their efforts to reduce poverty differently. Considerations about the best use of limited resources become even more complicated when several needs are equally pressing, such as reducing the high incidence of child mortality or improving poor water quality.

Differing Views on Whether to Directly Link Debt Relief to Poverty Reduction Strategies

Given the vulnerabilities and debt problems of poor countries, some creditor governments, the U.N. Secretary General, and nongovernmental organizations have urged creditors to quickly provide debt relief under the initiative. In September 1999, the Development and Interim Committees of the World Bank and the IMF urged the speedy implementation of the enhanced initiative so that as many countries as possible could qualify for assistance under the initiative by the end of the year 2000.[11] Some U.N. organizations and nongovernmental organizations stress that delaying debt relief adversely impacts countries' growth by diverting scarce resources from development needs to debt payments. Some assert that, with debt payments absorbing a large share of budgetary and foreign exchange resources, poor governments have turned to foreign donors, which further prolongs debt problems. They are also concerned that the conditions countries must meet in order to receive debt relief under the initiative may delay the receipt of debt relief and, in some cases, may hurt rather than help the country. However, the World Bank and the IMF argue that these concerns are mitigated because countries begin to receive a significant amount of debt relief when they qualify for the initiative (and before they prepare a full poverty reduction strategy) and that conditions are needed to ensure that governments undertake reforms and use resources effectively.

[11]In December 1999, the staffs of the World Bank and the IMF estimated that 22 countries could have their eligibility assessed by the end of the second quarter of the year 2000.

Officials from nongovernmental organizations, donor governments, and multilateral organizations have also raised the concern that countries' efforts to receive debt relief quickly may decrease the quality of the poverty reduction strategy as well as the level, quality, and type of civil society participation. However, World Bank and IMF staffs project that the preparation of a strategy should take up to 2 years, which for most countries is within the initiative's time frames.[12] They also note that the strategies are to last beyond the HIPC Initiative and to be reviewed and improved upon as more experience is gained in implementing these strategies. The World Bank and the IMF Executive Boards have said the strategies should be developed and owned by the countries—to increase the likelihood that the strategy will be implemented—and reflect countries' unique circumstances and capacities. Thus, the Boards have not defined specific criteria for judging key aspects of the strategies, such as a sufficient level or type of civil society participation. This has created some confusion about what recipients must do to receive debt relief. Given the high priority that recipient governments place on debt relief and future loans, they want to make sure that strategies meet the Boards' evolving expectations. To help communicate and meet the Boards' expectations, World Bank and IMF staffs and others are helping the recipients prepare the strategies.

Because recipient countries will be highly dependent on concessional financing and monitored under World Bank- and IMF-supported programs for the foreseeable future, officials from some nongovernmental organizations have said that HIPC debt relief should not be conditioned on the preparation of poverty reduction strategies and/or compliance with IMF programs. They seek to ensure that the quality of the strategies and the level of civil society participation will not be compromised in order to meet the initiative's time frames. Also, countries may have the incentive to quickly reach their completion point because debt relief only becomes irrevocable at that point. Prior to that, creditors may revoke debt relief due to recipients' unsatisfactory performance. On the other hand, the World Bank, the IMF, and the U.S. Treasury argue that these concerns are mitigated because some countries do not have to prepare a full poverty reduction strategy in order to qualify for debt relief and countries will receive interim debt relief after they qualify for the initiative. World Bank and IMF staffs estimated that for four countries—Mauritania, Mozambique,

[12] *Poverty Reduction Strategy Papers: Operational Issues* (Washington, D.C.: IMF and World Bank, Dec. 1999).

Tanzania, and Uganda—the reduction in debt service expected during the interim period is at least 70 percent of the debt service reduction expected with full debt relief.[13] Also, the staffs said that poverty reduction strategies are to be updated every 3 years and, thus, weaknesses in a country's initial poverty reduction strategy—such as limited civil society participation—could be addressed in subsequent iterations. According to World Bank and IMF staffs, creditors agreed in 1999 to increase the amount of HIPC debt relief if the link between debt relief and poverty reduction were strengthened and thus may resist weakening this link. Moreover, the World Bank and the IMF see the receipt of debt relief as a catalyst that should motivate countries to undertake difficult reforms and begin preparing the poverty reduction strategies.

[13]According to World Bank and IMF staffs, Bolivia is not expected to receive interim relief under the enhanced initiative.

Bilateral and Multilateral Creditors Face Financing Challenges

As a group, bilateral and multilateral creditors are expected to provide roughly equal shares of HIPC debt relief that is estimated to total over $28 billion[1] (in net present value terms); however, many creditors, especially the multilateral and smaller bilateral creditors, have said they are having difficulty securing their share of the necessary financing. For example, an underlying premise of the initiative is that debt relief is supposed to be additional to the assistance that donors and creditors would otherwise provide to low-income countries. Difficulties in financing the initiative could delay debt relief and ultimately undermine the success of the initiative.[2]

Although bilateral creditors are expected to provide about $13 billion (net present value terms) of HIPC debt relief, the estimated cost of providing this relief varies between creditors, and some have not secured the full financing to fund their obligations. Our review indicates that, for four of the seven leading industrial countries (France, Germany, Italy, and Japan), the estimated cost of providing debt relief is close to the face value of the debt. For Canada, the United Kingdom, and the United States, the estimated cost of debt relief is less than the face value of the debt because these countries have already budgeted/provisioned for the probability of nonrepayment of the loan. For example, it is expected to cost the United States about $346 million (in net present value terms) to forgive about $3.8 billion (in nominal terms) in debt owed by 22 potentially eligible countries under the enhanced HIPC Initiative. In addition to funding the costs of debt relief, large bilateral creditors also face challenges in providing continued aid flows and in contributing to help multilateral and smaller bilateral creditors meet their share of HIPC debt relief. Bilateral creditors have pledged over $2.5 billion to assist multilateral creditors.

Although most multilateral institutions have expressed support for the overall goal of the HIPC Initiative, many have yet to overcome difficulties in being able to provide their full share (about $14 billion) of debt relief. These difficulties stem from legal, technical, and financial restrictions that have made it problematic to obtain the needed financing from internal and

[1]Of the $28 billion, multilateral creditors are expected to provide about $14 billion, bilateral creditors to provide about $13.2 billion, and commercial creditors to provide about $0.8 billion.

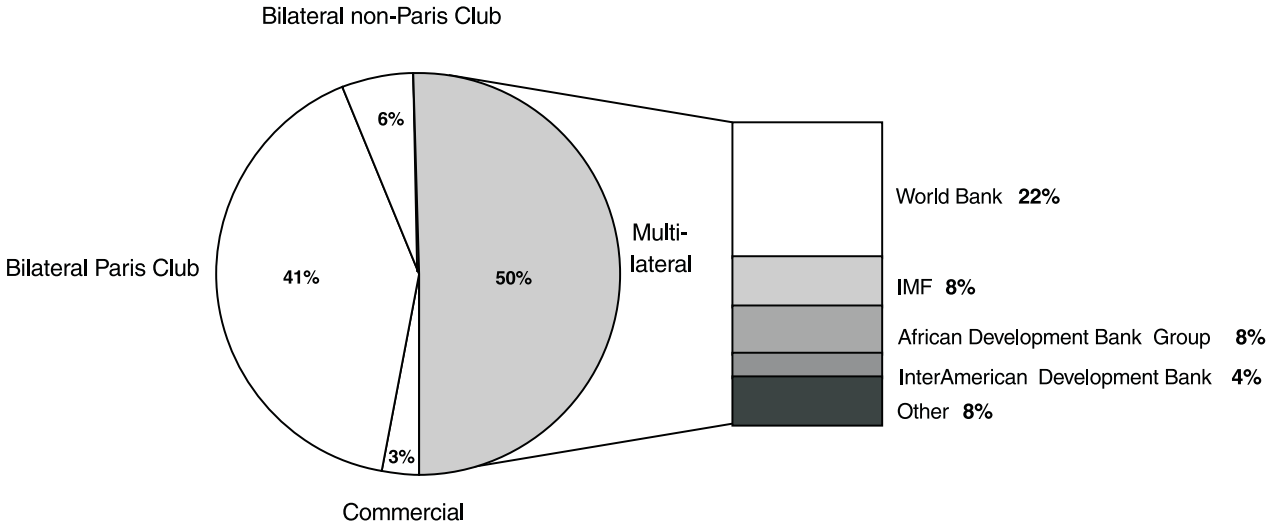
[2]A 1999 working paper of the International Monetary Fund, *"From Toronto Terms to the HIPC Initiative: A Brief History of Debt Relief for Low-Income Countries,"* estimates that debt relief initiatives since 1988 have cost creditors at least $30 billion.

external sources. Of the four major multilateral institutions—the World Bank, the IMF, the African Development Bank Group, and the Inter-American Development Bank—all but the IMF have large financing gaps that they are working to fill from internal and external sources. Some smaller multilateral institutions have raised the concern that providing debt relief under the initiative threatens their financial integrity.

Large Bilateral Creditors Are Important to HIPC Success

The success of the enhanced HIPC Initiative hinges on significant bilateral support. Bilateral creditors are expected to provide about 47 percent ($13.2 billion in net present value terms) of the HIPC debt relief, with about 87 percent of the bilateral total anticipated from a group of key bilateral creditors, known as the Paris Club.[3] (See fig. 7.)

Figure 7: Creditors' Shares of HIPC Debt Relief



Sources: Data from the U. S. Treasury, the IMF, and the World Bank.

[3]The Paris Club meets, on an as-needed basis, to negotiate debt relief on sovereign debt. Over the past 12 years, the Paris Club has undertaken actions to reduce or cancel public debt owed to them by heavily indebted poor countries. Prior to 1988, the Paris Club generally engaged in rescheduling, but not reducing, debt. This solved immediate debt-servicing crises but offered no permanent relief.

The Group of Seven countries' (Canada, France, Germany, Italy, Japan, United Kingdom, and the United States) share of the bilateral total is estimated at roughly $6.5 billion in net present value terms. Our review focused primarily on these seven leading industrialized countries. Our review of these countries indicates that providing debt relief will result in budgetary costs for each country.[4] The impact on their budgets in providing debt relief varies based on several key factors: the amount of outstanding loans, the method used to value loans, the method used to budget for debt relief, the options used to provide debt relief, and the constraints imposed by certain legal requirements. (See apps. IX and X for a detailed discussion on these factors for the seven leading industrialized countries.) Table 5 provides information that specifically relates to the enhanced HIPC Initiative as well as general information regarding the Group of Seven countries' treatment of debt relief. All members of the Group of Seven countries have indicated that they will provide debt relief beyond the enhanced HIPC terms. In addition, according to the IMF, Australia, Belgium, Netherlands, Norway, Spain, and Switzerland have also announced that they would be willing to provide debt relief beyond the enhanced HIPC terms.

[4]According to an Italian Treasury official, the costs of debt relief will have a direct impact on implementing agencies' budgets and an indirect impact on the national budget.

Table 5: Seven Industrialized Countries' Participation in the Enhanced HIPC Initiative

Dollars in millions

	France	Japan	Germany	United States	Italy	United Kingdom	Canada
Total nominal claims — 40 countries	$13,033	$11,200	$6,586	$6,210	$4,311	$3,092	$771
HIPC debt as a percent of G-7 GDP (40 HIPCs)	0.9%	0.3%	0.3%	0.08%	0.4%	0.2%	0.1%
Percentage and type of debt relief; debt relief in addition to enhanced HIPC	100% non-ODA; pre-cutoff date debt; debt stock reduction – 90% at completion point and 10% over time.	100% non-ODA; pre-cut - off date debt; type of relief is to be decided.	100% non-ODA; pre-cutoff date debt; debt stock reduction at completion point.	100% non-ODA; pre-and post cutoff date debts; debt stock reduction at completion point.	100% non-ODA; pre-cutoff date debt;debt stock reduction at completion point.	100% non-ODA; pre-and post cutoff date debts; debt stock reduction – 90% at completion point and 10% over time.	100% non-ODA; pre-and post-cutoff date debts; debt stock reduction at completion point.
	100% all ODA	100% all ODA	100% all ODA	100% all ODA	100% all ODA	ODA debt has been written off	ODA debt has been written off
Total estimated cost of debt relief	$8,000 Nominal	$8,000 Nominal	$5,689 Nominal	$3,771 Nominal $346 NPV	$3,000 Nominal	$2,720 Nominal	$665 NPV
Method for valuing loans and loan guarantees	Loans are valued at face value.	Loans are valued at face value.	Loans are valued at face value.	Loans are discounted based on country credit ratings.	Loans are valued at face value.	Non-ODA loans are discounted based on probability of default.	Non-ODA loans are discounted based on country credit ratings.
						ODA loans were valued at zero for HIPCs.	ODA loans were valued at zero for HIPCs.
Debt relief impact on national budget; national debt	Has a direct impact on national budget; no impact on national debt.	Has a direct impact on national budget with regard to ODA grants.	Has a direct impact on national budget; no direct impact on national debt.	Has a direct impact on national budget; indirectly impacts national debt.	Has an indirect impact on national budget and national debt.	Has a direct impact on national budget; indirectly impacts national debt.	Has a direct impact on national budget; no impact on national debt.

(Continued From Previous Page)

Dollars in millions

	France	Japan	Germany	United States	Italy	United Kingdom	Canada
Legal constraints	Parliament's approval is required for Paris Club and bilateral debt relief. A budget ceiling is set by parliament.	Parliament's approval is required when bilateral debt rescheduling and grant provision for debt relief agreement is concluded.	Parliament's approval is required for bilateral debt relief.	Congress' approval is required for Paris Club and bilateral debt relief.	Parliament's approval is required for change in Paris Club option and for bilateral debt relief.	Cabinet approval is required for bilateral debt relief. ECGD is restricted in the amount of debt relief it can provide.	Parliament's approval is required for bilateral debt relief.

Legend

ECGD = Export Credits Guarantee Department
G-7 = Group of Seven industrialized countries
NPV = Net present value
ODA = Official development assistance

Note: GDP as of 1998 and 1999 in millions of U.S. dollars. *World Development Indicators* database, July 1, 1999 and Standard & Poor's DRI electronic database, May 8, 2000.

Sources:

France: French Treasury data as of December 31, 1998.
Japan: Japan Ministry of Finance data as of December 31, 1998.
Germany: German Treasury data as of January 31, 2000.
United States: U.S. Treasury data as of December 31, 1998.
United Kingdom: United Kingdom Treasury data as of December 31, 1999.
Italy: Italian Treasury data as of December 31, 1999.
Canada: Canadian Treasury data as of March 31, 1999.

Outstanding Loans

The amount of outstanding loans influences the cost of debt relief. Table 5 shows that, in nominal terms, the exposure of the Group of Seven countries to the 40 potential HIPC recipients ranges from $771 million for Canada to about $13 billion for France. The Group of Seven countries' total outstanding loans to the 40 heavily indebted poor countries represents about 50 percent of the total bilateral exposure in nominal terms.[5] The U.S.' exposure is about $6 billion, or about 6 percent of bilateral exposure.

[5]As of the end of 1998, total nominal outstanding debt of the HIPC countries was about $213 billion. The bilateral exposure is approximately 50 percent.

Some Group of Seven countries are more exposed than others because some countries, such as the United Kingdom and Canada,[6] wrote off all of their official development assistance debt to the heavily indebted poor countries and now extend new official development assistance in the form of grants.[7] Other countries, such as France and Germany, wrote off a large part of the official development assistance debt they were owed.

Method Used to Value Loans

The costs of debt relief are influenced by the methods countries use to value their loans. Our review indicates that the Group of Seven countries use different accounting methods to value their direct loans and loan guarantees.

- Four of the seven countries (France, Germany, Italy, and Japan) value their loans at face value. Under this method, no provision is made for the nonrepayment of loans. Thus, the cost of HIPC debt relief for these countries can be as much as the full face value of the debt being relieved.
- The three remaining countries (Canada, the United Kingdom, and the United States) apply risk-based discounting methods (based on country credit rating) that lower the value of the loans below their face value. These methods budget for the likelihood that a portion of the loan may not be repaid. Different types of loans, such as concessional official development assistance and non-concessional loans, are sometimes valued differently. Two countries (the United Kingdom and Canada) budget fully for concessional official development assistance loans. In other words, their official development assistance loans were valued at zero at the time of disbursement, meaning they did not expect to be repaid, and therefore relief entails no additional budgetary cost. In the case of the United States, official development assistance loans are assumed to have a 30-percent grant element. This means that, in determining the cost of debt reduction, the official development assistance loans' face value is reduced by the grant element.

[6]Canada has written off all official development assistance loans to the HIPC countries except for Myanmar (Burma). The official development loan to Myanmar was fully budgeted at the time of disbursement and would not result in additional impact on Canada's budget to participate in the HIPC Initiative.

[7]Other countries that have written off all or nearly all official development assistance loans to potential HIPC recipients include Denmark, the Netherlands, Norway, Sweden, and Switzerland.

Method Used to Budget for Debt Relief

The cost of debt relief is also influenced by the accounting and budgeting rules that individual governments apply, as shown in table 5.

- For the United States, the cost of providing debt relief is the difference between the net present expected value of the loan before debt relief is provided and the net present expected value of the loan after debt relief. For the countries eligible for HIPC debt relief, this means that the current estimated cost of debt relief is much less than the face value of the debt. Since the United States had already recognized the cost of lending to these countries, the current costs to the United States to forgive 100 percent of pre- and post-cutoff date debt[8] is estimated at about $346 million in net present value terms, although the nominal value of these loans is about $3.8 billion. Thus, under this approach, the estimated budgetary cost to the United States is about 9 cents on average per $1 of outstanding debt.
- For France and Japan, the cost of debt relief is equal to the face value of the debt that is being canceled. For example, since France and Japan had carried their loans at face value, it is expected to cost each country a total of about $8 billion to provide debt relief, or $1 per each dollar of outstanding debt.
- For Germany, the cost of debt relief is defined in terms of the revenue forgone due to nonrepayment of a direct loan or additional spending needed to compensate the export credit agencies for loan guarantees made by the government. The maximum budgetary impact is about 90 percent of the face value of the commercial credits that are guaranteed by the government.[9]
- For Italy, the government's cost of debt relief is not necessarily 100 percent of the debt that is forgiven. Debt relief has a direct impact on the implementing federal agencies' budgets in the amount of the debt that is forgiven and an indirect impact on the national budget. The Italian Treasury is not required to reimburse its federal agencies immediately at the time of debt cancellation nor is it required to provide

[8]"Pre-cutoff date debt" refers to debt taken on by a debtor country before its first visit to the Paris Club, while "post-cutoff date debt" refers to debt taken on by the debtor after the first visit. Forgiveness of post-cutoff date debt stems from the U.S. administration's goal to offer relief beyond the terms called for in the enhanced HIPC Initiative. Implementation of this goal is subject to Congressional authorization and appropriation.

[9]Under the enhanced HIPC Initiative, Parliament has granted authority to the government to incur the cost of the 10-percent commercial loan portion that is generally borne by exporters.

100 percent debt relief. It restores the funds when the agencies are in need of the money.

- Both the United Kingdom and Canada have already written off their official development assistance loans to potential HIPC recipients. At the time of cancellation, most of the forgiveness had no impact on their budgets, since the loans were fully budgeted for at the time of disbursement. An exception was those official development assistance loans in which borrowers were expected to repay part of the interest. In contrast, the cancellation of non-official development assistance debt will result in budgetary outlays for these two countries to cover the costs of export credit guarantees.

Options for Debt Relief

Additionally, the options that creditors choose, through the Paris Club framework, to provide debt relief can affect the budgetary impact. In recognizing the legal and budgetary constraints of creditors, the options enable creditors to spread their costs over time. The two main options that creditors choose for the treatment of non-official development assistance debt are debt reduction (a cancellation in the stock of eligible debt) and debt-service reduction (a reduction in interest rate). In the case of the enhanced HIPC Initiative, most of the Group of Seven countries have chosen to cancel the stock of eligible debt. The stock of debt will be irrevocably reduced by bilateral and multilateral creditors when countries reach their completion points.[10] Although official development assistance debts are not generally treated in the Paris Club, forgiveness of this debt will be largely linked to the treatment of non-official development assistance debt.[11]

[10]Interim relief, or flow rescheduling, will be provided at the decision point. A flow rescheduling in the Paris Club involves the creditor agreeing to delay receipt of payments falling due during an agreed period, and to reschedule such amounts for eventual repayment over the medium and long term. In the case of the enhanced HIPC Initiative, most of the debt stock is expected to be written off at the completion point.

[11]At their summit in Cologne, Germany, in June 1999, the Group of Seven countries called on all bilateral creditors to forgive all official development debt of qualifying countries and said that new official development assistance should preferably be extended in the form of grants.

Under the enhanced HIPC Initiative, France[12] and the United Kingdom[13] are expected to write off 90 percent of the recipients' stock of debt at the completion points and to spread the remaining portion over time. The largest impact on France's budget will occur at each country's completion point, and the United Kingdom's Export Credits Guarantee Department has already provisioned for the Paris Club agreed upon portion of the debt relief that will be provided. It is anticipated that Japan will reschedule its official development assistance loans over 40 years and provide grant aid to recipients when their payments fall due.[14] Under its approach, Japan will require budgetary resources gradually over time, with the cost of debt relief spread over 4 decades. On the other hand, Italy and Germany have decided to write off the recipients' stock of debt at the time the countries reach their completion points and become entitled to irrevocable debt relief. While the United States and Canada are expected to write off their loans at countries' completion points, the impact on the U.S. budget, based on the Office of Management and Budget's rules, will occur at countries' decision points, and Canada has already realized the budgetary impact.

[12]For France, the bilateral portion of the debt relief, the part beyond the Paris Club agreement, will impact the budget annually as maturities fall due after full HIPC treatment at completion points.

[13]The United Kingdom's Treasury will fund the bilateral portion (10 percent) of the debt cancellation over a 23-year period.

[14]Official development assistance loans represent about 90 percent of Japan's outstanding loans to the heavily indebted poor countries. The Japanese government has not yet chosen an option for the treatment of its non-official development assistance loans.

Legal Constraints

Finally, six of the seven major industrial countries (except for the United Kingdom) need legislative authorization to provide debt relief or forgive debt.[15] For example, the U.S. Congress must authorize debt relief and appropriate funds in advance to cover the costs.[16] While the U.S. administration has said it would like to forgive all of the eligible debt HIPC recipients owed to the United States, Congress has not authorized this action. Congress has appropriated about one-third ($110 million) of the estimated $346 million needed to forgive this debt. Some major Paris Club members, such as Canada and Germany, have indicated that they will provide more debt relief than called for under the enhanced HIPC Initiative and have requested and obtained the legislative authority to do so.[17]

Non-Paris Club Creditors

It is not yet clear to what extent non-Paris Club creditors[18] and commercial creditors are willing and able to provide debt relief under the enhanced HIPC Initiative. Debtor countries, based on a Paris Club agreement, are required to seek comparable terms with their non-Paris Club creditors. However, in the past many debtor countries have found it extremely difficult to mobilize non-Paris Club creditor governments to provide debt relief on comparable terms with the Paris Club. While the IMF, the World Bank, and the debtor countries have been making efforts to ensure full participation and burden sharing since the original HIPC Initiative, so far only a few HIPC recipient countries have secured comparable treatment

[15]Two countries require legislative authorization to grant Paris Club agreed relief—the United States and France. In addition, only the United Kingdom does not need legislative authorization to grant bilateral debt relief, which is based on agreements reached outside of the Paris Club.

[16]For six of the Group of Seven countries, the loan valuation and budgetary treatment of debt forgiveness are covered in their respective accounting and budgetary rules. For the United States, the accounting and budgetary treatment of direct loans, guarantees, and debt forgiveness are covered in the *Statement of Federal Financial Accounting Standards Number 2* and the Office of Management and Budget's *Circular Number A-11*, which are based on the Federal Credit Reform Act of 1990. France's budgetary treatment of debt relief is based on rules emanating from the Maastricht Treaty, which created the European Union.

[17]Not all creditors that have announced their intention to provide debt relief beyond the enhanced HIPC terms have obtained legislative or cabinet authority to do so.

[18]Non-Paris Club creditors are governments that generally do not participate in regular Paris Club meetings to negotiate debt relief on government debt. However, the HIPC Initiative, as endorsed by the Boards of the World Bank and the IMF, stresses the full participation of all creditors in providing debt relief. Non-Paris Club creditors, in certain instances, may have a considerable amount of debt owed by potential HIPC recipients.

from non-Paris Club creditors. At its spring 2000 meeting, the International Monetary and Financial Committee of the IMF reaffirmed the importance of the principle of full participation in the HIPC Initiative by all creditors. In this respect, it called on all bilateral creditors to play their part while recognizing the need for flexibility in exceptional cases.

The majority of the debts owed to non-Paris Club creditors have been outstanding for many years and have typically not been rescheduled or repaid over the years. As such, the value of these claims reflects the accumulation of interest arrears and late interest charges. If comparable treatment were provided by non-Paris Club creditors, this would result in significant costs to these creditors since they would have to first provide relief under Naples terms,[19] which have already been offered through the Paris Club. While non-Paris Club creditors constitute, on average, only about one-fourth of all bilateral debt, some non-Paris Club creditors have claims outstanding to a large number of potential HIPC recipients. For example, China is exposed to 17 potential recipients with claims totaling over $1 billion, and Libya has exposure to 12 potential recipients with claims totaling over $1 billion as well.

In addition, some small non-Paris Club bilateral creditors are significantly exposed to one or more recipients and may face particularly difficult issues in providing their share of HIPC debt relief. For example, forgiveness of debt could result in balance-of-payments problems for creditors such as Costa Rica and Guatemala, which have loans outstanding to Nicaragua, a potential HIPC recipient. The debt owed by Nicaragua to these countries is recorded as part of their balance-of-payments reserves and thus will result in a reduction in these reserves, perhaps necessitating an IMF program to make up the shortfall. Assistance from other bilateral creditors is being sought to avoid this eventuality.

Further, most of the potential HIPC recipients are African countries that also owe debt to their neighboring countries, which may also find it difficult to absorb the costs of debt forgiveness. For example, Tanzania, which is a HIPC recipient, is also a creditor with exposure to Uganda. According to the IMF, given the difficulties debtor countries are encountering in obtaining such agreements, efforts by all sides will need to be intensified in order to reach more satisfactory outcomes. Larger

[19]Through the Paris Club, “Naples terms” offer indebted countries up to a 67-percent reduction in the net present value of specific parts of their bilateral debt.

bilateral creditors may be asked to contribute financing to help non-Paris Club bilateral creditors and, as will be discussed in the next section, to help multilateral creditors provide their share of debt relief.

Commercial creditors have already provided debt relief for a number of countries before the HIPC Initiative. This relief was usually in the form of commercial bank debt reduction operations or debt buyback operations financed with the support of the International Development Association Debt Reduction Facility and bilateral donors.[20] Partly due to these initiatives and the low level of access to financing from commercial creditors by potential HIPC recipients, commercial debt constitutes only about 8 percent of the total net present value of claims on these countries. Those commercial debts that have already been subject to restructuring agreements are typically being serviced. Commercial creditors are expected to provide about $800 million, or 3 percent, in debt relief under the enhanced HIPC Initiative.

Aid Flows Expected to Continue

As previously discussed, for HIPC recipients to maintain a sustainable level of debt they must continue to receive financial assistance from donors. In June 1999, the leading industrial countries said they will strive to gradually increase the volume of official development assistance and to put special emphasis on countries best positioned to use it effectively. To ease future debt burdens and facilitate sustainable development, they agreed to increase the share of grant-based financing in the official development assistance they provide to the least-developed countries.

Between 1992 and 1997, total official development assistance from Development Assistance Committee member countries of the Organization for Economic Cooperation and Development[21] to developing countries and multilateral institutions fell steadily from 0.33 percent of their combined

[20]The Debt Reduction Facility, established in 1989, is financed through (1) contributions from donor countries and (2) earnings from operations of the International Bank for Reconstruction and Development.

[21]The Organization for Economic Cooperation and Development provides member governments with a forum in which to discuss economic and social policies. The Development Assistance Committee consists of 23 industrialized countries.

gross national products to a record low of 0.22 percent.[22] Official development assistance from the Group of Seven industrialized countries fell by 29 percent in real terms between 1992 and 1997. According to a recent OECD report,[23] there was a small increase in aid flows to developing countries from donors in 1998.[24] However, the increase reflected temporary factors and did not signal a reversal of the declining trend in aid flows during the 1990s. According to the report, much of the increase was due in part to the timing of contributions to multilateral agencies and to other factors such as the Asian crisis. Some of the rise in aid flows, however, reflects the commitment by some countries such as the United Kingdom and New Zealand to increase their aid flows. Of the Group of Seven countries, only the United Kingdom and Canada have indicated that they will increase their official development assistance budgets.[25] The United Kingdom has pledged to increase its official development assistance budget by 28 percent in real terms over 3 years, and Canada has recently announced small increases for the next 2 years.

Three of the Four Largest Multilateral Creditors Face Considerable Financing Gaps

As shown in table 6, three of the four largest multilateral creditors—the African Development Bank Group, the Inter-American Development Bank, and the World Bank—face considerable financing gaps. The financing gaps of these institutions stem in part from their goal of maintaining sufficient resources to continue their existing lending levels, some of which, they state, cannot be generated through internal sources. The IMF has identified the means to provide its full share of HIPC debt relief and awaits the fulfillment of government pledges and approval to use the full amount of investment income on the profits from off-market gold sales.

[22]The United Nations has advocated that donor countries set a target level of aid equal to 0.7 percent of their gross national products. In 1998, only the Netherlands, Denmark, Norway, and Sweden reached or surpassed the U. N. target.

[23]*Development Co-operation Report 1999* (Paris: OECD, 1999).

[24]The increase was a measure of the net official development assistance from countries that are members of the Development Assistance Committee.

[25]According to OECD officials, Greece and Sweden also plan to increase their official development assistance budgets over the next 2 years.

Table 6: Financing Challenges Facing Major Multilateral Creditors

1999 U.S. dollars, net present value

Institution	Estimated amount of HIPC debt relief	Identified financing	Potential financing sources
World Bank	$6.3 billion of which 5.7 billion – IDA 0.6 billion – IBRD for 32 countries	$2.1 billion	*For IDA shortfall*: • IBRD net income • Donor funding provided for debt relief in the context of subsequent IDA replenishments • Donor contributions to the World Bank component of the HIPC Trust Fund[a] *For IBRD shortfall*: • IDA resources • Donor contributions to the World Bank component of the HIPC Trust Fund
IMF	$2.3 billion – HIPC $3.5 billion – PRGF-HIPC Trust for 32 countries	PRGF-HIPC Trust: Earnings on the investment of profits from off-market gold sales • SCA-2 contributions • Nonreimbursement of General Resources Account for administration costs • Member contributions	Authorization to use the remaining 5/14 of the earnings on the investment of profits from off-market gold sales Member contributions
African Development Bank Group	$2.2 billion for 29 countries	$320 million from internal sources ($263 million left) $83 million in pledges with HIPC Trust Fund	Contributions to HIPC Trust Fund Additional internal resources of $50 million
Inter-American Development Bank	$900 million[b] for 4 countries	$180 million from internal sources	According to a staff proposal: External sources – 40 percent Internal sources – 60 percent

Legend

IBRD = International Bank for Reconstruction and Development
IDA = International Development Association
PRGF = Poverty Reduction and Growth Facility
SCA-2 = Special Contingency Account-2

Note: Estimates exclude debt relief for Ghana, Liberia, Somalia, and Sudan.

[a]Donors have pledged about $2.5 billion to the HIPC Trust Fund to provide support for debt relief to be undertaken by multilateral creditors (excludes contributions specifically for the World Bank and the IMF). This includes 734 million euros from the European Union and $600 million from the United States.

[b]Estimate does not include debt relief of $200 million under the original HIPC Initiative.

Sources: GAO analysis of World Bank, IMF, African Development Bank Group, and Inter-American Development Bank data.

To help multilateral creditors provide their share of debt relief under the initiative, the World Bank established and administers the HIPC Trust Fund. The Trust Fund receives contributions from participating multilateral development banks and bilateral creditors that are to be used primarily to help other multilateral development banks, such as the African Development Bank Group, to finance their share of HIPC debt relief after they have fully utilized other sources of financing. The Trust Fund has also received funding from the International Bank for Reconstruction and Development net income transfers and contributions from a number of bilateral donors specifically to support World Bank debt relief. The banks have stressed that the means used to provide debt relief through the Trust Fund should accommodate constraints specific to these institutions, such as policies against debt restructuring or forgiveness. As of May 2000, 22 governments had made pledges or contributions to the Trust Fund totaling about $2.5 billion. (See app. XI for a list of contributors to the HIPC Trust Fund.)

World Bank

The World Bank—the largest multilateral creditor—is expected to provide $6.3 billion (in net present value terms) in enhanced HIPC debt relief for 32 countries. The bulk of this relief ($5.7 billion) is for the credits made by the International Development Association, which provides concessional financing to its poorest member countries. The remaining $600 million in debt relief will be for loans made by the International Bank for Reconstruction and Development (which provides market-based loans to its member countries) to Cameroon, Côte d'Ivoire, and Honduras. As of May 15, 2000, the World Bank had identified about $2.1 billion (in net present value terms) —the majority of which is International Bank for Reconstruction and Development net income—that could be used to fund debt relief.

The World Bank is exploring several options for fully financing its share of debt relief, including donor contributions to the World Bank component of the HIPC Trust Fund, resources provided by donors for World Bank debt relief in the context of International Development Association replenishments.[26] Additional transfers from the International Bank for Reconstruction and Development represent another potential source of

[26]"Replenishments" refer to when donors contribute to the International Development Association. Such replenishments normally occur every 3 years, with the next replenishment expected to take effect in 2002.

financing. According to the World Bank, its component of the HIPC Trust Fund will not have sufficient resources to fully fund debt relief when it needs to commit to providing this relief. As such, the World Bank will provide debt relief to these countries by forgiving a portion of future International Development Association debt service obligations as they fall due (instead of canceling its share of each country's debt at the completion point). The International Development Association will be reimbursed by the Trust Fund on a "pay as you go" basis annually, subject to the availability of resources to do so. The World Bank currently projects that its component of the HIPC Trust Fund will have enough resources to reimburse the International Development Association for the costs of debt relief through 2005. Beyond that point, additional funding will be needed to reimburse the International Development Association—roughly $500 million per year. According to the World Bank, any shortfalls in such funding would correspondingly reduce the International Development Association's lending capacity.

Also, additional funding will be needed in the short term to cover the costs of debt relief provided on International Bank for Reconstruction and Development debt. According to the World Bank, such debt will not be written off for financial integrity reasons.[27] In addition, resources in the Trust Fund that came from International Bank for Reconstruction and Development net income cannot be used to finance International Bank for Reconstruction and Development debt relief because this would result in the Bank paying itself. Thus, the World Bank is seeking funding from other sources. Several donors have already committed $10 million to the World Bank component of the HIPC Trust Fund to support debt relief to be undertaken by the World Bank and, according to the World Bank, other donors have indicated their intent to provide contributions for this purpose. To the extent that donor resources are not available when the debt relief is to be provided, the International Development Association will provide this relief primarily in the form of refinancing through new

[27]The World Bank does not consider the $3.6 billion available to the International Bank for Reconstruction and Development as a loan loss provision eligible to be used for HIPC debt relief. This is because the International Bank for Reconstruction and Development has not reserved resources specifically to provide HIPC debt relief. It determines the size of the loan loss provision based on the probability of lost revenue to the institution and the individual risks of each country with an outstanding International Bank for Reconstruction and Development loan. According to the financial statements of the International Bank for Reconstruction and Development, as of March 2000 the loan loss provision represents about 3 percent of loans outstanding of $119.1 billion. The loan loss provision has never been utilized in International Bank for Reconstruction and Development history.

grants and credits.[28] The World Bank intends to seek donor reimbursement for any such costs during the next replenishment discussions of the International Development Association.

The International Monetary Fund

The IMF has identified financing to meet most of its share of HIPC debt relief ($2.3 billion in net present value terms) from internal resources—including the earnings on the investment of profits from off-market gold sales—and contributions from its members. According to the IMF, full financing will be realized if the members provide the resources they pledged and the U.S. Congress authorizes the U.S. Executive Director at the IMF to approve the use by the IMF of all of the earnings on the investment of profits from off-market gold sales. Therefore, unlike the other major multilateral creditors, the IMF has a clearly identified means for closing its remaining financing gap.

The internal resources provided by the IMF to fund debt relief comes from two sources: (1) non-reimbursement of fees that the Poverty Reduction and Growth Facility normally owes to the IMF's General Resources Account for administration of the facility, which is worth approximately $65 million a year from 1999 to 2004;[29] and (2) the investment income on the profits from off-market gold sales of up to 14 million ounces. These transactions are considered "off-market" because the gold never enters the commercial market. In November 1999, the U.S. Congress authorized the U.S. Executive Director of the IMF to support the IMF's off-market sale of up to 14-million troy ounces of gold and to use 9/14 of the earnings on the investment of

[28]In discussions with World Bank officials, they said that these transactions should not be considered "round tripping" of the same resources since (1) the decision to have the two institutions aid each other's participation in debt relief was made in different years, with the International Development Association assisting the International Bank for Reconstruction and Development since 1988 under the Fifth Dimension program, while the International Bank for Reconstruction and Development has assisted the International Development Association in providing debt relief since 1996 under the HIPC Initiative and (2) the International Bank for Reconstruction and Development resources that will be used to provide debt relief on International Development Association credits are kept separately in the HIPC Trust Fund. Upon debt forgiveness by the International Development Association on the pay-as-you-go basis, the International Development Association will be reimbursed by the Trust Fund as long as there are sufficient funds available in the Trust Fund.

[29]The General Resources Account is used for most transactions between member countries and the IMF. These transactions include the receipt of quota subscriptions, purchases and repurchases, and the repayment of principal to the IMF's lenders. The assets held in this account include members' currencies, the IMF's own holdings of special drawing rights, and gold.

profits from off-market gold sales to be used solely for debt relief under the HIPC Initiative. From December 14, 1999, through April 5, 2000, the IMF had revalued about 12.9-million troy ounces of gold through seven off-market transactions with Brazil and Mexico.[30] With the seventh transaction, the IMF declared its gold transactions for poor country debt relief completed. The profits from these off-market sales are in the IMF Poverty Reduction and Growth Facility-HIPC Trust earning interest. However, the interest on the last 5/14 of the profits from the revalued gold are not available to the IMF for debt relief until Congress authorizes the U.S. Executive Director at the IMF to support the IMF's use of these funds. According to the IMF, if it cannot use all of these earnings, it will experience a financing shortfall beginning in early 2001.

The IMF has pledges worth $1.4 billion (net present value terms) from bilateral sources to help finance the IMF's share of HIPC debt relief and resources to the IMF's Poverty Reduction and Growth Facility. The U.S. Congress authorized the use of the U.S. share of a special contingent, or reserve, account (SCA-2) at the IMF, worth about $440 million for debt relief.[31] This contribution by the United States is the largest bilateral contribution towards the IMF's debt relief. In addition to the United States, many other countries also pledged resources from their share of the SCA-2 account, with other countries having pledged direct bilateral contributions to the Poverty Reduction and Growth Facility-HIPC Trust. If all of these pledges are fulfilled, the IMF will have received contributions from 93 of its 182 members.

[30]The transactions were accomplished by agreement between the IMF and the two countries. For example, at the time that Mexico had a large repayment to the IMF due, it agreed to purchase a portion of the IMF's gold at the prevailing commercial price. The value of the gold purchased was exactly equal to its loan repayment. Mexico then repaid its loan with this newly purchased gold. Thus, the total gold stock of the IMF remained unchanged, but the portion of the gold represented by the transaction was revalued from the Special Drawing Right rate (approximately $47 per ounce) to the market rate (approximately $282 per ounce).

[31]The Special Contingent Account-2 (SCA-2) was established in 1990 to provide the IMF with additional liquidity as a safeguard against the risk of loss arising from currency purchases made in connection with 11 countries that experienced severe debt problems in the 1980s. This account was formally terminated in 1999 when its purpose was deemed no longer necessary. When it was terminated, the account contained about $1.4 billion. According to U.S. law, the U.S. contribution can only be used to fund debt relief and not to contribute to the Poverty Reduction and Growth Facility.

The African Development Bank Group

The African Development Bank Group—the third largest multilateral creditor in the initiative—is expected to provide debt relief of $2.2 billion (in net present value terms) to 29 countries. It has identified $320 million from its own resources for this purpose, and the institution is considering contributing an additional $50 million of its own resources, in response to a call from the international community to increase its funding efforts. Of this $370 million in potential internal resources, about $313 million remains after accounting for debt relief provided to Uganda and Mozambique under the initial HIPC Initiative. In addition to these internal resources, the African Development Bank Group has approximately $83 million in donor-provided resources through the World Bank's HIPC Trust Fund. After accounting for these resources, the African Development Bank Group has a substantial financing shortfall remaining.

The African Development Bank Group expects that donor contributions will finance its remaining obligation under the initiative. Thus far, the European Union has pledged 670 million euros[32] that would help finance the African Development Bank Group's share. However, according to the African Development Bank Group, the European Union has made this contribution contingent upon fair burdensharing by other donors, most notably the United States. The African Development Bank Group projects that without further donor assistance, currently available resources will be exhausted in the year 2000. As of May 1, 2000, the African Development Bank Group had not formally committed to participate in the enhanced HIPC Initiative. According to a proposal for the African Development Bank Group's participation in the enhanced HIPC Initiative considered at an informal Board meeting in May 2000, the institution cannot commit to providing adequate debt relief unless adequate resources are identified. According to the African Development Bank Group, entering into debt relief commitments without sufficient funds could put the institution at risk by undermining its financial integrity and could potentially jeopardize future development assistance.

The Inter-American Development Bank

The Inter-American Development Bank—the fourth largest multilateral creditor in the initiative—is projected to provide about $900 million (in net present value terms) of additional debt relief for four countries—Bolivia, Guyana, Honduras, and Nicaragua. About 75 percent of the Inter-American

[32]As of May 30, 2000, 1 euro was equal to about $0.93.

Development Bank relief is for two countries, Bolivia and Nicaragua. As of May 12, 2000, the institution had not decided on the method for financing and delivering debt relief, but a staff paper outlined a possible approach. Under this approach, external resources would fund approximately 40 percent of the institution's total relief, with the remainder provided through internal resources. The institution has thus far identified $180 million in internal resources, but the external resources have yet to be secured. The staff paper cautioned that the impact of using so much of its internal resources to provide debt relief could result in a shortfall in new concessional lending starting after 2008. According to the staff paper, in the absence of a replenishment, this shortfall could result in the institution having no concessional resources available for lending for four consecutive years, 2009-2012.

Some Smaller Multilaterals Face Substantial Funding Challenges

In addition to the four major multilateral institutions, there are 23 smaller multilateral institutions that are expected to participate in the financing of the HIPC Initiative (see app. IV). These institutions cover a diverse set of countries across much of the world. However, these institutions generally share the characteristic of having a relatively small number of client countries in their portfolios (certainly in comparison to the four major multilateral institutions), and therefore their exposure to HIPC recipients can represent a significant portion of their outstanding loan balances. For example, the Central American Bank for Economic Integration lends to only five countries, with its lending to Nicaragua and Honduras (both of which are potential HIPC recipients) representing about 50 percent of its total equity. Although the Central American Bank for Economic Integration has raised approximately $230 million through its own resources, the total cost of its participation in the initiative is estimated to be $495 million (in net present value terms). According to the Central American Bank for Economic Integration, providing that much debt relief from internal sources will reduce its equity by almost half, having a large, negative effect on the financial integrity of the institution. The Bank is soliciting support from the donor community to assist in its participation in the HIPC Initiative.

At the meeting of 17 multilateral institutions in April 2000, only 8 reported that the decision-making bodies of these institutions had confirmed their participation in the enhanced initiative. Institutions, such as the East African Development Bank and the *Corporación Andina de Fomento* (Andean Development Corporation) told us that they support the initiative

but cannot afford to participate. They are also looking for support from the donor community to assist them.

Conclusions

The HIPC Initiative represents a step forward in the international community's efforts to relieve poor countries of their heavy debt burdens, and it does so by seeking to include all creditors and providing significant debt relief to recipient countries. Elements of the current initiative—especially its goals and financing—have required and continue to require much negotiation among the various creditors and recipients; however, unless strong, sustained economic growth is achieved, the initiative will not likely provide recipient countries with a lasting exit from their debt problems. This should not be seen, however, as a reason to abandon efforts to provide debt relief to eligible countries. Heavily indebted poor countries continue to carry unsustainable debt burdens that are unlikely to be lessened without debt relief, but participants and observers may need to have a more realistic expectation of what the initiative may ultimately achieve.

Although countries that receive full debt relief under the enhanced HIPC Initiative are likely to have their debt reduced significantly, our analysis shows that the decline in debt service will only "free up" resources for poverty reduction if the recipients borrow these resources. As such, recipients' debt levels will rise faster than they would without borrowing for increased spending on poverty reduction. In order for countries to remain debt sustainable, the World Bank and the IMF assume that countries will achieve continuous, strong economic performance, supported by their effectively using their resources and by donors continuing to provide assistance for 20 years or more following debt relief. Deviations from these assumptions may jeopardize a country's ability to pay its future loan obligations. For example, if actual growth in export earnings is lower than projected, countries may not be able to pay their debt obligations unless donor flows (loans and grants) increase. However, any additional borrowing will increase these countries' total debt levels over what was originally forecast following debt relief.

Under the initiative, there is a tension between quick debt relief and comprehensive poverty reduction strategies, with concerns raised that recipients' desire for quick debt relief may adversely affect the quality of their strategies and the level of civil society participation. As long as the initiative links debt relief to poverty reduction strategies, this tension is likely to continue. To counter these concerns, some have called for de-linking the timing of debt relief and the preparation of these strategies. However, others argue that debt relief under the initiative is a catalyst that should motivate countries to begin preparing their strategies for reducing poverty and that concerns are mitigated by the provision of significant

interim relief. Moreover, the call for strengthening the link between debt relief and poverty reduction was part of the political compromise that gave rise to the enhanced initiative in 1999 and was motivated by concern over recipient countries' continuing economic vulnerability.

Many creditors, especially the multilateral and smaller bilateral creditors, report they are having difficulty securing their share of the necessary financing. In addition to funding the direct costs of debt relief, large bilateral creditors also face challenges in providing continued aid flows and in contributing to help multilateral and smaller bilateral creditors meet their share of HIPC debt relief. Such difficulties could undermine the success of the initiative, since debt relief is supposed to be additional to the assistance that donors and creditors would otherwise provide to low-income countries. Despite the challenges in implementing and financing the initiative, poor countries continue to carry unsustainable debt burdens that are unlikely to be lessened without debt relief.

Human Development Indicators for 38 Countries

Table 7 in this appendix shows the human development indicators measured and reported by the United Nations Development Program for 38 of the 40 countries that may be eligible to receive debt relief under the enhanced Heavily Indebted Poor Countries (HIPC) Initiative. Data were not available for Liberia and Somalia. The indicators include life expectancy, adult literacy, school enrollment, and gross national product (GNP) per capita. The human development index (shown in the last column of the table) measures the overall achievements in a country in three basic dimensions of human development—longevity, knowledge, and standard of living. It is measured by life expectancy, educational attainment (adult literacy and combined primary, secondary, and tertiary enrollment), and adjusted income. A higher index indicates a higher level of human development. Using this index, 174 countries were then ranked from 1 to 174, with 1 indicating the highest level of human development and 174 indicating the lowest. The rank for each country is shown in the first column of table 7. The human poverty index concentrates on deprivations in three essential elements of human life already reflected in the human development index. It shows the percentage of a country's population living in poverty as defined in note "a" to the table.

The data for the United States, the aggregate data for the countries classified as medium development and low development, and the aggregate data for the world are given at the end of the table to provide points of comparison.

Table 7: Human Development Indicators of 38 Countries Potentially Eligible for Debt Relief Under the Enhanced HIPC Initiative, as of 1997

Rank (human development index)	Country	Life expectancy (in years)	Adult literacy rate (in percent)	School enrollment ratio (in percent)	GNP per capita (in U.S. dollars)	Human poverty index (in percent)[a]	Human development index value
	Countries classified as medium human development	66.6	75.9	64	$1,280	25.3	0.66
99	Guyana	64.4	98.1	64	800	10.2	0.70
110	Vietnam	67.4	91.9	62	310	28.7	0.66
112	Bolivia	61.4	83.6	70	970	21.1	0.65
114	Honduras	69.4	70.7	58	740	24.8	0.64
121	Nicaragua	67.9	63.4	63	410	28.1	0.62
123	Sâo Tomé and Principe	64	75	57[b]	290	N/A	0.61
128	Myanmar	60.1	83.6	55	N/A	32.3	0.58

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Rank (human development index)	Country	Life expectancy (in years)	Adult literacy rate (in percent)	School enrollment ratio (in percent)	GNP per capita (in U.S. dollars)	Human poverty index (in percent)[a]	Human development index value
133	Ghana	60	66.4	42	$390	36.2	0.54
134	Cameroon	54.7	71.7	43	620	38.1	0.54
135	Congo	48.6	76.9	68	670	32.3	0.53
136	Kenya	52	79.3	50	340	28.2	0.52
	Countries classified as low human development	50.6	48.5	39	274	44.9	0.42
140	Lao People's Dem. Rep.	53.2	58.6	55	400	38.9	0.49
141	Congo, Dem. Rep. of the	50.8	77[d]	39	110	N/A	0.48
142	Sudan	55	53.3	34	290	36.8	0.48
143	Togo	48.8	53.2	61	340	38.4	0.47
147	Madagascar	57.5	47[e]	39	250	N/A	0.45
148	Yemen	58	42.5	49	270	49.2	0.45
149	Mauritania	53.5	38.4	41	440	47.5	0.45
151	Zambia	40.1	75.1	49	370	38.4	0.43
153	Senegal	52.3	34.6	35	540	49.6	0.43
154	Côte d'Ivoire	46.7	42.6	40	710	46.8	0.42
155	Benin	53.4	33.9	42	380	50.9	0.42
156	Tanzania, U. Rep. of	47.9	71.6	33	210	29.8	0.42
158	Uganda	39.6	64	40	330	40.6	0.40
159	Malawi	39.3	57.7[e]	75	210	42.2	0.40
160	Angola	46.5	45	27	260	N/A	0.40
161	Guinea	46.5	37.9	28	550	50.5	0.40
162	Chad	47.2	50.3	29	230	52.1	0.39
164	Rwanda	40.5	63	43	210	N/A	0.38[c]
165	Central African Republic	44.9	42.4	26	320	53.6	0.38
166	Mali	53.3	35.5	25	260	52.8	0.38
168	Guinea-Bissau	45	33.6	34	230	51.8	0.34
169	Mozambique	45.2	40.5	25	140	49.5	0.34
170	Burundi	42.4	44.6	23	140	46.1	0.32
171	Burkina Faso	44.4	20.7	20	250	59.3	0.30
172	Ethiopia	43.3	35.4	24	110	55.8	0.30
173	Niger	48.5	14.3	15	200	65.5	0.30
174	Sierra Leone	37.2	33.3	30[f]	160	57.7	0.25
3	United States	76.7	99[b]	94	$29,080	N/A	0.93
	World	66.7	78	63	$5,257	N/A	0.71

Legend

N/A = Not available

[a]The human poverty index is calculated using the following measures of deprivation. For developing countries, deprivation in longevity is represented by the percentage of people not expected to survive to age 40; deprivation in knowledge is represented by the percentage of adults who are illiterate; and deprivation in living standard is represented by a composite of three variables—the percentage of people without access to safe water, the percentage of people without access to health services, and the percentage of moderately and severely underweight children under 5 years old.

[b]U.N. Human Development Report Office estimate.

[c]United Nations Children's Fund, *The State of the World's Children 1999* (New York: Oxford University Press, 1999).

[d]Data cited refer to a year or period other than that specified in the column heading, differ from the standard definition, or refer to only part of the country. U.N. Human Development Report Office estimate based on national sources. United Nations Children's Fund, *The State of the World's Children 1998.* (New York: Oxford University Press, 1998).

[e]Data cited refer to a year or period other than that specified in the column heading, differ from the standard definition, or refer to only part of the country. U.N. Human Development Report Office estimate based on national sources.

[f]United Nations Educational, Scientific and Cultural Organization, Correspondence on Gross Enrollment Ratios, Nov. 1997.

Source: United Nations Development Program, *Human Development Report, 1999* (New York: United Nations).

Type of Debt Incurred by Poor Countries

Poor countries incur two major types of debt—concessional and nonconcessional. Concessional debt has below market interest rates, whereas nonconcessional debt has market-based rates.

Types of Concessional Debt Incurred by Poor Countries

Official development assistance, or official aid, can be a grant or a loan with at least a 25-percent grant element, for the promotion of economic development or basic human needs. The loan portion is offered at a low interest rate and over a long repayment period, for example,

- the U. S. Department of Agriculture sells agricultural commodities to low-income countries with repayment periods of 10 to 30 years and low interest rates, under its Public Law 480 program.

Other concessional debt has a below market interest rate, as shown in table 8.

Table 8: Concessional Loans Offered by Four Major Multilateral Institutions

Institution	Lending arm	Interest rate/ service charge (in percent)	Maturity (in years)	Grace period for principal (in years)	Grant element, using a 10-percent discount rate[a] (in percent)	Grant element, using a 5.25-percent discount rate[a] (in percent)
World Bank Group	International Development Assistance	0 interest Service charge of 0.75	35-40	10	81.3	60.1
International Monetary Fund	Poverty Reduction and Growth Facility	0.5	10	5-½	74.4	51.7
African Development Bank Group	African Development Fund	0 interest Service charge of 0.75	50	10	83.8	64.4
Inter-American Development Bank	Fund for Special Operations	1 during grace period 2 thereafter	Up to 40	Up to 10	76.5	51.0

[a]"Grant element" is a measure of a loan's concessionality. It is calculated as the difference between the nominal, or face, value of a loan and the net present value of all scheduled principal and interest repayments, discounted at a market interest rate. The grant element is often expressed as a percentage of the loan's face value. For these loans, we use the Special Drawing Right interest rate as the discount rate (5.25 percent, which represents the July – December 1998 average Commercial Interest Reference Rates, or CIRR—the method used by the World Bank and IMF staffs in analyzing countries' debt profiles under the HIPC Initiative) to calculate the grant element. For example, a country may borrow $100 from the International Development Association, and the net present value of all future loan repayments is $40. This is equivalent to the country's receiving a grant of $60 and a loan of $40 repayable at a market interest rate. Two methods for measuring concessionality are cited here. The distinction is important because the degree of concessionality seems higher under one method—the Development Assistance Committee (DAC) of the Organization for Economic Cooperation and Development method that uses a standard 10-percent discount rate—than under the second method—the CIRR—which is a better measure of a country's debt burden. In other words, as shown in table 8 for World Bank loans, a country may think it has to pay about $19 for debt service when calculated using the DAC but actually has to pay about $40, as calculated under the CIRR method.

Source: GAO analysis of World Bank, IMF, African Development Bank Group, and Inter-American Development Bank documents.

Types of Nonconcessional Debt Incurred by Poor Countries

Various creditors offer nonconcessional loans. Table 9 shows the nonconcessional loans offered by four major multilateral institutions.

Table 9: Nonconcessional Loans Offered by Four Major Multilateral Institutions

Institution	Lending arm	Finance charges	Maturity (in years)	Grace period for principal (in years)
World Bank Group	International Bank for Reconstruction and Development	Average cost of borrowing + 0.75% + 1% front-end fee + 0.75% commitment charge per year for undisbursed amounts[a]	12-20 (amortization period)	3-5
International Monetary Fund	General Resources Account[b]	Special Drawing Right interest rate[c] + charge to increase reserves	1-10	0
African Development Bank Group	African Development Bank	Financial charges that reflect the cost of funds	12-20	Up to 5
Inter-American Development Bank	Ordinary Capital Account	Cost of borrowing + 0.5% + credit commission of 0.75% per year	Varies	Varies

[a]The International Bank for Reconstruction and Development interest rate is a "market-based" rate derived from the average cost of borrowing plus 0.75 percent. The weighted average interest rate for fiscal year 1999 was 6.63 percent. A portion of the finance charges may be waived based on an annual determination. For most of the past 10 years, a portion of the interest and commitment charges has been waived.

[b]The General Resources Account is used for most transactions between member countries and the IMF.

[c]The Special Drawing Right (SDR) interest rate is a composite interest rate derived as a weighted average of the 3-month interest rates of the IMF's five largest members (the United States, Japan, Germany, the United Kingdom, and France). As of May 1, 2000, this rate was 4.29 percent.

Source: World Bank, IMF, African Development Bank Group, and Inter-American Development Bank documents.

- *Loans from other multilateral financial institutions.*
- *Export credits* – Loans for the purpose of trade that may be extended by the government or the private sector. If extended by the private sector, they may be supported by government guarantees. For example,
  - the U.S. Export-Import Bank finances the exports of U.S. manufactured goods through buyers' credits, project finance, suppliers' credit, and small business credits and
  - the United Kingdom's Export Credit Guarantee Department provides guarantees, insurance, and reinsurance against loss to exporters of United Kingdom goods.
- *Commercial loans* – loans offered by the private sector (e.g., banks) at market rates.
- *Short-term credit* – trade financing with a maturity of 1 year or less.

Amount and Type of Debt Owed to the United States by 40 Heavily Indebted Poor Countries, End of 1998

U.S. dollars in millions

Country	Concessional loans	Nonconcessional loans	Guarantees	Total
Angola	$38.0	$7.0	$0	**$45.0**
Benin	0	0	0	**0**
Bolivia	32.3	43.1	13.9	**89.4**
Burkina Faso	0	0	0	**0**
Burundi	0	0	0	**0**
Cameroon	0	54.8	8.3	**63.1**
Central African Republic	0	8.8	0	**8.8**
Chad	0	0	0	**0**
Congo, Democratic Republic	449.1	1,678.9	0	**2,128.0**
Congo, Republic	32.1	27.4	0	**59.6**
Côte d'Ivoire	90.1	231.6	40.8	**362.5**
Ethopia	92.0	2.2	0	**94.2**
Ghana	0	8.1	9.1	**17.2**
Guinea	103.8	22.9	0	**126.7**
Guinea-Bissau	0	0	0	**0**
Guyana	32.8	5.6	0	**38.4**
Honduras	0	86.5	57.4	**143.9**
Kenya	36.5	39.0	36.5	**112.1**
Lao, PDR	0	0	0	**0**
Liberia	252.3	67.2	0	**319.5**
Madagascar	2.8	38.0	0	**40.8**
Malawi	0	0	0	**0**
Mali	0	0	0	**0**
Mauritania	0	6.6	0	**6.6**
Mozambique	0	53.0	0	**53.0**
Myanmar	2.6	0	0	**2.6**
Nicaragua	28.9	88.2	2.1	**119.2**
Niger	0	12.7	0	**12.7**
Rwanda	0	0	1.3	**1.3**
Sâo Tomé and Príncipe	0	0	0	**0**
Senegal	0	17.4	0	**17.4**
Sierra Leone	65.4	0	0	**65.4**
Somalia	207.4	249.6	0	**457.0**
Sudan	507.5	766.7	0	**1,274.2**
Tanzania	0	21.4	4.0	**25.4**
Togo	0	0	0	**0**

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U.S. dollars in millions

Country	Concessional loans	Nonconcessional loans	Guarantees	Total
Uganda	0	0.9	0.9	**1.8**
Vietnam	130.1	0	0	**130.1**
Yemen	98.6	2.5	0	**101.1**
Zambia	134.2	158.4	0	**292.6**
Total 22	**$1,066.1**	**$2,566.8**	**$137.8**	**$3,770.8**
Total 40[a]	**$2,336.6**	**$3,698.9**	**$174.3**	**$6,209.8**

[a] The Treasury has requested funding to provide debt relief to 22 countries of the 40 potential HIPC recipient countries. Of the remaining 18 countries, 4 countries are not likely to qualify as heavily indebted poor countries (Angola, Kenya, Vietnam, and Yemen); 4 countries have outstanding debt to the United States but are not likely to qualify within the next few years (Liberia, Myanmar, Somalia, and Sudan); and 10 countries have no understanding debt to the United States, as shown in the last column of the table.

Source: Preliminary data from the U. S. Treasury.

Multilateral Institutions Participating in the HIPC Debt Initiative

Table 10 shows the multilateral institutions with outstanding claims on the 40 heavily indebted poor countries. The institutions were expected to provide debt relief under the HIPC Initiative, but several, such as the East African Development Bank and the Central American Bank for Economic Integration, have said they support the initiative's goal but will not be able to finance debt relief. The institutions are listed by the amount of debt relief they were expected to provide, from highest to lowest.

Table 10: Multilateral Creditors' Outstanding Claims (end of 1998) on 40 Heavily Indebted Poor Countries and Estimated Amount of Debt Relief Under the HIPC Initiative, as of the End of 1999

U.S. dollars in millions

		Outstanding debt (claims)			
Institution	**Headquarters**	**Nominal value**	**Net present value**	**Of which arrears (net present value)**	**Debt relief (net present value)**
World Bank Group	Washington, D.C., United States	$39,247	$20,300	$746	$6,300
International Development Association		36,919	17,925	328	5,700
International Bank for Reconstruction and Development		2,327	2,376[b]	418	600
International Monetary Fund	Washington, D.C., United States	8,192	6,218	1,660	2,300
African Development Bank	Abidjan, Côte d'Ivoire	10,275	6,929	997	2,200
Inter-American Development Bank	Washington, D.C., United States	3,812	2,844	N/A	1,100
European Investment Bank/European Union	Brussels, Belgium; Luxembourg	2,373	1,811	209	638
Central American Bank for Economic Integration	Tegucigalpa, Honduras	853	920	N/A	392
International Fund for Agricultural Development	Rome, Italy	1,237	689	33	219
Arab Bank for Economic Development in Africa	Khartoum, Sudan	437	398	222	176
Organization of Petroleum Exporting Countries Fund for International Development	Vienna, Austria	533	488	153	145
Islamic Development Bank	Jeddah, Saudi Arabia	405	489	35	112

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U.S. dollars in millions

		Outstanding debt (claims)			
Institution	**Headquarters**	**Nominal value**	**Net present value**	**Of which arrears (net present value)**	**Debt relief (net present value)**
Asian Development Bank	Manila, Philippines	892	434	N/A	103
Corporación Andina de Fomento – Andean multilateral development bank	Caracas, Venezuela	178	185	N/A	77
Arab Fund for Economic and Social Development	Safat, Kuwait	451	738[b]	317	64
Caribbean Community Multilateral Clearing Facility	Port of Spain, Trinidad	108	101	N/A	54
Central Bank of West African States	Dakar, Senegal	229	194	1	48
West African Development Bank	Lomé, Togo	183	183	8	43
Fund for the Financial Development of the River Plate Basin	Santa Cruz de la Sierra, Bolivia	55	50	N/A	24
Caribbean Development Bank	St. Michael, Barbados	51	34	N/A	18
Bank of Central African States *(Banque des Etats de l'Afrique Centrale)*	Dakar, Senegal	51	54	18	16
Nordic Investment Fund	Helsinki, Finland	96	44	N/A	14
Arab Monetary Fund	Abu Dhabi, United Arab Emirates	122	160[a]	N/A	11
Economic Community of West African States Fund for Cooperation, Compensation and Development	Lomé, Togo	42	54[a]	9	11
East African Development Bank	Kampala, Uganda	10	11[a]	N/A	7
Nordic Development Fund	Helsinki, Finland	33	32	N/A	3
Central American Fund for Monetary Stabilization *(Fondo Centroamericano de Estabilización Monetaria)*		N/A	3	N/A	2
Conseil de l'Entente (Council of the Entente)	Abidjan, Côte d'Ivoire	10	11[a]	N/A	2
Eastern and Southern African Trade and Development Bank	Nairobi, Kenya	1	1	N/A	1
Total		**$69,878**	**$43,370**	**$4,409**	**$14,080**

Legend

N/A = Not available.

Note: Figures include Ghana, Liberia, Somalia, and Sudan.

[a]For these institutions, the net present value of these claims is greater than the nominal value, because the interest rate used to discount in 1998 was lower than the interest rate charged on these claims.

Source: World Bank documents, including *Updates on Costing the Enhanced HIPC Initiative* (Washington, D.C.: World Bank, Dec. 1999).

Conditions Eight Countries Are Expected to Meet to Reach HIPC Milestones

Table 11 describes the conditions eight countries are expected to meet in order to reach their milestones under the enhanced HIPC Initiative. These milestones are the entry (decision) point and exit (completion) point. The eight countries have either reached their decision points under the initiative or are expected to reach this point by September 2000. These conditions are contained in documents describing the reforms countries agreed to undertake for the HIPC Initiative as well as targets and actions they agreed to meet under their existing World Bank- and International Monetary Fund (IMF)-supported programs. In addition to these conditions, countries are also to receive satisfactory assurances that creditors will provide debt relief. Countries agree to not impose or intensify restrictions on international trade or payments.

Table 11: Conditions Eight Countries Are Expected to Meet in Order to Reach HIPC Initiative Milestones (Monitored under World Bank- and IMF-supported programs)

Country	Poverty reduction strategy	Macroeconomic stability and public finances	Foreign exchange system reform	Tax reform	Financial sector reform	Public sector reform	Social sector reform	Governance/ anticorruption	Privatization
Bolivia									
Before decision point – reached Jan. 2000	Prepare interim strategy	X			X	X		X	X
Before completion point	Prepare full strategy	X		X		X			
Guinea[a]									
Before decision point	Prepare interim strategy	X			X	X		X	
Before completion point – possible areas	Prepare full strategy Prepare one progress report on implementation	X			X		X	X	
Honduras[a]									
Before decision point	Prepare interim strategy	X						X	X

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Country	Poverty reduction strategy	Macroeconomic stability and public finances	Foreign exchange system reform	Tax reform	Financial sector reform	Public sector reform	Social sector reform	Governance/ anticorruption	Privatization
Before completion point	Prepare full strategy Prepare one progress report on implementation	X			X			X	X
Mauritania									
Before decision point – reached Jan. 2000	Prepare interim strategy	X	X		X	X	X		X
Before completion point	Prepare full strategy Successfully implement for at least 1 year	X	X	X	X		X	X	X
Mozambique									
Before decision point – reached April 2000	Prepare interim strategy	X			X	X			
Before completion point[b]	Prepare full strategy	X				X	X	X	X
Nicaragua[a]									
Before decision point	Prepare interim strategy	X			X	X	X	X	X
Before completion point – tentative	Complete strategy Implement strategy	X			X		X	X	X
Tanzania									
Before decision point – reached April 2000	Prepare interim strategy	X							

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Country	Poverty reduction strategy	Macroeconomic stability and public finances	Foreign exchange system reform	Tax reform	Financial sector reform	Public sector reform	Social sector reform	Governance/ anticorruption	Privatization
Before completion point	Prepare full strategy	X		X		X	X	X	X
Uganda									
Before decision point – reached Jan. 2000	Prepare contents of strategy	X				X	X		
Before completion point – reached May 2000	Finalize strategy	X							

[a]Information for Guinea, Honduras, and Nicaragua is based on preliminary HIPC documents and is therefore subject to change.

[b]World Bank and IMF staffs note that, in assessing Mozambique's performance before the completion point, due consideration will be given to the damage caused by the floods in January and February 2000.

Sources: World Bank and IMF documents.

Methodologies Used to Analyze the Debt Sustainability of Potential Recipients of HIPC Debt Relief

We addressed a number of methodological issues in evaluating the debt sustainability of potential recipients of HIPC debt relief. The HIPC documents that we analyzed presented detailed economic projections by World Bank and IMF staffs and host country officials for countries that are reviewed for eligibility in the initiative (referred to as the "debt sustainability analysis"). We examined the debt sustainability analyses documents for seven countries: Bolivia, Honduras, Mauritania, Mozambique, Nicaragua, Tanzania, and Uganda.[1] The documents provide projections over a 20-year period for key macroeconomic variables as well as for countries' debt service and the net present value of the debt stock. The projection period provides a baseline scenario of how the economy would evolve over the long term, under certain assumptions. However, inconsistencies and gaps in the types of information reported in the debt sustainability analyses presented challenges in our analysis of the documents.

General Approach

We examined the implications of the World Bank and IMF staffs' and host country officials' projections contained within the debt sustainability analyses for key economic variables, including debt levels, GDP, government revenue, donor grant and loan assistance, exports, and debt relief for each of the seven countries' total debt, debt service, and external finance requirements. We also compared the nominal dollar growth rate projections for these variables—implicit in the HIPC documents—with historical data from the World Bank's *Global Development Finance* and the IMF's *International Financial Statistics*. We supplemented our analyses with information from IMF and World Bank officials. We reviewed with these officials the underlying methodology of the debt sustainability analyses, clarified areas of ambiguity, and asked country-specific questions. In situations where we had to make assumptions, we vetted these with IMF officials as well as among our own staff economists. We also met with U.S. Treasury and nongovernmental organization officials in the United States; and government, donor, and nongovernmental organization officials in four recipient countries—Bolivia, Nicaragua, Tanzania, and Uganda — to help us clarify their understanding of "freed-up resources" and how this was applied under the HIPC Initiative.

[1]Our analysis focused on seven of the eight countries in which a debt sustainability analysis from the World Bank and the IMF was available to us to analyze. Due to the limitations of time, we were unable to review the final country, Guinea.

Main Methodologies Used

Our examination of the debt sustainability analyses required us to make projections for a number of variables, including the amount of borrowing countries would have to undertake after receiving debt relief to remain debt sustainable, the impact of a decline in exports on debt sustainability, and projections of future donor assistance. A brief description of the approach we used in each of these areas is described in the next paragraphs.

External Viability Analysis

According to the IMF, a country is externally viable if it is able to pay its external obligations with its own resources (tax revenues, external account surpluses, and nonconcessional borrowing), without recourse to donor assistance. If, after subtracting HIPC debt service relief, further external financing[2] is required, then a country is not considered externally viable. Hence, the continued presence of a financing gap after HIPC debt service relief indicates that the country is not externally viable after HIPC debt relief. When the documents provided data separately for program grants and loans (i.e., external assistance used specifically to finance the balance-of-payments gap) from project assistance, we were able to directly determine if the country would become externally viable after receiving HIPC debt relief.

When there was no separation in the data between program and project assistance after debt relief, we employed a financing gap analysis to identify the point of external viability for each country. The financing gap analysis measures the amount of continued external assistance that each country would require after accounting for identified sources of financing (including internal resources and assistance) in order to remain debt sustainable. If, after receiving HIPC debt relief, a country continues to require concessional external assistance to close its remaining financing gap, it is not considered externally viable.

[2]External financing (or balance-of-payments financing) includes program grants concessional program loans, and any additional exceptional finance such as IMF disbursements and the remaining financing gap (sometimes referred to as “new borrowing” or “unidentified borrowing”).

To determine what a country's external financing needs would be if the country did not choose to spend resources equivalent to the amount of resources "freed up" for spending on poverty reduction, we focused on each country's pre-HIPC debt relief external financing requirements. From those external financing requirements we subtracted the annual HIPC debt service relief that they are projected to receive and the additional debt service the country would incur had it borrowed the equivalent amount of "freed-up" resources for poverty spending.[3]

Determining Additional Borrowing Requirements Under Alternative Export Growth Assumptions

If the growth rate in export earnings declines from its projected level (as contained in HIPC documents), the country will generate a lower amount of foreign exchange earnings than projected in subsequent years. This would impact the country's requirement for external financial assistance, its stock of debt, and its debt burden. To estimate these effects, we assume that the annual shortfall in foreign exchange earnings from a fall in exports will be replaced by increased donor assistance (loans and grants).[4]

Comparing Projected Levels of Donor Assistance

The projections of donor assistance are based on the data given in the debt sustainability analysis for each country. Assistance includes official grants and loans for both program and project purposes.[5] We calculated the net present value of the loan and grant components, generally from the year 2000 to 2018 for each country. We then compared these debt sustainability analysis-based projections of donor assistance (in net present value terms) to net present value projections we calculated based on historic data on donor assistance for the same country. The data for the historic-based projections of assistance are from the World Bank *Global Development Finance 1999.* We developed three approaches for comparing the debt sustainability analysis-based projections to both high and low versions of

[3]The actual amount of borrowing may be less than the HIPC debt service relief if (a) the amount of program grants provided by donors is greater than projected, (b) the decision is made not to borrow all of it, and (c) the country becomes externally viable after receiving HIPC relief.

[4]This methodology implicitly assumes that GDP has declined because exports have decreased, but domestic spending remains the same because external loans and transfers have increased.

[5]Loans include disbursements (such as those from the IMF) and "balance-of-payments" financing such as international reserve buildup, unidentified new borrowing, and/or other exceptional financing.

historical projections assuming (1) constant nominal levels for historical assistance, (2) constant real levels of historical assistance (2 percent nominal growth rate),[6] and (3) growth of nominal assistance at each country's 1990s historic assistance growth rates. These approaches yielded very similar results.

Challenges in Analyzing and Comparing HIPC Documents

In our examination of the debt sustainability analyses, we confronted several challenges that derived from the reporting decisions made within these documents. While recognizing that there are differences in data availability across countries and that different World Bank/IMF teams prepare each debt sustainability analysis, the absence of consistency as well as gaps in information provided make comparisons across countries very difficult. Addressing inconsistencies in the types of information reported and gaps in the presentation of some key variables would assist future analysis and improve the transparency of these documents.

Reporting Inconsistencies

We found considerable variation in the form and substance of the data presented in the IMF and World Bank debt sustainability analyses we reviewed. Although there was uniformity in the general types of tables presented within these documents, the specific variables included within these tables varied from country to country. In many cases, data for key economic variables such as IMF purchases, loan disbursements, or government revenue either were not provided or could not be easily deduced. For example, although the dollar amount of total debt after relief, annual exports, and government revenue were all available for other countries, in the case of Uganda, this information was not directly reported and had to be deduced from other data. Projected annual information for key variables was not available for Mozambique, Mauritania, or Tanzania, and instead the data were reported as averages over certain periods of time (e.g., 2008-2017).[7] The breakout of future external financing between program and project assistance was available for only two countries, Uganda and Tanzania. The absence of this information in the documents of

[6]We used 2 percent because U.S. inflation is expected to grow at this rate over the projected period. Adding the 2-percent inflation rate means assistance will also grow at a rate of 2 percent, thus maintaining a constant real level of assistance.

[7]According to the IMF, the use of averages instead of the full-time series is due to the difficulty of presenting large amounts of data in long-time series on one page.

the other countries made our calculations of external viability more challenging.

Information Gaps

Critical information that we derived from the debt sustainability analyses is not presented explicitly within HIPC documents. In some of the decision point documents, the actual amount of debt relief a country would receive is not explicitly presented and had to be deduced from other data provided. In addition, the amount of borrowing that each country would need after debt relief in order to remain debt sustainable is not reported and required a complex methodology for us to derive. Finally, although the documents discuss the resources that debt relief would contribute to poverty reduction activities, they do not mention that these are financial resources that each country would have to borrow.

Information on Selected Elements of Poverty Reduction Strategies

This appendix provides information on selected elements of the poverty reduction strategies to further illustrate the challenges countries face in developing the strategies and the numerous causes of poverty that were discussed in chapter 3. Reducing poverty takes time and effort. This appendix discusses (1) the multiple definitions and measurements of poverty, (2) the numerous causes of poverty, and (3) the use of decentralization and citizen participation as ways to reduce poverty in Bolivia and Uganda.

The Characteristics of Poverty Are Broadly Defined and Multidimensional

Poverty is defined broadly because it can combine economic considerations with those of living conditions and quality of life. Countries use both national and international definitions to define poverty and a variety of indicators to measure various socioeconomic sectors such as health and education. Poverty can derive from numerous and mutually reinforcing factors, such as disease, natural disasters, war, weak economic systems, and governance. It can affect a significant portion of the population and can be concentrated in specific regions and ethnic groups and on women.

The reduction of poverty has been a priority goal of international development. Targets set by the United Nations and the World Bank to address poverty include reducing (1) the number of people living in global poverty by half between 1993 and 2015, (2) the proportion of malnourished children by half between 1995 and 2005 and by half again by 2015, and (3) global adult illiteracy (ages 15-24) by three fourths between 1990 and 2015.[1]

Poverty Is Broadly Defined

According to the U.N. Development Program, poverty can be defined as the inability to satisfy minimum food and nonfood needs, the lack of minimally adequate income or expenditures, or the lack of essential human capabilities such as being literate or adequately nourished.[2] In addition, countries can use their own national standards that can differ between countries and change as a country's per capita income grows. They can also

[1]This means reducing global male and female poverty illiteracy rates to 8 percent by 2015, according to the United Nations.

[2]*Overcoming Human Poverty Report 1998*, U.N. Development Program (New York: United Nations, 1998).

use the international poverty line jointly agreed to by the United Nations and the World Bank that is calculated as one person living on $1 per day.

The countries that we analyzed used a variety of indicators to assess their levels of poverty. According to a U.N. Development Program survey, the majority of countries use both non-monetary and monetary definitions of poverty. Table 12 shows which measures of poverty countries that we analyzed use, whether they have estimated the rates of poverty, and whether they have set targets for reducing poverty.

Table 12: Status of Six Selected Countries' Efforts to Define and Address Poverty

	Poverty definitions			Poverty planning	Poverty estimates		Poverty targets	
Country	Uses income definition of extreme poverty [a]	Uses income definition of overall poverty [b]	Uses non-income definition of poverty	Has explicit national poverty plan in place	Has estimate of overall poverty [a]	Has estimate of overall poverty [b]	Sets target for extreme poverty reduction	Sets target for overall poverty reduction
Bolivia			●	◆	●	●		
Mauritania	●	●	●	●	●	●		●
Mozambique	○	●	●	●	●		●	
Nicaragua	●	●	●	◆	●	●		
Tanzania		●	●	◆	●	●	●	
Uganda	●	●	●	●	●	●	●	●

● Uses definition; has poverty plan, estimates, and/or target

○ Non-income definition of poverty

◆ Plan under development, according to country authorities

[a]"Extreme poverty" is defined as indigence or destitution, usually specified as the inability to satisfy even minimum food needs.

[b]"Overall poverty" is defined as a less severe level of poverty, usually the inability to satisfy essential nonfood as well as food needs.

°Non-income definition of poverty.

♦Plan under development, according to country authorities.

Source: *Overcoming Human Poverty Report 1998*, U.N. Development Program (New York: United Nations, 1998).

In Tanzania, poverty is indicated by the national poverty line of $0.65 a day and by the definition that it is "a state of deprivation, prohibitive of a decent human life." Bolivia uses a nonincome definition of poverty and describes it as the inability to satisfy basic needs as a result of lack of opportunities to obtain sufficient income, reduced access to public services, high vulnerability, and social exclusion. Countries also use a variety of poverty monitoring indicators that measure socioeconomic areas such as infant mortality, maternal mortality, mortality for children under 5 years old, and life expectancy and other factors including the percentage of the population with access to safe water and the number of children in primary school (enrollment rates).

Uganda provides an example of the challenges countries face in relying on indicators as a means for monitoring reductions in poverty. Although Uganda has achieved substantial improvements in some indicators, many others remain low and some critical ones have in fact deteriorated, according to World Bank and IMF staffs. The most notable success has been in primary education, where the net primary school enrollment rate increased from 56 percent in 1995/96 to 94 percent in 1998/99. Improvements were also realized with regard to access to clean water, literacy rates, and the prevalence of stunting (generally caused by malnutrition) among small children. However, life expectancy at birth has declined from 47 years in the early 1990s to 42 years in 1998, with Uganda now having one of the shortest life expectancies in Africa, according to the U.N. Development Program. (See app. I.) This decline in life expectancy is directly related to the estimated 10 percent of the population that is infected with the HIV/AIDS virus.

Poverty Is Caused by Numerous Factors

The causes of poverty are numerous and often involve mutually reinforcing factors that can vary significantly between different countries, according to the United Nations. Some of these factors, for example, include the lack of productive resources to generate material wealth, illiteracy, the prevalence of diseases such as HIV/AIDS, weak and/or discriminatory economic and political systems, natural disasters such as drought and floods, and man-made calamities such as war. According to the U.N. Development Program, human poverty is the result of a whole set of intersecting inequalities—social, political, and economic. Poverty is thus caused by more factors than simply a shortage of income, as the following examples illustrate.

- According to Bolivia's interim poverty reduction strategy paper, poverty is caused by economic, social, and cultural factors such as limited access to health services, limited property rights that restrict the ability of the poor to gain physical and financial assets, and social exclusion. In Bolivia, the poor lack property rights to accumulate both physical and financial assets, and this has led the poor to be more vulnerable to factors such disease, economic shock, natural disaster, conflict, or discrimination.
- In a Ugandan study that included the views of the poor,[3] in addition to low income, consumption, education levels, and health status, the poor said poverty is also caused by previously unconsidered factors such as lack of security (that is, living in areas prone to conflict) and vulnerability to risks such as droughts and poor harvests.
- In Tanzania, low economic growth has been the main reason for continuing high poverty, while other factors such as the insufficient funding of the social sector are also an issue. Although social sector spending has gradually recovered in Tanzania after a fiscal crisis in the mid-1990s, according to its Public Expenditure Review, compared to the actual requirements for the sectors to provide basic social services to all Tanzanians, the current allocations are inadequate to meet their needs.

Poverty Can Concentrate on Specific Groups and Affect Significant Portions of a Country

Poverty can also affect a significant portion of a country's population and be concentrated in specific regions and ethnic groups or be rooted in gender inequalities. Bolivia's interim poverty reduction strategy estimated that in 1992, 70 percent of households lived below the national poverty line. In 1998, the U.N. Development Program reported that 94 percent of Bolivia's rural households lived in poverty, as opposed to about 50 percent of households in urban areas. In Nicaragua, 44 percent of the population is estimated to live under its poverty line, while Mozambique's interim poverty reduction strategy estimated this proportion to be 70 percent.

Women in these countries also suffer from poverty disproportionately compared to men. According to the United Nations, compared to men, women have a higher incidence of poverty, their poverty is more severe, and their incidence of poverty is increasing. In addition to lower income levels, women also suffer from compounding problems of low status, incidences of violence against them, and lower levels of education and

[3] *Uganda Participatory Poverty Assessment: Key Findings* (Kampala, Uganda: The Ministry of Finance, Planning, and Economic Development, 1999).

health care. For example, of the 900 million illiterate adults in the world, two-thirds of them are women. In Tanzania, literacy rates for women are 62 percent compared to the male literacy rate of about 82 percent, according to the U.N. Development Program.

Decentralization Is an Important Part of Bolivia's and Uganda's Poverty Reduction Strategies

Countries may choose a number of strategies to reduce poverty. In addition to undertaking many economic and social actions, some countries have been focusing on the importance of decentralization of government services as a means to improve efficiency of service delivery and increase civil society involvement. The process of decentralization may seek to transfer political decision-making power from the federal to subordinate levels, improve efficiency in the provision of services, and promote accountability at the local level. The experience of developing countries demonstrates some of the advantages of decentralization as well as the difficulties of pursuing this method. Both Bolivia and Uganda have pursued decentralization for several years, including efforts to transfer responsibilities to district governments from the federal level and to build citizens' participation in planning and monitoring government activities.

Bolivia

According to Bolivia's interim poverty reduction strategy, decentralization is an important tool for both reducing poverty and enhancing equality since this approach makes it possible to focus on local needs, encourages good governance, and generates a desire for communities to begin having a say in the development of their region.[4] According to Bolivian government officials, decentralization and popular participation in Bolivia have achieved some benefits, such as reducing distortions in the allocation of resources (resources were not previously allocated based primarily on need) and increasing citizens' involvement in identifying priority needs. World Bank staff reported that decentralization has increased efficiency and local accountability, and popular participation has helped to make many municipalities more autonomous and responsive to civil society.[5] However, the government and the Bank also noted that additional

[4] *Bolivia: Interim Poverty Reduction Strategy Paper* (La Paz, Bolivia: Republic of Bolivia, Jan. 13, 2000).

[5] *Bolivia: Implementing the Comprehensive Development Framework* (Washington, D.C.: World Bank, May 21, 1999).

improvements are needed for decentralization to be effective in reducing poverty.

Decentralization seeks to transfer political power to municipal governments, promote fiscal responsibility through the handling of local public finances, and achieve greater efficiency in the provision of social services. According to the Bolivian government, such considerations led to administrative decentralization and popular participation laws in the mid-1990s that sought to decentralize political and economic decision-making, transfer the administration of key public services and resources to the local level, promote citizens' participation, and improve the allocation of resources at the local level. The U.N. Development Program stated that the main objective of the Popular Participation Law is to improve the quality of life of men and women through a more equitable distribution of public resources and decision-making authority.[6] The U.N. Development Program also said that it is the first Bolivian law that recognizes, promotes, and institutionalizes participation processes at the local level. According to the United Kingdom's aid organization, for the first time these laws have put significant resources into local hands, offering the potential for more demand-driven development and greater local ownership and accountability.[7]

Bolivia's interim poverty reduction strategy stated that, in the 5 years these laws have been implemented, several improvements have been made. For example, some urban areas were getting more resources on a per capita basis than poorer rural areas. The allocation of public resources has been improved due to these laws. Also, civic participation has become much more extensive, with the inclusion of about 14,000 local community organizations and 311 "vigilance committees" that help identify the communities' priorities and monitor government activities as well as the removal of several mayors for mishandling public funds. Municipal investment in basic social services has also increased in recent years.

Despite these gains, Bolivia's interim poverty reduction strategy noted that efforts are needed to improve equity, municipal administration, basic social

[6]*UNDP: Country Cooperation Frameworks and Related Matters – First Country Cooperation Framework for Bolivia (1998-2002)* (New York: U.N. Development Program, DP/CCF/BOL/1, Feb. 2, 1998).

[7]*Bolivia: Country Strategy Paper 1998* (London: Department for International Development, Dec. 1998).

services, and civil participation. World Bank staff identified problems implementing the government's decentralization strategy as key constraints in strengthening institutional capacity at the local level and improving the quantity and quality of basic services to the population. The staff also said that failure to address these problems would limit progress in the fight against poverty. To address the problems, the government's strategy proposed allocating more resources to regions with high levels of poverty and increasing the efficiency of social services. In order to help meet local demands, the processes of participatory planning are to be strengthened and implemented through municipal development plans, annual operating plans, and municipal institutional development plans. These plans are to be subject to public monitoring and evaluation.

In Bolivia, officials from the government and vigilance committees of two municipalities—Punata and Colomi—told us that, with technical assistance from the U.S. Agency for International Development, they have prepared plans that describe and prioritize the communities' needs through a process that involves public participation and approval. Priorities are graded from A to E, with A being the highest priority. Excerpts from the city of Punata's annual operating plan are outlined in table 13.

Table 13: Examples of Projects Prioritized by the Communities for the Annual Operating Plan for 1997 of the City of Punata, Agreed Upon in Assembly, December 12, 1996

Community	Problem	Proposed project	Number of families	Priority
Chirusi Kollo "A"	Health	Health center	55	C
Román Calle	Low production	Irrigation system	53	A
Pucara	Morbidity/mortality	Drinking water	100	A
Jorge Rojas Tardio	Morbidity/mortality	Sewage system	263	A
Leon Rancho Centro	Sale of goods	Local road	150	B
Junta Vecinal #2 (Gral Pando)	Dust	Pave roads	400	B
Capilla	Sale of goods	Local road	280	B
Junta Vecinal #4		Household gas	155	E
Junta Vecinal #11	Morbidity/mortality	Drinking water	350	A
Vintu Cancha	Morbidity/mortality	Drinking water	120	A
Tajamar B	Low production	Irrigation system	48	A
Junta Vecinal #3	Lack of road	Completion of avenue	510	B
Chirusi Grande	Low production	Irrigation system	95	A
Tajamar Centro	Low production	Irrigation system	50	A
Laguna Centro	Morbidity/mortality	Drinking water	48	A
Pampa Grande	Community enhancement	Chapel restoration	290	E
Saca Saca	Community enhancement	Sports fields	85	E

Source: GAO translation of document provided by government officials from the city of Punata, Bolivia.

Table 13 shows that the highest priority projects are for irrigation and drinking water, second-tier priorities include access roads, and the lowest priorities are for community enhancements like chapel restoration and playing/sports fields. Officials said the vigilance committees have worked to ensure that the communities' priorities are included in municipal plans and to exercise public oversight of the government's implementation of these plans.

Uganda

Decentralization, including active civil society participation, is a crucial element of the Ugandan government's poverty reduction strategy.[8] District government officials in Uganda told us that while decentralization and greater civil participation have achieved the benefits of improved service delivery and government accountability, increased government expenditure and greater transparency, accountability, and capability are needed to improve the local governments' ability to manage resources.

According to a HIPC document, the government's antipoverty programs will increasingly be implemented at the local government level, because local governments (including local councils) are considered to be in the best position to assess local needs and to respond quickly and effectively to changing poverty conditions.[9] District government officials we spoke with in Uganda said that most of the priority services in rural areas—such as education, health, safe and reliable water, agriculture extension services, resettlement of displaced persons (important to districts bordering on countries in conflict), and land management—are now the responsibility of the local government. They said that the Ugandan government turned to participation as a means of letting local people decide their priorities and translate them into actions that reduce poverty.

For decentralization to be effective, the transfer of responsibilities and resources to the districts should be accompanied by efforts to build technical, operational, and administrative capacity at the local level. Donor governments, the World Bank, and others are undertaking efforts to improve local governments' capacity in 20 of Uganda's 45 districts, as shown in figure 8.

[8]In Uganda, the 1995 constitution mandates the decentralization of public services to districts, and the 1997 Local Governments Act details the responsibilities assigned to each level of government. As stated in the constitution, Uganda's principles include democratic elections; participatory decision-making; involvement of the underprivileged, especially women, youth, and the disabled; self-reliance; and accountability.

[9]*Uganda—Enhanced Heavily Indebted Poor Countries Initiative—Second Decision Point Document* (Washington, D.C.: IMF and World Bank, Jan. 19, 2000).

Figure 8: Districts in Uganda with Capacity-building Programs Funded by Official Donors and Creditors (Shown by Shaded Areas)

Source: Ministry of Local Government, Uganda.

Despite these efforts and those of the Ugandan government, 25 districts are likely to need technical assistance from donors to further build local capacity to plan, budget, execute, and monitor projects and services.

To build budgeting and programming capacities at the local level, the central government extended its medium-term budget framework to include all district governments. The government, the IMF, the World Bank, and others have been providing technical assistance in budget preparation, execution, and monitoring to district governments in order to improve their capacity to control and monitor expenditures and to assess the impact of district spending.

The Ugandan government has also sought to enhance accountability in the use of resources by implementing an integrated fiscal management system and strengthening systems that enable citizens to monitor government performance. Uganda's poverty reduction strategy notes that good governance involves making public expenditure transparent and efficient. This includes "bottom-up" accountability, meaning that communities hold local government and service deliverers accountable through local councils. To increase transparency, the amount of funding disbursed by the central government to districts for education is posted on many school notice boards so that citizens and others can monitor the receipt and use of funds. District government officials in Uganda told us that local citizen committees help oversee the use of resources, which increases accountability and democracy. Members of a school management committee that includes parents, teachers, and administrators told us they monitor expenditures, the quality of education, and students' test results. They said this has become particularly challenging because Uganda's program to provide free primary education to most students doubled the school enrollment rate over a very short period. Also, to increase the transparency in the use of money from the Poverty Action Fund—set up to channel savings from debt relief and other funds into priority spending areas—notices are published in the newspaper indicating the amounts disbursed to each district. Expenditures and outcomes are reviewed quarterly by the government, donors, and representatives of civil society.

District government officials we spoke with in Uganda said that decentralization is a continuous process whose benefits—such as widespread service improvements and citizen empowerment— are mainly long term. The initial implementation is expensive as capacity is built and local governments and councils are established. They said decentralization motivates the government to be more accountable and requires

open-mindedness and government officials willing to share power because citizens' sense of ownership and questioning of authority increase.

Officials also said that while decentralization has increased the quality of services delivered and citizens' sense of empowerment, the districts have not received enough funding from the central government—the local governments' major source of revenue—to carry out all of the responsibilities they have been given. In part this reflects Uganda's decision to transfer responsibilities before building sufficient local capacity. Government officials said that they were concerned that other countries that worked to build capacity first never actually decentralized. The officials said that significant resources are needed to build local government's capacity to manage human resources and finances.

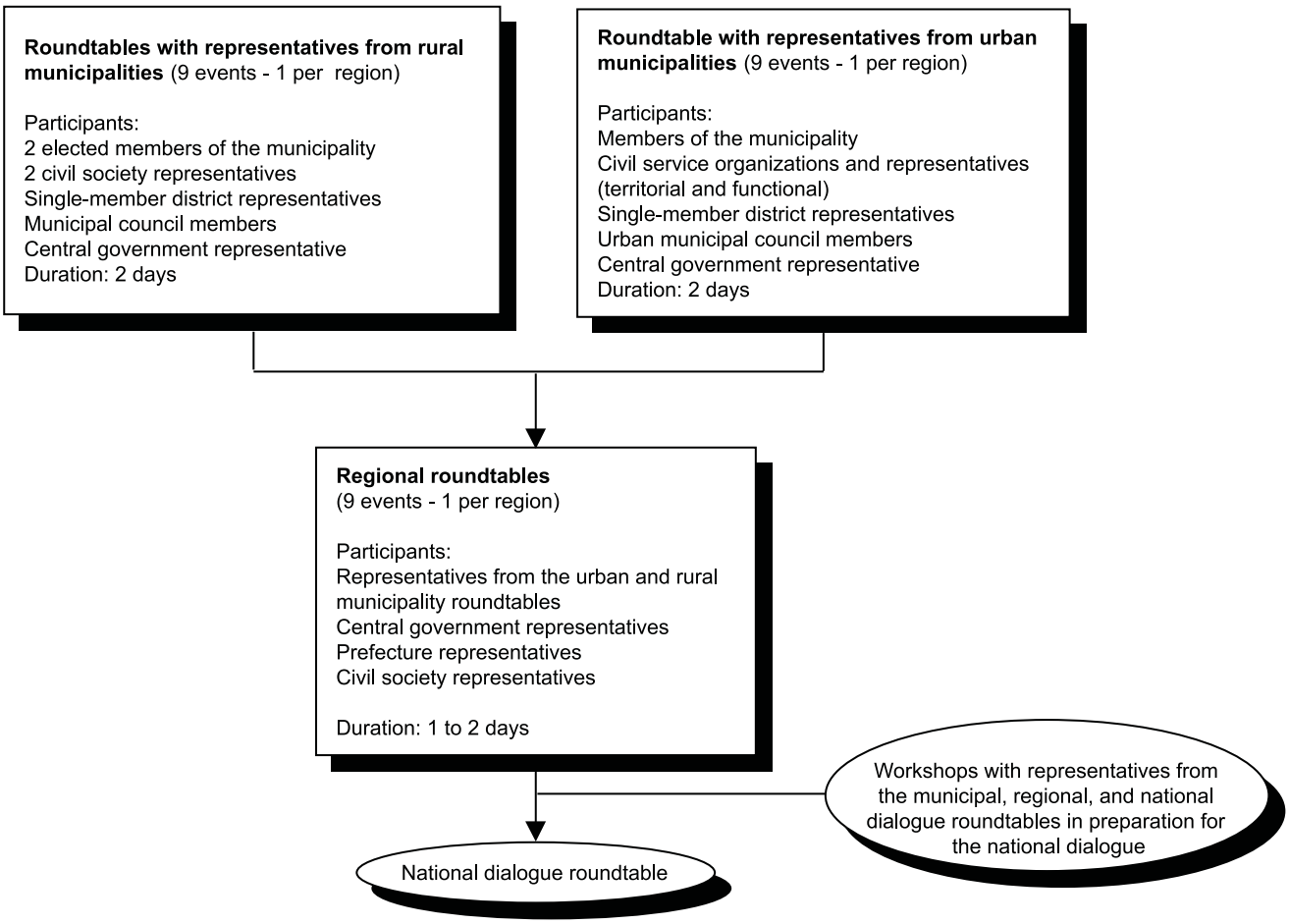
Representatives of nongovernmental organizations in Uganda told us that the main issue is building civil society capacity, especially at the local level, to (1) participate in identifying and executing projects and (2) monitor the level, use, and impact of government borrowing and expenditures. They said that local capacity needs to be strengthened if decentralization is to succeed. In their view, there has been much discussion of civil society participation at the national level, but it has not yet translated into greater activity or ownership at the local level. They told us that local governments need to be made aware of the importance of local civil society participation and that it takes a lot of energy and resources to build civil society and government capacity. They also said that grants from donors are needed to finance efforts to build local governments' and civil society's capacity because Uganda does not have sufficient funding.

Civil Society Participation in Bolivia

In 1997, the government of Bolivia conducted a "national dialogue" to involve civil society in its effort to build support for its new economic and social priorities. Although government officials said they considered that effort to have been quite worthwhile, nongovernmental organizations and donors that we talked with disagreed. They told us the dialogue consisted of a 1-day meeting in which the government selected whom to invite, involved little regional participation, gave little advance notice regarding the agenda to the invitees, provided little background information, and used the meeting to present its views. One nongovernmental organization representative characterized this effort as having been more a "regional monologue than a national dialogue." In 1998, the United Nations reported that, according to a recent survey, 70 percent of Bolivians felt that their opinions did not count at all in the political system's decision-making process. Additionally, there was little follow-up after this dialogue to ensure that actions were undertaken. In light of this experience, the drive for a new dialogue as part of the HIPC Initiative was met with some suspicion.

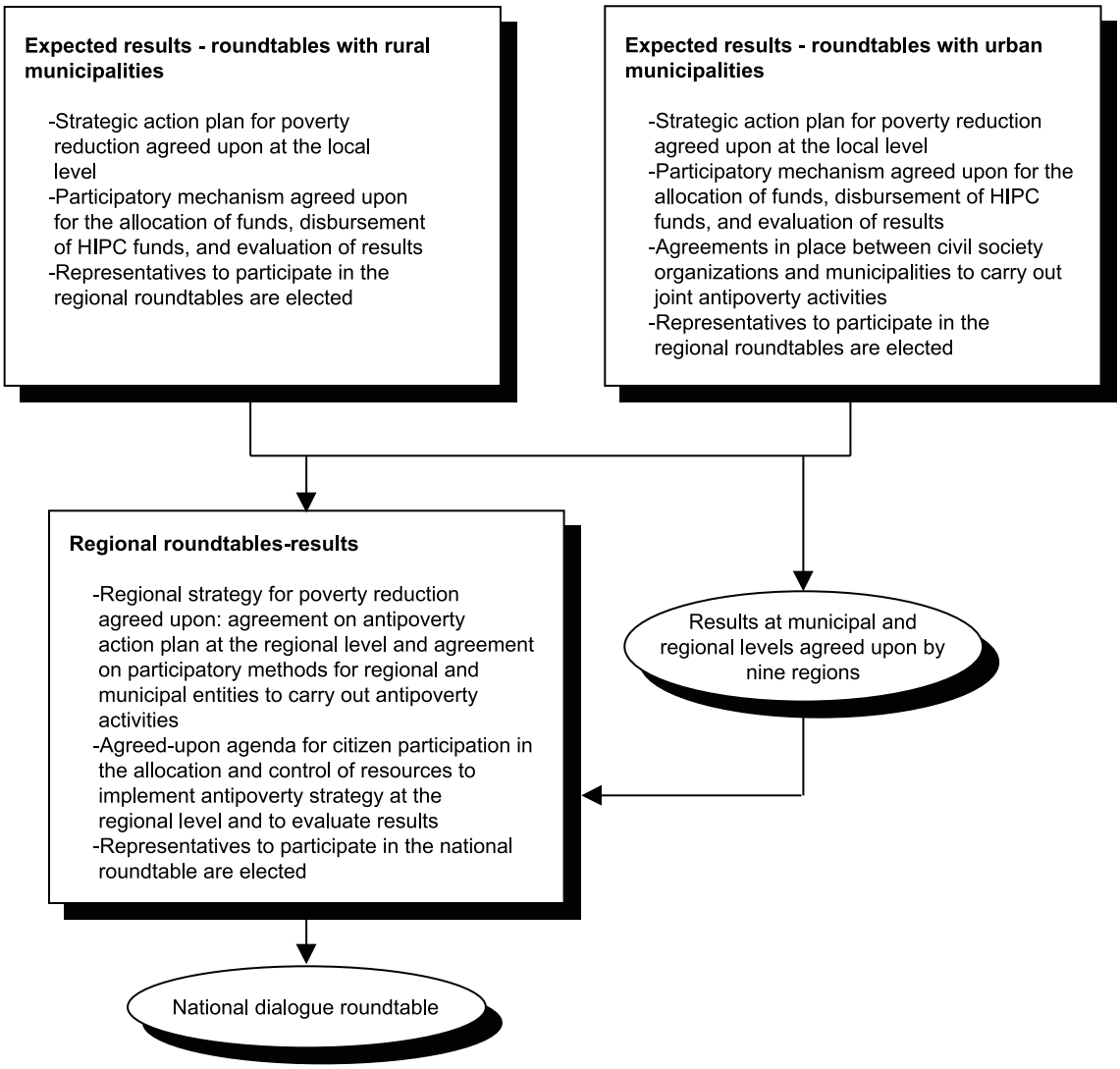
To overcome the previous criticisms and involve civil society in preparing its poverty reduction strategy, the government is convening a second national dialogue that is to involve more participants, provide background papers prepared by the government and others, and establish a mechanism to follow up on commitments made during the dialogue. To involve more participants, the consultation process involves 27 meetings, lasting 1-2 days each, at rural, urban, and regional levels, as shown in figure 9. Figure 10 describes the results expected from this process.

Figure 9: Bolivia's Process for Involving Civil Society in Developing the Poverty Reduction Strategy



Source: Government of Bolivia.

Figure 10: Results Expected from Bolivia's Process for Involving Civil Society in Developing the Poverty Reduction Strategy



Source: Government of Bolivia.

The process is to culminate in a national dialogue in July 2000 and a full poverty reduction strategy shortly thereafter.

According to the government of Bolivia, the goals of the national dialogue are to

- transform initiatives into state policies aimed at promoting growth and reducing poverty on the basis of agreements reached between the government, the opposition, and civil society;
- strengthen civil society trust in this approach;
- prioritize the use of resources for poverty reduction; and
- institute a participatory body in charge of following up on and monitoring commitments made in the course of the national dialogue.

A steering council and secretariat composed of government and civil society representatives are to oversee the national dialogue process. Meeting participants include representatives from local, regional, and central governments and civil society. Bolivia's interim poverty reduction strategy, which contains a brief analysis of poverty and a conceptual framework that could guide discussions, and other documents prepared by the participants are to be used in the discussions.

Two other ongoing efforts are trying to achieve greater civil society involvement in the national dialogue. First, the Catholic Church in Bolivia is sponsoring a dialogue that it hopes will mobilize civil society participation, facilitate inclusion in setting poverty-reduction goals, and generate independent conclusions that will be integrated into the national dialogue. The church is sponsoring workshops in all nine Bolivian regions and a national dialogue to discuss

- the impact of structural adjustment and macroeconomic policies on poverty;
- human rights and participation, including a mechanism for civil society to monitor resource allocations;
- urban development, including education, health, employment, and productivity; and
- rural development, including education, health, land ownership, and productivity.

The Catholic Church, which a recent U.N. poll identified as the most respected and credible institution in Bolivia, opted to not become a member of the steering committee in order to remain independent,

according to U.N. Development Program officials. The church will participate in the national dialogue as a regular "invitee."

Under the second effort, private sector representatives from nine regions are meeting to prepare strategies that highlight the important role of the productive sector—particularly small- and medium-sized industries, agriculture producers, and mining—in fighting poverty. Their goal is to bring the productive sector into the national dialogue.

The new process of civil society participation appears to address some of the criticisms that were expressed because it seeks to obtain a wider range of views, provide more information for discussion, and establish a participatory mechanism to follow up on the commitments made during the national dialogue.

How the United States Budgets and Accounts for Debt Relief

Our review of the seven leading industrial countries indicates that providing debt relief results in additional budgetary costs for each country. However, the impact on their budgets in providing debt relief vary based on five key factors: the amount of outstanding loans, the method used to value loans, the method used to budget for debt relief, the options used to provide debt relief, and constraints imposed by certain legal requirements. This appendix provides detailed information on those five factors for the United States. For the United States, the cost of debt relief is lower than the face value of the debt because the value of the debt is discounted. It will cost the United States about $346 million (in net present value terms) to forgive $3.8 billion (in nominal terms), or an average of 9 cents per dollar of the outstanding debt owed by 22 countries under the enhanced initiative. However, the U.S. administration faces challenges in obtaining the full $346 million from Congress as well as in obtaining its proposed contribution of $600 million to the multilateral trust funds. This appendix also provides information on the amount of U.S. debt reduction provided to heavily indebted poor countries over the past 12 years. Similar information for Canada, France, Germany, Italy, Japan, and the United Kingdom is provided in appendix X, and a summary was provided in chapter 4.

Outstanding Loans

As of December 31, 1998, the U.S.' exposure to the 40 heavily indebted poor countries was estimated by officials of U.S Treasury as $6.2 billion. The United States has outstanding claims with 30 of the 40 countries.[1] Two countries, the Democratic Republic of the Congo (34 percent) and Sudan (21 percent), accounted for about 55 percent of total U.S. claims (see app. II). U.S. official development assistance loans account for about 38 percent of its total loans to the 40 HIPCs.[2] The United States has

[1]Of the 40 potential HIPC recipient countries, the Treasury has requested funding to provide debt relief to 22 countries. Of the remaining 18 countries, 4 countries are not likely to qualify for HIPC debt relief (Angola, Kenya, Vietnam, and Yemen); 4 countries have outstanding debt to the United States but are not likely to qualify within the next few years (Liberia, Myanmar, Somalia, and Sudan); and 10 countries have no outstanding debt to the United States.

[2]Official development assistance can be a grant or a loan with at least a 25-percent grant element for the promotion of economic development or basic human needs. (See app. II.)

proposed to cancel 100 percent of its pre- and post- cutoff date[3] non-official development assistance loans, as well as 100 percent of its official development assistance loans to 22 potentially eligible HIPC recipients.[4] The U.S. Treasury estimates that the cost to fully cancel these loans is $346 million in net present value terms, or about $3.8 billion in nominal terms.

The major programs under which international debt is owed to the U.S. government are loans and loan guarantees made under the Export-Import Bank Act;[5] loans under the Agriculture Trade Development and Assistance Act;[6] loans and loan guarantees under the Foreign Assistance Act;[7] loans under the Arms Export Control Act;[8] and loan guarantees under the Commodity Credit Corporation Charter Act.[9] Most of the U.S.' international loans are associated with agriculture, defense, and export credits. Commercial bank loan guarantees by the U.S. government constitute only a small portion (about 3 percent) of total outstanding claims on the 40 HIPCs. The U.S. claims on the 40 HIPCs represent about 6 percent of total bilateral creditors' claims and about 3 percent of total creditors' (bilateral and multilateral) outstanding claims.

[3]Pre-cutoff date loans refers to loans made by a creditor before his first visit to the Paris Club to negotiate with a debtor, and post-cutoff date refers to loans made after the first visit to the Paris Club. Post-cutoff date loan cancellation refers to loans made by the U.S. government on or before June 30, 1999.

[4]The International Debt Relief Act (Title V of H.R. 3425, incorporated by reference into the Consolidated Appropriations Act, 2000) requires the President to cancel these debts subject to appropriations.

[5]Export-Import Bank Act, 12 U.S.C. §635 (et seq.).

[6]Agriculture Trade Development and Assistance Act, 7 U.S.C. §1701 (et seq.).

[7]Foreign Assistance Act of 1961, Public Law 87-195, as amended, 22 U.S.C. § § 2181 and 2182.

[8]Arms Export Control Act, 22 U.S.C. §2751 (et seq.).

[9]Commodity Credit Corporation Charter Act, 15 U.S.C. § 714 (et seq.); and Agricultural Trade Act, 7 U.S.C. §§ 5621 and 5622.

Method Used in Valuing Loans

The budget costs of debt relief are influenced by the method the U.S. government uses to value its loans. The method used in valuing U.S. government international loans and loan guarantees is based on the Federal Credit Reform Act of 1990.[10] The act requires U.S. agencies to value debts owed to the U.S. government on the basis of their net present value rather than their face value.[11] Before new direct loans are obligated[12] and loan guarantees are committed, agencies must calculate the cost of the credit to the U.S. government by estimating factors such as the likelihood of default, a loan's interest rate, and the repayment period (maturity). This cost is called the "subsidy cost." The subsidy cost is budgeted in net present value terms and is the estimated long-term cost to the government of a direct loan or a loan guarantee, excluding administrative costs. The net present value is calculated by discounting estimated future cash flows (disbursements by the government and payments to it) of each loan or guarantee, using a discount rate equal to the interest paid by the Treasury on loans of comparable maturity. The accounting standards and the budgetary treatment of federal credit programs are covered in the *Statement of Federal Financial Accounting Standards Number 2*[13] and the Office of Management and Budget's (OMB) *Circular Number A-11*.

[10]Federal Credit Reform Act, 2 U.S.C.§661-661f.

[11]The act shifted the method of accounting for the budgetary cost of federal credit commitments made after September 30, 1991, from a cash-flow basis to a net-present value basis. Cash-flow accounting credits income as it is received and expenses as they are paid. Net present value records the current value of a single payment or of a stream of payments to be received in or made over a specified time period.

[12]A direct loan is a loan made by the government to a nonfederal government borrower. Loan guarantee means any guarantee, insurance, or other pledge with respect to the payment of all or part of the principal or interest on any debt obligation of a nonfederal borrower to a nonfederal lender. *OMB Circular A-11*, section 85.3 (d) (k) (1999).

[13]The accounting standards for federal credit are covered in the Federal Accounting Standards Advisory Board's *Accounting for Direct Loans and Loan Guarantees*, Statement of Federal Financial Accounting Standards, No. 2, August 23, 1993. Beginning with fiscal year 1992, this method of accounting for the budgetary cost of direct loan and loan guarantees became effective.

The Federal Credit Reform Act of 1990 requires that funds be appropriated and budgeted in advance to cover the subsidy cost. [14] The unsubsidized or unappropriated portion of direct loans is financed with funds borrowed from the U.S. Treasury.[15] The subsidy payment is combined with the unsubsidized portion to finance the direct loan. The direct loan is recorded on the balance sheet as an asset in the amount of the present value of its estimated net cash flows. With respect to loan guarantees, the estimated present value of the net cash outflows of the guarantee is appropriated to the program account before the guarantee can be made and is recognized as a liability on the balance sheet. The loan guarantee financing account holds the subsidy payment from the program account as a reserve against default claims.[16] Based on *OMB Circular Number A-11*, agencies are required to reestimate the subsidy cost after the close of each fiscal year.

As a result of the Federal Credit Reform Act of 1990, an Inter-Agency Country Risk Assessment System was created to ensure and encourage more effective and consistent risk assessment by U.S. agencies, including those agencies that issue foreign loans and loan guarantees.[17] The Inter-Agency Country Risk Assessment System technical team established an indicator system that results in placing a country within 1 of 11 risk categories,[18] from the most creditworthy to the least creditworthy. Among other things, agencies calculate the cost of country risk[19] based on the assigned Inter-Agency Country Risk Assessment System ratings and

[14] *OMB Circular Number A-11*, (hereinafter *OMB Circular No. A-11*), section 85.3, (1999).

[15] *OMB Circular No. A-11*, 85.6 (a) (1) (1999).

[16] The financing account and the program account were established pursuant to the Federal Credit Reform Act of 1990. The program account is a budget account that receives and obligates appropriations to cover the subsidy cost of a direct loan or loan guarantee and disburses the subsidy cost to the financing account. The financing account records all of the cash flows resulting from post-1991direct loans and loan guarantees. These accounts will be discussed further in this section of the report.

[17] OMB chairs the Inter-Agency Country Risk Assessment System, and other members include the Departments of State, Treasury, Defense, and Agriculture; the U.S. Export-Import Bank; the Overseas Private Investment Corporation; the Council of Economic Advisors; and the Federal Reserve.

[18] The 11 categories are A, B, C, C-, D, D-, E, E-, F, F-, and F= (read as “double minus”).

[19] Country risk costs are the costs due to the risk that international loans or guarantees may not be fully repaid. It is one component, often the largest, of the subsidy cost in the Federal Credit Reform Act. See *Credit Reform: U.S. Needs Better Method for Estimating Cost of Foreign Loans and Guarantees* (GAO/NSIAD/GGD-95-31, Dec. 19, 1994).

corresponding risk premiums[20] to arrive at the subsidy cost and thus the net present value of the loan.[21]

The Inter-Agency Country Risk Assessment System's top eight country categories are assigned risk premiums and default rates, which vary by loan maturity. However, for the bottom three risk categories, a default rate is estimated for each category, which remains constant over all maturities. Most of the potential HIPC recipients are rated in the bottom three risk categories. The estimated present value of the loan for these last three categories is determined by multiplying the face value of the loan by a flat price, where the price is equal to one minus the estimated default rate. To estimate price for the last three categories, the Inter-Agency Country Risk Assessment team considers, among other things, the expected treatment by the Paris Club of official creditors. For example, if country A, which has the lowest rating, has an expected default rate of 93 percent, this means that the U.S. government expects, on average, to be repaid $0.07 per dollar of outstanding debt, on a net present value basis.[22] Put another way, if country A borrows $100 million from the United States at the current Treasury rate, the U.S. government expects, on average, to be repaid $7 million on a net present value basis.[23] Seven million dollars is the estimated net present value of the loan to the U.S. government, and the $93 million is the subsidy cost to the U.S. government, or the amount that is not expected to be repaid. As mentioned previously, agencies are required to reestimate the subsidy cost annually for each credit account. A reestimate could result in an increase or a decrease in the estimated net present value of the loan, thereby decreasing or increasing the expected cost to the U.S. government of extending the loan.[24]

[20]Risk premiums reflect the probability of default for a country by loan maturity and are applied to scheduled payment streams to obtain loan repayment projections. See *Credit Reform: U.S. Needs Better Method for Estimating Cost of Foreign Loans and Guarantees.*

[21]The other component includes interest rate costs (or income) and fee income. See *Credit Reform: U.S. Needs Better Method for Estimating Cost of Foreign Loans and Guarantees.*

[22]Actual country ratings are considered classified information.

[23]If the loan is provided at the current Treasury rate, there is no interest subsidy or income.

[24]Reestimates that resulted in an increase in the subsidy cost are financed by permanent indefinite authority. *OMB Circular No. A-11*, section 85.2 (1999). Permanent authority is available as a result of permanent legislation and does not require an annual appropriation. Indefinite budget authority is budget authority of an unspecified amount of money.

The Method Used in Budgeting for the Cost of Debt Relief

The Federal Credit Reform Act of 1990 substantially affects the way the U.S. government treats the cost of debt relief. The act makes it possible for the government to forgive several dollars in international loans and guarantees for only $1 in current budgetary cost. Since agencies must value their loans on the basis of their net present value, many outstanding loans to developing countries are reflected on the agencies' books at a substantial discount from their face value. Countries that are considered high risk will have loans that are valued at a deep discount, and thus the additional budgetary cost of forgiving these loans would be relatively low because the government would have already recognized the cost of lending to risky countries.[25]

In addition, based on *OMB Circular Number A-11*, debt forgiveness is a "direct modification" of loans or guarantees.[26] A direct modification is an action that alters the terms of existing contracts or results in the sale of loan assets.[27] The act requires that any action by the government that changes the value of a direct loan or loan guarantee must be counted as a change in its cost.[28] If the modification results in an increase in cost, the administration must request, and Congress must appropriate, funds before debt forgiveness can take place. Thus, debt relief creates new demands on the U.S. budget.

[25]2 U.S.C. §661-661f.

[26]In addition, forbearance, reductions in interest rates, extensions of maturity, and prepayments without penalty are other examples of alterations to contract terms that are direct modifications. *OMB Circular A-11*, section 85.3(n) (1999).

[27]Loans can also be "indirectly" modified. Examples include a new method of debt collection prescribed by law or a statutory restriction on debt collection. *OMB Circular No. A-11*, section 85.3(n) (1999).

[28]According to OMB officials, most of the HIPC loans that are being forgiven are pre-credit reform (or pre fiscal year 1992) loans; however, since they have been directly modified, their budgetary treatment becomes fully subject to the requirements of the 1990 act, and they are now accounted for on a net present value basis.

The U.S. cost of providing debt relief is the difference between the net present expected value[29] of the loan before debt relief is provided and the net present expected value of the loan after debt relief.[30] The calculation of how much money must be appropriated to reduce or forgive a certain amount of debt is complex and depends on a number of factors, including the value of the debt (the likelihood of repayment by the debtor) and whether the loan is concessional or nonconcessional. For nonconcessional loans that were made to countries with a good repayment history, the cost to the United States would be much higher than for concessional loans to countries that do not have a good repayment history. Table 14 provides a simplified illustration of how the Treasury and OMB generally determine the cost of debt relief (subsidy cost) for a country.[31]

Table 14: Country A's Debt Reduction at 90 Percent

U.S. Dollars in millions

Steps	Description of the loan	Value
1	Total scheduled payments – face value	**$90.00**
2	Net present expected value before debt relief ($90 x 0.07)	**6.30**
3	Face value of debt reduced ($90 x 0.90), assuming a 90-percent reduction based on the enhanced HIPC terms	**81.00**
4	Face value after debt relief ($90 - $81)	**9.00**
5	Net present expected value after debt relief ($9 x 0.07)	**0.63**
6	Debt reduction cost or increased subsidy costs = net present expected value before debt relief minus net present expected value after debt relief ($6.30 - $0.63)	**$5.67**

Note: This illustration assumes a constant default rate that does not vary with maturity or interest rates.

Source: GAO analysis of OMB and Treasury information.

[29]This is the term OMB uses to characterize the value of the loan.

[30]The estimate of remaining cash flows before modification must be the same as assumed in the baseline of the President's most recent budget. The estimate of the remaining cash flows after modification must be the premodification cash flows adjusted solely to reflect the effects of the modification. *OMB Circular A-11*, section 8.56, 1999.

[31]Our simplifying assumptions include the assumption that the country is placed in one of the bottom three risk categories (F categories) and thus has a flat price. It also assumes that the U. S. Treasury borrowing rate is equal to the loan's interest rate, thus there is no interest subsidy or cost.

Based on the table, the following occurs:

- Country A has total nonconcessional debt to the U.S. government of $90 million. The illustration also assumes that the U.S. Treasury borrowing rate is equal to the loan's interest rate, thus there is no interest subsidy or cost (step 1).[32]
- An "F=" rating is assumed for country A, which is the lowest Inter-Agency Country Risk Assessment System rating. Based on the Inter-Agency Country Risk Assessment System rating, the expected default rate for this loan would be about 93 percent, which is constant and does not vary by maturity or interest rate. The expected repayment rate would be about 7 percent, or $0.07 to be repaid per dollar of net present value of outstanding debt. An expected repayment rate of 7 percent (or the flat price) was used to derive the net present expected value of the loan before debt relief is granted to country A (step 2).
- This illustration also assumed that country A would receive a 90-percent debt reduction, based on the proposed forgiveness under the enhanced HIPC Initiative. The face amount of the debt is multiplied by the percentage of debt reduction to derive the total stock of debt reduced (step 3).
- The face value of debt after debt relief was determined. Again, we assumed that there is no interest subsidy (step 4).
- To arrive at the net present expected value after debt relief, the face value after debt relief was multiplied by the flat price ($0.07) associated with the F= risk category (step 5).
- Thus, the total debt reduction costs to the U.S. government is $5.67 million. This was determined by subtracting the net present expected value after debt relief from the net present expected value before debt relief (step 6).

According to OMB and the U.S. Treasury, a multilateral debt reduction, such as under the enhanced HIPC terms, will result in an improvement in a country's Inter-Agency Country Risk Assessment System rating, due to both the reduction in debt burden and the adoption of the economic reforms necessary to reach the completion point. As a result, the U.S. government assumes that countries that are rated F= would experience an increase of 2 steps, to the F rating. Such a change would affect the cost of debt relief to the U.S. government.

[32]If the loan's interest rate were less than the Treasury borrowing rate, then there would be an interest subsidy.

- For example, country A's Inter-Agency Country Risk Assessment System rating of F= would be increased to F. As a result of the increase in rating, the net present expected value of the remaining 10 percent of country A's debt could be higher than the $0.63 million indicated in step 5. Based on the Inter-Agency Country Risk Assessment System rating, the expected repayment rate would increase from 7 percent (the F= rating expected rate of repayment) to 31 percent (the F rating expected rate of repayment). As a result, the net present expected value after debt relief would be about $2.79 million ($9 million x 0.31). In this case, the cost to the U.S. government for debt reduction would be less: the net present expected value before debt relief ($6.30 million) minus the net present expected value after debt relief ($2.79 million) results in a cost of $3.51 million versus $5.67 million, as indicated in step 6.

Option Used in Providing Debt Relief

The U.S. administration has decided to provide a stock of debt reduction[33] (a cancellation of principal, interest, and arrears, if any) to potentially eligible HIPC countries at the completion point, with interim relief beginning at the decision point. Under the enhanced HIPC Initiative, debt relief will be calculated based on actual data at the decision point; thus, the administration is expected to obligate budgetary authority on the date of the Paris Club agreement ("agreed minute") of each HIPC recipient's decision point. While the bulk of the debt relief will be provided at the completion point, the impact on the budget, based on OMB rules, will occur at each country's decision point.

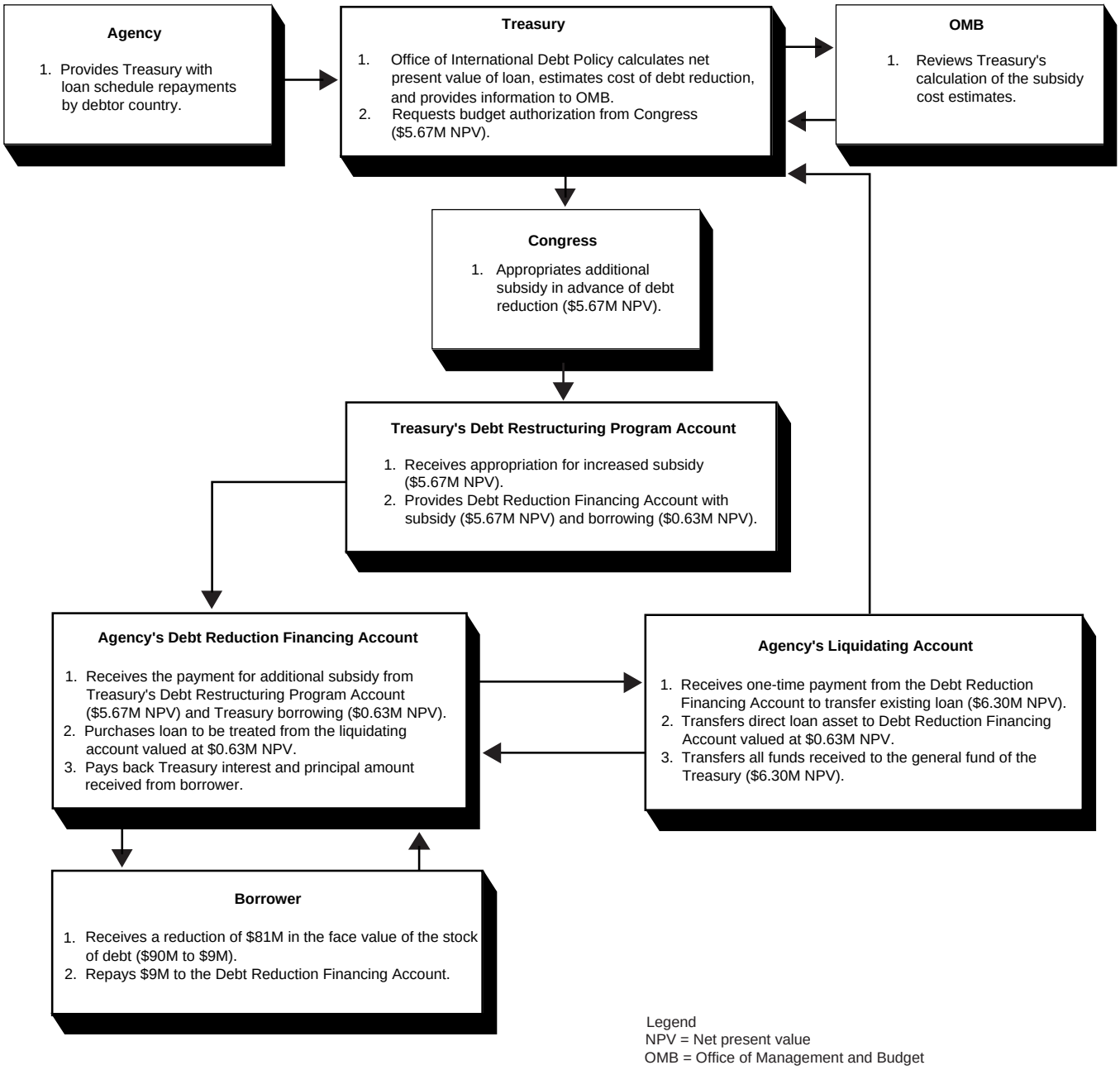
[33]Within the framework of the Paris Club, the two main options are debt reduction (a cancellation of principal and interest payments) and debt service reduction (a reduction in interest rate).

The Budget and Accounting Treatment of Debt Relief

Credit reform provides for three accounts to handle credit transactions: program, financing, and liquidating. The program account receives appropriations for the subsidy cost of loans and for associated administrative expenses and is included in budget totals. When the direct loan is disbursed, the amount of the subsidy expense is charged to the agency's program account and paid to a financing account. At the same time, the financing account borrows the balance (the nonsubsidized or nonappropriated portion) from the U.S. Treasury. The financing account handles all cash inflows and outflows of direct loans obligated or guarantees committed after fiscal year 1991 (when the new system took effect). The liquidating account handles cash flows deriving from direct loans obligated or guarantees committed before fiscal year 1992. Most of the loans that are being forgiven under the enhanced HIPC Initiative were obligated or committed before fiscal year 1992, that is prior to October 1, 1991.[34] Figure 11 illustrates the budgetary and accounting treatment of providing debt relief on precredit reform loans, which results in a subsidy cost increase. The flowchart continues with the illustration of debt reduction for country A, as described previously. In addition, an explanation of the flowchart follows the chart.

[34]The Federal Credit Reform Act of 1990 separates credit into credit obligated or committed before October 1, 1991 (the beginning of fiscal year 1992) and credit obligated or committed on or after that date. For accounting purposes, the two groups of loans are treated differently.

Figure 11: Illustration of U.S. Government International Debt Reduction Program Direct Modification - Subsidy Cost Increase



Source: Treasury and OMB.

The following narrative provides an explanation of the flowchart:[35]

1. As the flowchart shows, the agency provides Treasury's Office of International Debt Policy with loan schedule repayments for debtor country A.

2. The Treasury calculates the net present value of the loans, estimates the cost of debt reduction at 90 percent, and provides information to OMB.

3. OMB reviews the calculation of the subsidy cost estimate.

4. The Treasury requests and receives budget authority for the increased subsidy from Congress ($5.67 million in net present value). The budget authority necessary to cover the increased subsidy cost must be available in the Debt Restructuring Program Account at the Treasury's Bureau of Public Debt before the debt relief can be provided.[36]

5. The Treasury provides the increased subsidy ($5.67 million) to the Debt Reduction Financing Account at the agency level.

6. The illustration assumes that the loans are precredit reform loans, which are being directly modified for the first time. As such, the Debt Reduction Financing Account will purchase the loans from the liquidating account where the loans are held.[37] In the case of precredit reform loans, the agency will first write down the loans to the net present expected value, according to credit reform rules. (Both the Debt Reduction Financing Account and the Liquidating Account are maintained at the agency level.)

7. The value of the existing loans is the estimate of the net present value of the remaining cash flows assumed for the direct loans. In country A's case, this net present expected value is $6.30 million, which is the

[35]This illustration covers only a direct loan modification with increased subsidy cost.

[36]The Treasury is acting in two separate roles. Steps 1 and 2 involve the Treasury's Office of International Debt Policy acting in the role of a program agency, working to achieve policy goals. Step 4 involves the Bureau of the Public Debt, acting as a financing agent.

[37]If the loans have been treated before (that is, there was a Paris Club rescheduling), they would be held in the Debt Reduction Financing Account, and the additional subsidy would be used to pay back outstanding borrowing from the Treasury.

remaining cash flow expected before the modification, or the amount before debt reduction takes place. The direct loan asset is transferred from the Liquidating Account, because it is a precredit reform loan, to the Debt Reduction Financing Account, where the loans are modified based on the terms of the debt reduction.

8. Before the loan asset is transferred to the Debt Reduction Financing Account, the Debt Reduction Financing Account pays the Liquidating Account $6.30 million. To carry out this transfer, the financing account borrows $0.63 million from the Treasury and, together with the $5.67 million in subsidy cost it receives from the Treasury's Debt Restructuring Program Account, the Debt Reduction Financing Account makes a one-time payment to the Liquidating Account.

9. All funds received by the Liquidating Account are transferred to the general fund of the Treasury. In this case, the amount transferred is $6.30 million.

10. The borrower receives a reduction in its stock of debt from a face value of $90 million to $9 million. (Funds transferred from the Debt Reduction Financing Account to an agency's regular financing account are used to pay back borrowing from Treasury.)

11. When the borrower repays the loan, the Financing Account uses the loan repayments from the borrower to make principal and interest payments to the Treasury on the amount borrowed from the Treasury ($0.63 million in net present value terms). Once this debt to the Treasury has been satisfied, any remaining funds would be paid to a Treasury receipt account.

The flowchart covers only a direct modification of precredit reform loans with increased subsidy costs. Loan guarantees are treated differently because they are a liability, not an asset, as in the case of direct loans. In that case, the Liquidating Account would pay the financing account because the financing account is acquiring a liability. The third party, the lender, has to be made whole for the total amount of the loan.[38] The portion that is not forgiven (10 percent) becomes a direct loan between the U.S.

[38]The unobligated balances and permanent indefinite appropriations to the Liquidating Account will be used to make the payment. Outlays will be recorded in the Liquidating Account in the amount of the payment when made.

government and the borrower. This new loan is also transferred to the financing account (as an asset of the government) to be repaid by the borrower.

Legal Constraints

As previously discussed, the accounting and budgetary rules governing international loan valuation and debt forgiveness are embodied in *the Statement of Federal Financial Accounting Standards Number 2 and OMB Circular Number A-11*, which are based on the Federal Credit Reform Act of 1990. Under this act, loans must be valued on a net present value basis, and the administration must seek, and Congress must also appropriate in advance, the estimated costs to the U.S. government of providing debt relief before such relief can take place.[39] An appropriation by Congress is required for legislating debt reduction on a bilateral and multilateral (Paris Club) basis. The appropriated amount is the estimated costs to the U.S. Treasury of implementing the debt reduction initiative. The administration had requested approximately $346 million under the enhanced HIPC Initiative in fiscal year 2000; however, so far Congress has appropriated about one-third of the bilateral contribution (approximately $110 million).[40]

Contributions to Multilateral Trust Funds

In addition to the $346 million request for bilateral contribution, the administration has pledged approximately $600 million as part of its contribution to the multilateral trust funds. The $600 million has not received congressional authorization. Further, Congress authorized the use of about 333 million Special Drawing Rights (SDR), or about $440 million[41] by the IMF under the Second Special Contingency Account-2 at the IMF for debt relief.[42]

[39]Prior to the Federal Credit Reform Act, the administration did not require budget authority to provide debt reduction. Debt reduction was treated as a grant of authority to the President and did not require an appropriation.

[40]In addition, $37.4 million that remains unobligated from prior fiscal years will also be used for bilateral debt reduction under this program for a total of $147.4 million currently available.

[41]The exchange rate as of June 6, 2000, is SDR1.33 = US$1.

[42]In addition, the United States contributed $25 million to the Central American Trust Fund at the World Bank. This trust fund provides debt relief to those countries in Central America that were devastated by Hurricane Mitch. Two of the countries benefiting from this fund, Nicaragua and Honduras, are eligible for HIPC debt relief.

Prior Debt Reduction Activities

The United States did not participate in Paris Club (multilateral) debt reduction activities until 1994. Prior to 1994, the United States participated through multilateral rescheduling options. However, unilaterally, the United States forgave about $2.7 billion in heavily indebted poor countries' debt between 1989 and 1991.[43]

Under authority first granted by Congress in 1993, the United States began in 1994 to participate in Paris Club arrangements to reduce nonconcessional debt owed by developing nations with strong records of economic reform. This authorized the United States to cancel partial repayment on loans issued under the U.S. Agency for International Development housing and other credit programs; military aid loans; U.S. Export-Import Bank loans and guarantees; and, for Latin American nations, agriculture credits guaranteed by the Agriculture Department's Commodity Credit Corporation. All of these loans and loan guarantees are made on a nonconcessional basis. Since 1994, the United States has reduced nonconcessional debt through the Paris Club, on both Naples and the original HIPC terms, by about $784 million, resulting in budgetary costs of about $69 million.

[43]The United States forgave about $10 billion in debt owed by three severely indebted middle-income countries, Egypt (1991), Poland (1991), and Jordan (between 1994 and 1997) to assist in economic reform and to further national security interests.

Six Industrial Countries' Methodologies for Budgeting and Accounting for Debt Relief

Our review of the Group of Seven leading industrial countries (Canada, France, Germany, Italy, Japan, United Kingdom, and the United States) indicates that providing debt relief results in additional budget costs for each country.[1] However, the impact on their budgets varies based on five key factors: the amount of outstanding loans, the method used to value loans, the method used to budget for debt relief, the option used to provide debt relief, and the constraints imposed by certain legal requirements. Chapter 4 provides a summary of this information. This appendix provides detailed information on those five factors for Canada, France, Germany, Italy, Japan, and the United Kingdom. Similar information for the United States was provided in appendix IX. These governments confront varying degrees of challenges to providing debt relief under the enhanced HIPC Initiative. For example, the Japanese government is currently deliberating whether to write off the stock of eligible non-official development assistance debt at HIPC countries' completion points. Current authorization allows Japan to grant interest rate reduction (a debt service reduction option, within the framework of the Paris Club), which could take many decades to achieve the net present value debt reduction called for by the enhanced HIPC Initiative.

In addition to funding the costs of direct relief, large bilateral creditors, such as the Group of Seven industrialized countries, also face challenges in providing continued aid flows and in contributing to help multilateral and smaller bilateral creditors meet their share of debt relief under the enhanced HIPC Initiative. This appendix also provides information regarding the amount of funds that these seven countries have offered to contribute to the multilateral trust funds as well as their contribution over the past 12 years to debt relief initiatives, both bilaterally and through the Paris Club framework. The Group of Seven industrialized countries' total outstanding loans to the heavily indebted poor countries represent about 50 percent of bilateral creditors' exposure.[2] Their share of the total estimated debt relief to be provided is about $6.5 billion in net present value terms, or roughly 25 percent of the total $28 billion in net present value terms. In addition, these seven countries have pledged at least

[1]According to an Italian Treasury official, debt relief has a direct impact on the implementing agencies' budgets and an indirect impact on the national budget.

[2]As of the end of 1998, total nominal debt outstanding of the 40 heavily indebted poor countries was estimated at $213 billion. Bilateral creditors' exposure is approximately half of this total.

$2.5 billion to multilateral trust funds or development banks under the enhanced HIPC Initiative.

Canada

Outstanding Loans

As shown in table 5, of the Group of Seven countries, Canada has the least exposure to the 40 heavily indebted poor countries, approximately C$1.2 billion, or US$771 million in nominal terms.[3] Canada has indicated that it will go beyond the enhanced HIPC framework and provide 100 percent cancellation of pre-and post-cutoff date, non-official development assistance debt to all potentially eligible countries. In addition, Canada has written off its official development assistance loans to the heavily indebted poor countries (with the exception of Myanmar)[4] and has extended official development assistance only in the form of grants since 1986.

According to the Canadian Finance Ministry, Canada's debt initiative would provide more generous and timely debt relief to more countries than the heavily indebted poor countries. For example, Canada has written off Bangladesh's debt, and Haiti, which is not considered a heavily indebted poor country, may also qualify. The total cost of Canada's debt relief initiatives, under the traditional mechanisms, the enhanced HIPC Initiative, and the Canadian debt initiative, is estimated at approximately C$1 billion, or about US$665 million in net present value terms. The Canadian government has already set aside provisions to implement this debt relief plan.

[3]Seventeen of the 36 countries potentially eligible for HIPC debt relief have debts outstanding to Canada.

[4]The official development loan to Myanmar was fully budgeted at the time of disbursement and would not result in additional impact on Canada's budget to participate in the HIPC Initiative.

Canada provides loans and loan guarantees to foreign sovereigns through two principal venues: (1) the Export Development Corporation and (2) government guarantees to support Canadian Wheat Board sales. The Export Development Corporation is Canada's official export credit agency.[5] It promotes Canada's exports abroad by guaranteeing and insuring payments to Canadian exporters in the case of default by foreign countries, as well as through direct lending. The government of Canada also guarantees the sovereign receivables of the Canadian Wheat Board under the Credit Grain Sales Program. Prior to 1986, the Canadian International Development Agency provided concessional loans as official development assistance.[6] Currently, the Canadian International Development Agency provides development assistance on a grant-only basis and is no longer offering loans as part of its development program.

Method Used in Valuing International Loans

Canada determines the value of its nonconcessional loans based on country risk assessments.[7] Nonconcessional loans are discounted using a rating system, which is established by the government and is based upon the assessment of country risk, including information from credit rating agencies, the Export Development Corporation, and other sources. For heavily indebted poor countries, the discount is based upon the amount of debt reduction that these countries are expected to receive at the Paris Club or under the Canadian debt initiative, which is usually between 80 and 100 percent. As mentioned earlier, Canada has written off its official development assistance loans to the heavily indebted poor countries, with the exception of Myanmar. Official development assistance loans were valued at zero, meaning that official development assistance loans were fully budgeted at the time they were disbursed. At the end of each fiscal year, Canada reassesses the value of its foreign loans and guarantees, and the fiscal costs of any deterioration in their values are reflected in its public accounts' data.

[5]The Export Development Corporation functions in a similar capacity to the U.S. Export-Import Bank.

[6]The Canadian International Development Agency is similar to the U.S. Agency for International Development.

[7]Canada's accounting treatment of asset (loan) valuation is embodied in its Financial Administration Act, which requires assets and liabilities to adhere to generally accepted accounting principles.

Method Used in Budgeting for the Cost of Debt Relief

The costs of debt relief are influenced by the methods countries use to value their loans. With respect to non-official development assistance loans, all Paris Club debt reduction operations are provisioned for in an account for general allowances. Specific provisions were accumulated within the general allowances in previous years to reflect the cost of multilaterally agreed debt reductions. Therefore, there is no new budgetary impact for Paris Club debt reduction operations. The cost of debt forgiveness, over and above the percentage agreed to by the Paris Club, such as the Canadian debt initiative, resulted in additional impact on the budget. In 1999, the government had set aside $50 million to cover the expected cost of the Canadian debt initiative.

In the past, whenever there has been a write-down of sovereign debt as part of a Paris Club agreement, the Canadian government has paid the Export Development Corporation the amounts that would otherwise have been paid by the debtor government. This policy is currently under review. The Export Development Corporation is an independently capitalized corporation, which undertakes loans on commercial terms. However, the Export Development Corporation's accounts are consolidated with those of the government of Canada at year-end, and the value of the loans, net of provisions, are reflected in the government's consolidated fiscal position.

As mentioned previously, Canada has already written off nearly all of its official development assistance loans. Since Canada had fully budgeted for official development assistance loans to the heavily indebted poor countries at the time they were disbursed by the Canadian International Development Agency, the forgiveness of official development assistance loans did not result in additional impact on its budget when they were written off.

Option Used to Provide Debt Relief

In addition, the options creditors have chosen through the Paris Club framework to provide debt relief may affect the budgetary impact. In recognizing the legal and budgetary constraints of creditors, the options can enable creditors to spread their costs over time. Within the context of the Paris Club, creditors may chose options such as debt reduction (a cancellation of the stock of eligible debt)[8] or debt service reduction (interest rate reduction)[9] for the treatment of non-official development assistance debt.[10] According to Ministry of Finance officials, while the choice has no differential budgetary effect on Canada since assets are valued on a current basis, Canada applies the debt reduction option for reasons of administrative simplicity. In addition, while Canada expects to provide interim relief beginning at a country's decision point, in accordance with the Paris Club procedures, 100 percent of the heavily indebted poor countries' debt (pre- and post-cutoff date) will be written off as each country reaches its completion point. Since Canada has already provisioned for the cost of debt relief beyond the enhanced HIPC terms, there is no additional budgetary impact of this forgiveness.

Legal Constraints

Canada does not require additional legal authorization to provide debt relief within the context of the Paris Club. However, providing additional bilateral debt relief, such as the Canadian debt initiative, required parliamentary approval for the additional expenditure. The Canadian government has already received Parliament's authorization to provide bilateral debt forgiveness under the enhanced HIPC Initiative.

[8]This option involves a cancellation of part of the stock of eligible debt and a rescheduling of the remaining debt at market interest rates.

[9]This option involves a rescheduling or refinancing of the total eligible debt over a long period with interest rates below market rates.

[10]Official development assistance debt is not generally treated in the Paris Club. The treatment of official development assistance debt is largely linked to the treatment of non-official development assistance debt.

Contributions to the Multilateral Trust Funds

Canada has contributed a total of C$215 million, or about US$143 million, to the multilateral trust funds.[11] Of this total, C$150 million, or about $100 million, has already been provided to the HIPC Trust Fund at the World Bank. The remainder, C$65 million, or about $43 million, was provided to the Poverty Reduction Growth Facility/HIPC Trust at the IMF. Canada's total contribution also includes about $27 million to the World Bank HIPC Trust Fund as part of the Interest Subsidy Fund allocation.

Prior Debt Reduction Activities

Since 1990, Canada has forgiven about C$600 million in official development assistance loans to several potential HIPC recipients.[12] In addition, as a member of the Paris Club, Canada has participated in the debt reschedulings of several potential HIPC recipients since 1990.

France

Outstanding Loans

Of the Group of Seven industrialized countries, France has the highest exposure to the heavily indebted poor countries. As of December 31, 1998, France had claims outstanding on the 40 heavily indebted poor countries totaling about 11.2 billion euros, or about US$13 billion, according to officials of the French Ministry of Finance.[13] Official development assistance loans account for about 34 percent of total claims. France has proposed to cancel 100 percent of its pre-cutoff date non-official development assistance claims and all official development assistance claims and estimates that its total costs for debt relief would be approximately French francs (FF) 42 billion, or about US$8 billion.

[11]In addition, Canada has contributed $5.4 million to the Central American Trust Fund at the World Bank. This trust fund provides debt relief to those countries in Central America that were devastated by Hurricane Mitch. Two of the countries benefiting from this fund, Nicaragua and Honduras, are eligible for HIPC debt relief.

[12]Since 1978, about C$900 million in official development assistance loans was granted to several potential HIPC recipients.

[13]The debt owed by the 40 heavily indebted poor countries represented about 0.9 percent of France's gross domestic product as of the end of 1998, also the highest proportion of the Group of Seven countries. The euro rate was about 1.17 to US$1 on January 4, 1999.

Agence Francaise de Developpement, a public agency, manages the majority of official development assistance claims, and *Banque de France* and *Natexis*, a private bank, manages the rest. Non-official development assistance claims are provided in the form of direct loans by the French government to another government or as commercial claims, which are guaranteed by the French government. COFACE, a private company, manages the non-official development assistance claims of the French state and is paid a fee for its service.

Method Used in Valuing International Loans

France's method for valuing its loans is based on the general principle in its accounting and budgeting system that loans are worth their face value. For example, if France lends FF200 million to one of the potential HIPC recipients, the loan is valued and recorded at the full FF200 million. The loans are not discounted based on risk, and provisions are not set aside, in case of default, when the loans are disbursed.

When a loan is made to a given country, it has an impact on France's cash flow but only an indirect impact on its budget. The disbursement of the loan has no direct impact on the budget because the French government borrows the funds to issue the loan. The loan is recorded in a capital account, which is not a budget account. The capital account is subject to prior authorization by the French parliament, even if there is no impact on the budget. The capital account has an indirect effect on the budget because when a loan is made, there is a budgetary cost associated with the interest the French government pays on its own borrowing. The budgetary cost varies by the types of loans and the interest rates. In addition, interest repayments have a direct impact on the budget.

Method Used in Budgeting for the Cost of Debt Relief

The cost of debt relief is equal to the face value of the loan that is being reduced. For example, if a loan with a face value of FF100 million is cancelled, the impact on the budget is FF100 million. The treatment is the same for both official development assistance and non-official development assistance loans. According to French Ministry of Finance officials, France's budgetary treatment is governed by rules emanating from the Maastricht Treaty.[14] Under the rules, when a decision is taken to cancel a loan, the direct impact on the budget is equal to the amount of

[14]The Maastricht Treaty created the European Union. The Treaty was approved in Maastricht by the heads of government of the 12 members of the European Community in 1991.

debt that is cancelled when the final decision is made. For example, under the enhanced HIPC Initiative, the final decision will be made at the completion point. Therefore, the largest impact on the budget will occur at the completion point of each country and not at the decision point.[15] Interim relief will impact the budget at the decision point, and will be provided through flow treatments during the interim period, for France's bilateral claims and for its multilateral claims through the European Development Fund.[16]

The French government recently reported that its debt relief initiative, for debt relief beyond what is provided under the enhanced HIPC Initiative, would allow for debt write-offs in the form of annual cash grants from France to all eligible HIPC countries. The decision to provide grants rather than simply to write off the debt was intended to foster greater transparency in the post write-off period with the funds being used to finance social programs and to reduce poverty. In practice, this means that a vote from parliament will be required annually to provide grants to cover the debt falling due each year.

The parliament sets a budget ceiling for the treatment of debt cancellation through the Paris Club, and the ceiling has been increased recently to 3.1 billion euros (about $3.1 billion).[17] In addition, according to French Ministry officials, debt reduction has no direct impact on the national debt because the national debt is measured on an aggregate basis with each component not separately valued.

[15]There could be a debate as to whether the Maastricht Rule is the same as France's accounting rules. Eurostat (the accounting body of the European Union) is in charge of reviewing this issue and establishing a rule for all European Union countries.

[16]The origin of the European Development Fund is in the signing of international conventions between the member states of the European Union and 71 African, Caribbean, and Pacific states, known as the Lomé conventions. The aid these countries are granted by the European Community is for financing development projects and programs.

[17]The 3.1 billion euros will be used to cover Naples terms, and the original HIPC and enhanced HIPC reductions, including official development assistance. France had argued in Cologne for a fair burden-sharing arrangement because of the significant impact that debt relief would have on its budget. The decision was that debt relief would amount to about 0.1 percent of France's GDP. The exchange rate used is 1 euro = US$1.

Option Used to Provide Debt Relief

The French government has requested authorization from parliament to cancel principal, interest, and arrears, if any (debt stock reduction) at HIPC countries' completion points, as part of the 3.1 billion euros requested from Parliament. Therefore, the largest impact on France's budget will occur at countries' completion points. In addition, as mentioned previously, the bilateral portion of the debt relief beyond the enhanced HIPC terms will impact the budget annually as payments fall due after full HIPC treatment at the completion point.

Legal Constraints

Some countries need legislative authorization to provide multilateral debt relief, that is, forgiveness of debt within the context of a Paris Club agreement. For France, if a debt reduction or cancellation is being provided, the debt reduction has to be authorized by the French parliament. For multilateral treatment of debt reduction, France complies with the rules of the enhanced HIPC Initiative as agreed in September 1999. When countries reach a completion point, France will grant debt reduction provided it has parliamentary authorization. In addition, in order to provide additional debt reduction on a bilateral basis, a parliamentary decision is also required. The authorization from parliament is also limited in size. The French Treasury is given a ceiling, and it must request new authorization from parliament when that ceiling is reached. As previously mentioned, France complies with the Maastricht Rule in its treatment of budgeting for the cost and the timing of providing for debt relief.

Contributions to the Multilateral Trust Funds

France has pledged funds totaling about US$310 million to the multilateral trust funds. France will provide about $21 million directly to the World Bank HIPC Trust Fund as well as about $180 million through the European Development Fund and the European Union's budget. The European Development Fund and the European Union budget are expected to make a contribution to the World Bank HIPC Trust Fund in the amount of 734 million euros (about US $734 million).[18] Of the 734 million euros pledged to the World Bank HIPC Trust Fund, 680 million euros will be channeled primarily to the African, Caribbean, and Pacific countries and

[18]The European Development Fund will make a contribution of about 1 billion euros to the HIPC initiative, including 320 million euros for the cancellation of the European Development Fund's claims in the context of the HIPC Initiative.

the rest to Latin American countries.[19] France and Germany are the main contributors, with shares of about 25 percent each, compared to about 12 percent each for Italy and the United Kingdom. The funds are already a part of the European Development Fund and have not yet been disbursed to the HIPC Trust Fund. France's contribution to the Trust Funds creates no new demand on its national budget, or the other members of the European Union, since this money was already part of the European Development Fund. In addition, France has pledged $110 million to the IMF's Poverty Reduction and Growth Facility/HIPC Trust.

Prior Debt Reduction Activities

France has canceled about FF55 billion, or US$9.8 billion, of debt to the heavily indebted poor countries, which occurred primarily in two phases through the Paris Club: (1) 1988-89 and (2) 1994. Additional debt reductions resulted in smaller bilateral cancellation in 1988 and 1994 as well as in 1991 and 1998, which are included in the FF55 billion total.

Germany

Outstanding Loans

As of January 31, 2000, Germany's total exposure to the 40 heavily indebted poor countries is estimated at deutsche marks (DM) 11 billion, or about US$6.6 billion in nominal terms (about $2.7 billion, or 41 percent, is official development assistance loans), according to Germany's Treasury officials.[20] Under the enhanced HIPC Initiative, Germany is expected to provide 100 percent reduction on pre-cutoff date, non-official development assistance claims as well as 100 percent cancellation of all official development assistance claims. Official development assistance to the least developed countries has been given only in the form of grants since 1978. The total cost to the German Treasury of providing debt relief is estimated at $5.7 billion.[21]

[19]This contribution is contingent upon the participation of other creditors, especially the United States, to the HIPC Trust Fund.

[20]The debt owed by the 40 heavily indebted poor countries represented about 0.3 percent of Germany's gross domestic product as of the end of 1999.

[21]This includes an additional bilateral topping-up to 100 percent cancellation of debt worth approximately DM700 million, or US$350 million.

The German Ministry of Economic Cooperation and Development provides official development assistance grants and loans as well as technical assistance to developing countries. Grants and loans are disbursed by a government-owned development bank *(Kreditanstalt für Wiederaufbau)*, which also manages the loan portfolio. German commercial banks provide trade financing for exports and for investment in development projects. The German government, primarily through the Hermes export credit agency, guarantees some of the debt.

Method Used in Valuing International Loans

The federal government values and records loans at face value. The loans are not rated and are not valued for budgetary purposes, meaning that funds are not budgeted at the time the loans are disbursed to cover expected defaults. The federal government guarantees, up to a maximum of 90 percent, repayment of commercial credits to exporters in the event of nonrepayments by debtor countries. The exporter incurs the loss of the 10 percent, which the federal government does not guarantee. In the event of default, these claims would then become the asset of the federal government and subject to treatment in the Paris Club.

Method Used in Budgeting for the Cost of Debt Relief

In principle, the German federal budget is based on an annual expenditure and revenue cycle. International loans and guarantees are only budgeted when an expenditure or revenue arises. Therefore, the cost of debt reduction, or the impact on the budget, for official development assistance loans is defined in terms of the amount of revenue forgone—the value of the loans that is being forgiven. For commercial loans, the cost of debt relief is determined by the amount of expenditure required to indemnify or honor loans guaranteed by the government, which is generally up to a maximum of 90 percent of the face value of loan guarantees. In the case of the enhanced HIPC Initiative, the German government will forgive 100 percent of pre-cutoff date commercial credits. As a result, the parliament has agreed that the government would incur the cost of the 10-percent portion of the loan guarantee that is usually borne by the exporters.

Debt relief directly impacts the national budget and indirectly impacts the national debt. Debt reduction results in a reduction in revenues. No funds are earmarked for this purpose, therefore, if a budget deficit results, the deficit is financed by borrowing, which affects the national debt (debt held by the public). Loan valuation and, in consequence, treatment of debt relief are based on Germany's national accounting system.

Option Used to Provide Debt Relief

Germany anticipates providing a stock of debt reduction (a cancellation of principal, interest, and arrears, if any) at the countries' completion points for both official development assistance loans and nonconcessional credits. Interim relief, or flow rescheduling, will be provided at countries' decision points. However, full write-off or cancellation of the eligible debt stock at HIPC countries' completion point is contingent upon these countries satisfying the conditions set under the IMF and the World Bank poverty reduction strategy program. Thus, the majority of the relief will impact Germany's budget at countries' completion points.

Legal Constraints

With respect to nonconcessional claims, the German government is authorized to grant partial debt forgiveness in the context of multilaterally agreed debt settlements. However, bilateral debt reduction, in addition to multilaterally agreed debt reduction, requires approval by a parliamentary committee.[22] With respect to Germany's pledge to write off 100 percent of all HIPC countries' debt, parliamentary approval was secured in April 2000. Parliament also agreed in April that the government would incur the cost of the 10-percent commercial loan guarantee that is borne by exporters.

As far as official development assistance claims are concerned, debts can be cancelled only if repayment would cause undue hardship for the debtor country (so stipulated by the German Federal Budget Act.) This law defines "undue hardship" as "requiring unjustifiable efforts on the debtor's part to settle his debt." As mentioned previously, under the enhanced HIPC Initiative, Germany will provide 100-percent debt cancellation of all official development assistance claims to the heavily indebted poor countries.

Contributions to the Multilateral Trust Funds

Germany has pledged approximately DM150 million, or US $75 million, to the World Bank HIPC Trust Fund. Of this US$75 million, about $24 million has already been contributed to the HIPC Trust Fund. A further DM500 million, or US$250 million, represents Germany's share of the European Union's (European Development Fund and the European Union's debt cancellation as a HIPC creditor) pledge to the HIPC Trust Fund. With regard to the IMF, Germany will contribute DM500 million, or US$250

[22]This is the Budgetary Committee (roughly equivalent to the U.S.' Ways and Means Committee).

million, by means of an interest-free loan of the *Deutsche Bundesbank* to the Poverty Reduction Growth Facility/HIPC Trust.[23]

Prior Debt Reduction Activities

Since 1989, when concessional debt reschedulings were first introduced by the Paris Club, Germany has cancelled approximately DM4 billion, or US$2 billion, of non-official development assistance claims to the heavily indebted poor countries. In addition, since 1989, Germany forgave approximately DM3.8 billion, or about US$2 billion, in official development assistance claims primarily to the heavily indebted poor countries.

Italy

Outstanding Loans

As of December 31, 1999, Italy's exposure to the 40 heavily indebted poor countries is estimated at US$4.3 billion in nominal terms, with official development assistance loans comprising about 31 percent, according to an Italian Treasury official. Based on a new debt relief initiative that is currently under consideration by the Italian parliament, Italy anticipates providing 100-percent debt relief of pre-cutoff date, non-official development assistance debts of potentially eligible HIPC countries.[24] In addition, Italy is expected to write off all (pre- and post-cutoff date) official development assistance loans to HIPC countries that have reached their completion points. The Italian government anticipates providing only official development assistance grants to the HIPC countries in the future. The total cost to the Italian government of providing debt relief is estimated at US$3 billion in nominal terms, which is based on the assumption that all eligible HIPC countries will reach their decision points.

Italy provides loans and loan guarantees through three federal agencies. *SACE* is the insurer, which provides insurance (or guarantees) against political risks on export credits (for example, supplier and buyer credits). *Mediocredito Centrale* is a bank, which is the agent of the Italian

[23]Germany has also contributed $13.2 million to the Central American Trust Fund at the World Bank.

[24]The prior government proposal had requested 100 percent cancellation for eligible HIPC countries with annual per capita income below $300. This new proposal presented by the government in March calls for 100-percent debt cancellation for all eligible HIPC countries.

government that is responsible for extending concessional (official development assistance) loans. *Mediocredito Centrale* has the authority to sign the financial agreement with the relevant counterpart of the recipient country, and the Ministry of Foreign Affairs signs the intergovernmental agreement on official development assistance. *Mediocredito Centrale* can cancel official development assistance credits if duly authorized by the Italian government. *Simest* provides interest subsidy (for example, interest stabilization from floating to fixed interest rate) for export credits to Italian exporters, which is funded from the national budget.

Method Used in Valuing International Loans

Technically, loans are valued at face value. The loans or guarantees are recorded in the budgets of *SACE* and *Mediocredito Centrale* at face value. The loans are outside the national budget; therefore, when loans are disbursed or guarantees are called, they do not have a direct impact on the national budget. These agencies can request reimbursement from the Italian government (Treasury) if they are not repaid because the government has guaranteed repayment of the loans.

At the time when the loans were disbursed, the Italian government did not budget for the cost of expected defaults of the heavily indebted poor countries because such costs were considered to be marginal. However, the government budgets for the expected defaults of emerging market countries. According to a Treasury official, the emerging market countries' loans are not discounted, and they are not recorded at less than face value. For example, when *SACE* prepares its budget, it includes assumptions concerning the expected repayments of the loans. Its assumptions of expected repayments are usually high with respect to emerging market countries and lower, as little as zero, for the poorest countries. According to the Italian Treasury official, under this financial scenario the Italian Treasury is providing the money needed to run the agency. It is providing the difference between "expected losses" and "income" generated during the year.

In the past, the agencies did not establish provisions when the loans were made. However, under recent export credits legislation (Law 143/98), *SACE* has adopted a "provisioning" mechanism, by which for every loan guarantee extended since October 1999 a provision is established. The funds for provisioning (based on the risk associated with each specific recipient country) are supplied through the budget of the Italian government.

Method Used in Budgeting for the Cost of Debt Relief

Debt relief has a direct impact on each agency's budget and an indirect impact on the national budget. With respect to official development assistance loans, *Mediocredito Centrale* may be authorized by the Italian state to cancel official development assistance loans. For nonofficial development assistance claims, *SACE* issues supplemental/indirect guarantees of the Italian government, which guarantees reimbursement. Since the Italian state has made the decision to provide debt relief to all potentially eligible HIPC countries, and it did not budget for the likelihood of default or nonrepayment of these loans when they were disbursed, the cancellation of these debts will have an impact on the national budget. However, the Italian government is not required to reimburse its agencies immediately at the time of debt cancellation nor is it required to provide 100 percent reimbursement. It can restore the money when the agencies are in need of the funds. Debt relief will not have a direct impact on the national debt because the government did not borrow funds from the public specifically for this purpose.

Option Used to Provide Debt Relief

Under the enhanced HIPC Initiative, Italy anticipates providing full cancellation of principal and interest payments, and arrears, if any, at countries' completion points (debt stock reduction) as well as granting interim relief at decision points. The impact on the federal agencies' budgets will primarily occur at HIPC countries' completion points, but the impact on the national budget depends on when funds are needed by its federal agencies. According to an Italian Treasury official, the budget treatment of debt relief is based on the Italian national accounting system.

Legal Constraints

The Italian government does not require authorization from its parliament to grant Paris Club debt relief under the debt service reduction option, which is a reduction in interest rates. However, since the Italian government has proposed to grant a reduction in the stock of debt and to provide further relief beyond the Paris Club agreement based on the enhanced HIPC Initiative, additional authorization must be provided by parliament.

Contributions to the Multilateral Trust Funds

To date, Italy has pledged a total of about $258 million to the multilateral trust funds. About $138 million of this pledge is anticipated to flow directly from Italy to both the World Bank HIPC Trust Fund ($70 million) and to the IMF Poverty Reduction Growth Facility/HIPC Trust ($68 million). As part

of the European Development Fund and the European Union's budget contribution, Italy's share is estimated at 12 percent of the approximately $1 billion, or about $120 million.[25]

Prior Debt Reduction Activities

Between 1991 and 1999, Italy canceled bilateral official development assistance loans worth about $555 million to the HIPC countries. In addition, since about 1990, Italy has participated in debt reduction under the Paris Club terms for non-official development assistance loans and granted debt relief of approximately $500 million to heavily indebted countries.

Japan

Outstanding Loans

As of December 31, 1998, Japan's total exposure to the 40 heavily indebted poor countries was approximately US$11.2 billion, according to Japan's Ministry of Finance officials. Official development assistance loans account for almost 90 percent of Japan's total claims on the HIPC countries. Under its new debt reduction plan, which was announced on April 10, 2000, Japan agreed to forgive 100 percent of pre-cutoff date, non-official development assistance debt and 100 percent of (pre and post-cut off date) official development assistance debt owed by heavily indebted poor countries that reach their completion points.[26] Japan estimates its total cost for debt relief at $8 billion.

The Japan Bank for International Cooperation is responsible for administering the foreign loan and loan guarantee programs.[27] The Ministry of Foreign Affairs, with the assistance of the Japan International Cooperation Agency, provides grant aid and technical assistance. Trade

[25]Italy has also contributed $12 million to the Central American Trust Fund at the World Bank.

[26]Japan announced its plans for official development assistance debt relief prior to the Cologne Summit in June 1999.

[27]In March 1995, the Export-Import Bank of Japan and the Overseas Economic Cooperation Fund were merged and became known as the Japan Bank for International Cooperation.

insurance is administered, implemented, and provided by the Ministry of International Trade and Industry.

Method Used in Valuing International Loans

The government of Japan values its loan on a face value basis. When loans are disbursed, they are recorded at face value.

Method Used in Budgeting for the Cost of Debt Relief

The amount of debt relief that is provided is equivalent to the amount of the face value of the loan that is being forgiven. With respect to official development assistance claims, the Japanese government provides grant aid for debt relief. The grant aid for the official development assistance debt relief is drawn from the national budget through the Ministry of Foreign Affairs. The HIPC countries are required to spend this grant to purchase goods from countries that are members of the Organization for Economic Cooperation and Development/Development Assistance Committee countries.[28] In addition, debtor countries are required to provide the Japanese government with a list of imports, which is to ensure that the grant aid is not used to purchase so-called "unprofitable goods."[29] However, official development assistance loans in yen are considered untied loans.

With respect to the treatment of debt relief for non-official development assistance claims, the Japanese government is currently deliberating whether to write off HIPC countries' debts at their completion points. In past Paris Club debt reductions, Japan provided debt relief through a reduction in interest rate. If Japan were to choose the interest rate reduction option (with interest rate approaching zero) under the enhanced HIPC Initiative, it could take many decades to achieve the net present value reduction of 100 percent pre-cutoff date debt. However, the impact on the implementing agency's budget (the Ministry of International Trade and

[28]Based on the Organization for Economic Cooperation and Development terms and concepts, this form of aid would be considered "partially untied aid." Partially untied aid is official development assistance (or official aid) for which the associated goods and services must be procured in the donor country or among a restricted group of other countries. Partially untied aid is subject to the same disciplines as tied aid credits and associated financing.

[29]According to the Ministry of Finance, unprofitable goods include weapons, goods relating to military, or other things that do not contribute to increasing the productivity of heavily indebted poor countries.

Industry) would be gradual over time. According to the Ministry of Finance, this form of debt relief has an indirect impact on the national budget and a direct impact on the implementing agency's budget. In addition, according to Japan's Ministry of Foreign Affairs, once debt relief is extended to a country, it will be quite difficult to extend new loans to those countries in the future. Therefore, all future capital assistance will, in principle, have to be made in the form of grants.[30]

Option Used to Provide Debt Relief

As previously mentioned, the bulk of Japan's loans outstanding to the HIPC countries is official development assistance loans. With respect to official development assistance loans, the Japanese government will reschedule the loans over 40 years and provide grant aid for debt relief when it receives debt service payments from the HIPC countries. Based on this treatment of official development assistance loans, the impact on the national budget is expected to be limited in the short run since the debt relief will be spread out over 40 years. With regard to non-official development assistance claims, the Japanese government has not decided on how it will treat this debt. Non-official development assistance claims comprised only about 10 percent of total claims outstanding, and only pre-cutoff date claims are eligible.

Legal Constraints

According to an official of Japan's Ministry of Finance, Japan is not faced with any legal restrictions to granting any particular option of debt relief or write-off on its claims. The government does not require the Diet's[31] approval to reschedule debt or to grant debt relief through the Paris Club (multilateral agreement). However, Diet approval is required when the agreement for bilateral rescheduling and provision of grants for debt reduction is concluded.

Contributions to the Multilateral Trust Funds

Japan's total pledge or contribution to the multilateral trust funds is estimated at approximately US$328 million. So far, Japan has contributed US$10 million to the HIPC Trust Fund at the World Bank and has pledged to

[30]Vietnam, Myanmar, Kenya, and Ghana indicated that they may not accept the grant assistance for debt relief approach because they would like to continue to receive official development assistance in yen loan form in the future.

[31]The Diet is the legislative body, which is similar to the United Kingdom's parliament.

make an additional contribution of $190 million. About $128 million will go to the IMF Poverty Reduction Growth Facility/HIPC Trust, of which $62 million has already been contributed.

Prior Debt Reduction Activities

Between 1990 and 1998, Japan granted about US$2.4 billion in nominal terms of grant aid for debt relief of official development assistance claims to the least developed countries. In addition, Japan has provided debt reduction on a net present value basis within the framework of the Paris Club.[32]

The United Kingdom

Outstanding Loans

As of December 31, 1999, the United Kingdom had total commercial (non-official development assistance) claims outstanding of about 2 billion pounds (about US$3.1 billion) against the heavily indebted poor countries, according to the United Kingdom's Treasury.[33] About 1.6 billion pounds (US$2.5 billion) of this total amount is pre-cutoff date claims.[34] The United Kingdom will forgive all pre- and post-cutoff date debts of countries that participate in the enhanced HIPC Initiative.

The United Kingdom's export credit agency, the Export Credits Guarantee Department,[35] holds all non-official development assistance claims. Its primary function is to facilitate exports of goods and services by providing guarantees and insurance. The Export Credits Guarantee Department will incur an estimated cost of about 1.4 billion pounds in nominal terms, or about US$2.2 billion to write off claims, for which it had already provisioned. The United Kingdom Treasury will only fund the cancellation of the non-official development assistance debts over and above the levels

[32]Japan has not provided us with the amount of relief granted under the Paris Club framework.

[33]Of the 40 HIPC countries, 34 are indebted to the United Kingdom.

[34]Only three countries owe post-cutoff date debts: Ghana, Côte d'Ivoire, and Vietnam.

[35]The Export Credits Guarantee Department is a department of the Secretary of State for Trade and Industry. The Export Credits Guarantee Department derives its statutory authority from the Export and Investment Guarantees Act of 1991.

of cancellation required under the HIPC Initiative. The face value of the remaining debt that the United Kingdom Treasury will fund is estimated at 300 million pounds, or about $480 million, which represents new demands on the budget.[36] The Department for International Development provides grants, loans, and technical assistance to developing countries and manages the loan portfolio. The Department for International Development has written off all its official development assistance loans to the HIPC countries since about 1997 and has since been providing official development assistance only in the form of grants to these countries.[37]

Method Used in Valuing International Loans

In terms of valuing non-official development assistance claims, the Export Credits Guarantee Department considers the potential recoverability of the loan. The Export Credits Guarantee Department performs a provision exercise, which assesses the debtor country's ability to repay the debt.[38] It sets provisions for irrecoverable claims based upon current perceptions of risks, including an assessment of the debtor country's economic situation. The Export Credits Guarantee Department's provisioning is based on country-specific estimates of the probability of default, and not on country ratings per se. The Department's accounting system takes into account the different premiums and expected losses in discounting the loans. For accounting purposes, the Export Credits Guarantee Department has two accounts—Account 1 and Account 2.[39] Account 1 is a reserve account, which is reflected on the balance sheet, and it handles guarantees issued for project business prior to April 1991 and guarantees issued by the Insurance Services Group of the Export Credits Guarantee Department. Account 2 covers guarantees issued for project business since April 1991.

[36]The countries that will not be eligible for HIPC debt relief will receive a 67-percent reduction based on Naples terms.

[37]The cancellation of official development assistance loans is the result of the Retrospective Terms of Adjustment, a policy of aid loan write-off introduced by the British government following a resolution passed by the United Nations Conference on Trade and Development in 1978. The Conference had called for either the cancellation of aid loans or their availability on more concessionary terms.

[38]Based on the Export Credits Guarantee Department 's Annual Report 1997/98, provisions are estimated according to the following categories of risk: political, buyer, specific political risk provision, and specific buyer risk provisions.

[39]Account 1 is a liquidating account and appears similar to the U. S. government's Liquidating Account, which was established as part of the Federal Credit Reform Act of 1990.

The Export Credits Guarantee Department performs a reestimate of its loan assets every year, and the account reserve is adjusted to reflect any change in estimates.

As mentioned earlier, the United Kingdom has written off all of its official development assistance loans. However, official development assistance loans were valued at zero because they were fully budgeted for at the time they were disbursed.

Method Used in Budgeting for the Cost of Debt Relief

Based on the 1991 Export and Investment Guarantees Act, the Export Credits Guarantee Department must maximize recoveries and manage its assets and liabilities in a way that minimizes the cost to the taxpayers. In the past, and for most countries, this has been taken to mean that the Export Credits Guarantee Department can offer debt reduction only if the value of the claims after debt relief is greater than or equal to the risk-discounted value before debt relief. In other words, debt relief is granted under the condition that it will improve future collection rates.

However, in the context of the HIPC Initiative, the Export Credits Guarantee Department is judged able to provide up to 100-percent debt relief within its statutory obligations if supported by a multilateral agreement. In order to fulfill the United Kingdom's bilateral commitment to relieve all the debt of HIPC countries, when the level of relief given through the multilateral process is less than 100 percent, the United Kingdom's Treasury will provide additional funds to the Export Credits Guarantee Department to make up the difference between the multilateral and bilateral levels of debt relief. This funding will be channeled through the Department for International Development's budget, which will be increased especially for this purpose. The Department for International Development will provide grants to countries to cover their scheduled debt.

When the Department for International Development cancels official development assistance loans, it is effectively converting an outstanding loan into a grant. The Department for International Development's accountants record both the repayment of the outstanding loan and a grant issued to the debtor country. The impact on the Department for International Development's budget is neutral. The original cost to the Department was budgeted at the time that the debt was created, and cancellation results in no new demands on the Department for International Development's budget. As mentioned earlier, the United

Kingdom has written off all its official development assistance loans. If interest payments were anticipated, however, the interest payments forgone (through debt cancellation) would have an impact on the Department for International Development's budget. The aid program would be reduced in proportion to the interest that is forgone on the debt that has been written off.

While debt relief does not directly impact the national debt, the consolidated fund benefits each year from any revenue it receives from the Export Credits Guarantee Department. Therefore, debt relief will lessen the amount contributed to the consolidated fund.

Option Used to Provide Debt Relief

When a country reaches its decision point, the United Kingdom will provide interim relief of 100 percent of debt service between the decision point and the completion point. Only when the country reaches the completion point is the commitment to provide 100-percent debt relief irrevocable. This mirrors the operation of the multilateral process through the Paris Club. In that case, the relief provided through a flow rescheduling at the decision point is made final through the reduction in the stock of debt at the completion point. As mentioned previously, the United Kingdom's Export Credits Guarantee Department has already provisioned for most of the debt relief that it will provide under the enhanced framework. According to United Kingdom Treasury officials, the extra cost (bilateral portion of the debt relief) will be written off as principal and interest payments fall due over a 23-year period; therefore, the impact on the budget will occur gradually over this period.

Legal Constraints to Providing Debt Relief

The extra costs of financing the commitment to provide 100-percent debt relief will be met from the (Treasury) reserve in the first year and from the Department of International Development's budget in subsequent years. The extra resources will therefore be voted as part of the United Kingdom's public expenditure process. Separate parliament approval for the 100-percent relief proposal is not required. As previously mentioned, the Export Credits Guarantee Department is restricted in the amount that it can provide for debt relief. Based on its enabling act, it must maximize its return to the taxpayers.

Contributions to the Multilateral Trust Funds

The United Kingdom has pledged a total of $359.3 million to the World Bank HIPC Trust Fund. It has made a contribution so far of about $36 million to this trust fund. The total amount pledged includes an expected $95 million share of the European Union's contribution from the European Development Fund, which is earmarked for the African, Caribbean, and Pacific countries. The United Kingdom has also made a contribution of $43.3 million to the World Bank HIPC Trust Fund, which is earmarked for use by the International Monetary Fund to provide relief for Uganda at the completion point.[40]

Prior Debt Reduction Activities

Since 1992, the Department for International Development has provided about $513 million in debt relief to the heavily indebted poor countries. The Export Credits Guarantee Department did not participate in the loan write-off until about 1991-92. Since that time, the Export Credits Guarantee Department has written off debt to HIPC countries with a face value of 372 million pounds.

[40]In addition, the United Kingdom contributed $16.3 million to the Central American Trust Fund at the World Bank.

Bilateral Contributors to the HIPC Trust Fund

Table 15 shows the amount and status of bilateral donor (government) pledges to the HIPC Trust Fund, as of May 31, 2000. Twenty-two countries have pledged about $2.5 billion to this Fund, which is used to help multilateral creditors provide their shares of HIPC debt relief to recipient countries.

Table 15: Status of Bilateral Donor Pledges to the HIPC Trust Fund, as of May 31, 2000

U.S. dollars in millions

Donor	Contributions received[a]	Contributions pledged prior to Sept. 1999	Contributions pledged during and after Sept. 1999		Total outstanding announced pledges	Overall contributions and pledges to original and enhanced HIPC Initiatives[b]
			European Union[c]	Others		
Australia	$12					$12
Austria			$19		$19	19
Belgium	4	$8	28		36	40
Canada	102					102
Denmark	26		16	$19	35	61
Finland	15		11		11	26
France		21	178		199	199
Germany	24	24	171	48	219	243
Greece	1		9		9	10
Ireland	15		4		4	19
Italy			92	70	162	162
Japan	10			190	190	200
Luxembourg	1		2		2	3
Netherlands	131		38		38	169
New Zealand	2					2
Norway	42					42
Portugal	15		7		7	22
Spain	15		43	70	113	128
Sweden	28		20		20	48
Switzerland	30			30	30	60
United Kingdom[d]	36	135	95	50	280	316
United States				600	600	600
Total	**$509**	**$188**	**$733**	**$1,077**	**$1,974**	**$2,483**

Note: Figures are approximate. Some contributions are in the donor's national currency and in the form of a promissory note.

[a]Includes allocations from the Interest Subsidy Fund (ISF)—that was set up in 1975 with donor contributions to subsidize the interest rates on International Bank for Reconstruction and Development loans to the poorest of this Bank's borrowers—to the HIPC Trust Fund. Australia is retaining its surplus resources in the ISF (rather than transferring them to the HIPC Trust Fund) but has authorized the World Bank to use them to provide debt relief as necessary under the HIPC Initiative. There remains approximately $83 million in ISF surplus assets that have not been allocated.

[b]Many donors have also provided debt relief through other initiatives and mechanisms including the Debt Reduction Facility for International Development Association-only countries that provides financing for commercial debt reduction efforts and specific country-held multilateral debt relief facilities. Most notably, additional debt service relief has also been provided to several Central American countries in the aftermath of Hurricane Mitch through the Central American Emergency Trust Fund. Bilateral donor funding to that trust fund to provide debt service relief to Honduras and Nicaragua include $2.7 million from Austria, $5.4 million from Canada, $10.9 million from Denmark, $13.2 million from Germany, $12 million from Italy, $12.8 million from the Netherlands, $15 million from Norway, $30 million from Spain, $16.6 million from Sweden, $15.5 million from Switzerland, $16.3 million from the United Kingdom, and $25 million from the United States. These resources are not included in the table since HIPC debt relief is additional to these efforts.

[c]For illustration, the exchange rate is 1 euro equal to 1 U.S. dollar, and the attribution to member states is based on their respective contributions to the European Development Fund's Eighth Replenishment.

[d]In addition, the United Kingdom has contributed 31.5 million Special Drawing Rights to the HIPC Trust Fund for the IMF for debt relief to Uganda.

Source: World Bank.

Comments From the Department of the Treasury

Note: GAO comments supplementing those in the report text appear at the end of this appendix.

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C.

UNDER SECRETARY

June 8, 2000

Mr. Henry L. Hinton, Jr.
Assistant Comptroller General
National Security and International Affairs Division
U.S. General Accounting Office
441 G Street, N.W.
Washington, D.C. 20548

Dear Mr. Hinton:

Thank you for the opportunity to comment on the draft GAO report on the enhanced Heavily Indebted Poor Countries (HIPC) debt initiative. As you know, this report attempts to review a complex policy initiative that continues to be in the early stages of implementation. It provides the reader with useful information, and raises pertinent questions that will continue to be considered as we move forward on this important initiative.

We agree with the following main conclusions of the report:

- Debt relief provided under the initiative is significant, and efforts to reduce the debts of eligible countries should continue.
- Debt reduction by itself does not guarantee a permanent exit from debt problems. Strong economic policies, sound debt management, and continued donor assistance are essential to reaching this objective.
- There is a tension between the objective to provide debt relief quickly and the need to develop quality poverty reduction strategies.
- Securing full financing of the initiative is a major challenge.
- Participants in the initiative and observers may need to have more realistic expectations about what the initiative may ultimately achieve.

Nonetheless, we believe that the draft report could be improved, and would better serve the reader, if portions were expanded or modified to highlight a number of important points.

Durable Debt Solutions

See comment 1.

The report asserts that the degree of debt reduction provided in this framework is not likely by itself to provide a "lasting exit from debt problems," justifying this in part on the grounds that the economic assumptions about growth and exports are too optimistic. Although the GAO is right to be concerned about potentially optimistic economic assumptions, it is also important to highlight a point made later in the report that the growth levels assumed "are generally consistent with the levels since 1990."

2

Our view is that there is no degree of debt reduction that can by itself provide a definitive exit from debt problems and ensure adequate growth to improve living standards in these countries. This initiative provides a substantially greater degree of debt reduction and a greater financial cushion than had been available previously. However, these countries cannot be fully insulated through debt reduction programs from the impact of external shocks, commodity price swings, political distress, failures of policy performance, and acts of nature.

The most effective way to enhance the prospect of a more durable improvement in the economic performance of a country is to try to design incentives and conditions that are likely to work. That is why the centerpiece of this initiative is a new approach to the design of conditionality. In addition to promoting investments in poverty reduction areas with high development returns, the initiative focuses on growth-oriented economic reforms, including in such areas as openness to trade and investment, privatization, and transparency and anti-corruption efforts.

Sustainable Borrowing Path

See comment 2.

The GAO report also argues that the initiative does not in fact free resources for increased spending at the national level unless countries continue to borrow at what is implied could be unsustainable rates. We think this is misleading. Debt relief that reduces debt service obligations below what was actually being paid previously does by definition release resources for alternative uses. It is also true, in contrast to the way the summary reads, that a country can increase spending for specified expenditures even if it is reducing its overall spending and borrowing. And even if countries continue to borrow at pre-debt relief levels, the net debt service savings will be significant for a long period of time because of the highly concessional terms of new loans. IDA loans have a zero percent interest rate (with only a minimal service fee), a ten-year grace period, and maturity of forty years. In addition, most bilateral donors are moving to much larger shares of grant financing in total development assistance.

The enhanced HIPC program is designed to ensure that the IMF and World Bank, together with the country, make a shared judgement about a sustainable borrowing plan and the appropriate fiscal path of the country going forward. Within that framework the country, in consultation with the Bank, Fund and civil society, outlines how available resources should best be directed to support better development outcomes. Given the prolonged underinvestment by these countries in meeting the basic human needs that are critically important to long-term development performance, we and other donors have stressed that the resources saved from debt relief should be directed to increased poverty reduction expenditures in areas with high development returns. In all cases, the HIPC countries, with assistance from the IMF and World Bank, will be called upon to demonstrate how they are employing HIPC savings to strengthen the prospects for high quality growth and poverty reduction going forward.

See comment 3.

It would also be useful to note more prominently that the assumed borrowing profile for a country is not a static concept and would be adjusted over time to reflect changing circumstances. If in fact a country experienced a sustained shortfall in export performance, it would be reasonable to expect that adjustments would be made in its expenditure and borrowing plans to avoid unsustainable increases in debt.

3

Speed vs. Quality

We fully agree that there is a tension between the desire to deliver debt relief quickly and the need to ensure that a proper framework is in place. As GAO notes, in an attempt to find a pragmatic balance we have agreed to a transitional period during which countries can reach their decision points and begin to receive interim debt relief on the basis of interim PRSPs. It is also important to note that countries are required to have a three-year track record of economic reforms in order to reach their decision points, which should provide additional assurances about their ability to make effective use of debt reduction. Under the enhanced HIPC framework the completion point is an additional point of leverage to improve policies. Most countries will be required to complete at least a year of performance after a full PRSP has been prepared in order to qualify for debt stock reduction. It is also important to stress that the PRSPs will be establishing the framework for all new concessional assistance from the IFIs. Providing debt reduction independent of or ahead of a systematic effort to improve the policy framework would in our view be ill advised.

Financing HIPC

The GAO report provides a useful update on the status of financing the enhanced HIPC initiative. We are actively engaged in discussions aimed at resolving the remaining financing gaps in the multilateral development banks, including for some of the smaller multilateral creditors. Securing our share of the financing burden is essential to catalyze additional contributions from other donors and to build a credible financing framework.

The Treasury Department, in conjunction with the rest of the Administration, is committed to helping HIPCs and other developing countries move ahead with the policy reforms needed to achieve sustained growth and development, including substantial poverty reduction. We will continue to work to improve implementation of the HIPC initiative, which is an important component of these overall efforts.

My staff has separately provided GAO with detailed comments, which we believe would strengthen the report. We appreciate the open and constructive working relationship we have had with the GAO.

Sincerely,

Timothy F. Geithner
Under Secretary
(International Affairs)

The following are GAO's comments on the Department of the Treasury's letter dated June 8, 2000.

GAO Comments

1. Although the Treasury agrees that there is reason to be concerned about potentially optimistic economic assumptions, the Treasury highlights the fact that growth levels are generally consistent with what countries experienced from 1990 to 1997. As we discuss in the report, since HIPC recipient countries rely on primary commodities for much of their export revenue, and the prices of such commodities fluctuate over time and decline in certain years, a sustained growth in export earnings in excess of 9 percent over 20 years may be overly optimistic. For example, Uganda's growth rate has declined since 1997, and the projected growth rates of the seven countries we analyzed are considerably higher than what those countries experienced from 1978 to 1997.

2. The Treasury states that our report is misleading when it argues that the initiative does not free up resources for increased spending because we imply that the interest rates HIPC recipients borrow at are unsustainable. We disagree with the characterization that our report is misleading. We report that the resources derived from debt relief can be used to increase spending on poverty reduction only if the country continues to borrow at the same level and below market terms as in the years prior to qualifying for debt relief. Furthermore, our analysis of countries' future debt burdens incorporates the level of grants and lending projected by World Bank and IMF staffs.

3. The Treasury states that it is reasonable to expect that adjustments would be made in countries' expenditure and borrowing plans to avoid unsustainable increases in debt. However, this implies that good debt management practices will be utilized. We agree with this point. However, we note that although efforts are being undertaken to improve debt management, there has not been a history of strong management in this area. Moreover, we note that if policymakers adjust to lower levels of export earnings by reducing imports, lowering domestic spending, raising tax revenue, or using a combination of these approaches, this would likely result in lower economic growth and lower expenditures on poverty reduction.

Comments From The International Monetary Fund

Note: GAO comments supplementing those in the report text appear at the end of this appendix.

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C.

UNDER SECRETARY

June 9, 2000

Mr. Henry L. Hinton, Jr.
Assistant Comptroller General
National Security and International Affairs Division
U.S. General Accounting Office
441 G Street, N.W.
Washington, D.C. 20548

Dear Mr. Hinton:

The World Bank and IMF were asked to comment on the General Accounting Office's draft report on the enhanced Heavily Indebted Poor Country (HIPC) debt initiative. Enclosed are letters from World Bank President Wolfensohn and IMF First Deputy Managing Director Fischer to Treasury Secretary Summers with their comments on the draft report.

Sincerely,

Timothy F. Geithner
Under Secretary
(International Affairs)

Enclosures

INTERNATIONAL MONETARY FUND
WASHINGTON, D.C. 20431

FIRST DEPUTY
MANAGING DIRECTOR

CABLE ADDRESS
INTERFUND

June 9, 2000

The Honorable Laurence Summers
Secretary of the Treasury
United States Treasury
15th Street and Pennsylvania Avenue, NW
Washington, DC 20220

Dear Mr. Secretary:

Thank you for giving us the opportunity to comment on the draft report of the General Accounting Office (GAO) on the enhanced Heavily Indebted Poor Country (HIPC) Initiative. We welcome the draft report, and in particular the Observations and the discussion of the financing gaps currently facing the Initiative. We have the following three principal comments.

See comment 1.

First, the draft report argues that the HIPC Initiative will not free up resources for poverty reduction unless countries continue to borrow. It does not emphasize sufficiently that this borrowing is now on highly concessional terms—in contrast to when most of the debt was accumulated—and a larger share of the provision of aid is now in the form of grants. Indeed, a fundamental premise of the HIPC Initiative is that assistance under the Initiative is additional to these external flows precisely so that spending on poverty reduction can be increased.

See comment 2.

Second, the draft argues that this continued borrowing will threaten external debt sustainability. This is not what the current projections show with six out of seven country cases showing declining debt ratios from the decision point (and the seventh showing a temporary rise with low debt-service ratios). There is, however, clearly a risk that lower export growth than projected could threaten future debt sustainability, in the absence of corrective policy actions or additional grants. We see the appropriate response to this as to monitor carefully future borrowing in response to economic developments to prevent the reoccurrence of debt problems—something that will be necessary in any event—rather than to curtail poverty-reducing expenditures now, in anticipation of such problems.

See comment 3.

Third, the draft report notes the tension between quick debt relief and comprehensive country-owned poverty reduction strategies. However, the report does not emphasize sufficiently the measures taken to reduce this tension with Interim-PRSPs being sufficient—on a transitional basis—for countries to reach the decision points and the

provision of substantial debt relief from the decision point. Nor does it stress sufficiently the strong wish of the international community to link the provision of debt relief to effective poverty reduction. This is the fundamental goal of HIPC Initiative assistance and indeed of all our concessional support for our low-income members.

Yours sincerely,

Stan Fischer

Stanley Fischer

The following are GAO's comments on the IMF's letter dated June 9, 2000.

GAO Comments

1. The IMF said that the report does not emphasize sufficiently that the borrowing to increase spending on poverty reduction is on highly concessional terms and that a larger share of the provision of aid is now in the form of grants. We disagree with the IMF's characterization. We report that, in order for recipient countries to have the funds that are expected to be spent on poverty reduction, these countries must continue to borrow—at the same level and below market terms as in the years prior to qualifying for debt relief under the initiative—given each country's projected amount of grants, loans, and revenue. Our analysis of countries' future debt burdens incorporates the level of grants and lending projected by World Bank and IMF staffs.

2. The IMF said that current projections show that for six of the seven country cases analyzed, the debt ratios of these countries are projected to decline. The IMF said that lower than projected export growth could threaten future debt sustainability, in the absence of corrective policy actions or additional grants. They see the appropriate response to this as to monitor carefully future borrowing in response to economic developments to prevent the reoccurrence of debt problems. We believe this implies that good debt management practices will be utilized. We agree with this point but note that although efforts are being undertaken to improve debt management, there has not been a history of strong management in this area. Moreover, we report that a 20-percent decline in projected export earnings could more than double the debt-to-export ratio over what was originally forecast for the projection period. We consider it to be a reasonable assumption that the response to such a relatively small decline in export earnings would be an increase in concessional borrowing and grants in order to preserve what would be a fairly robust economic growth level with substantial progress on poverty reduction. If instead, policymakers adjust to these lower levels of export earnings by reducing imports, lowering domestic spending, raising tax revenue, or using a combination of these approaches, this would likely result in lower economic growth and lower expenditures on poverty reduction.

3. The IMF said the report does not emphasize sufficiently the measures taken to reduce the tension between quick debt relief and comprehensive country-owned poverty reduction strategies or the strong wish of the international community to link the provision of debt

relief to effective poverty reduction. The report discusses the measures taken to reduce the tension—interim poverty reduction strategies and interim debt relief. We also report that countries may have an incentive to reach the completion point quickly because only then does HIPC debt relief become irrevocable. Chapter 3 discusses the desire of the international community to link debt relief and poverty reduction. We have added similar wording to the executive summary.

Comments From the World Bank

The World Bank
Washington, D.C. 20433
U.S.A.

JAMES D. WOLFENSOHN
President

June 8, 2000

The Honorable Lawrence H. Summers
Secretary
United States Department of Treasury
Washington, D.C. 20220

Dear Mr. Secretary,

In response to the letter by Mr. Henry Hinton, Jr., dated May 25, 2000, we would like to thank you very much for the opportunity to comment on the draft report entitled "DEVELOPING COUNTRIES: Debt Relief Initiative for Poor Countries Faces Challenges" that was sent with your letter of May 25, 2000.

We find that the review provides much useful information and underscores some important aspects of the Heavily Indebted Poor Countries (HIPC) Initiative, which we, the International Monetary Fund and other key partners will be able to take into account as we continue to move forward with its implementation.

What follows are some comments and observations on the main findings of the report.

We very much welcome the report's key finding that the enhanced HIPC Initiative, launched only last fall, provides substantial debt relief for qualifying countries. We estimate that after receiving HIPC Initiative debt relief, countries will have annual debt service obligations that average 10 percent or less of their annual export earnings.

We also welcome the report's emphasis that the redirection of resources that the HIPC Initiative makes possible – from debt service to poverty reduction – can only be realized if the recipient countries continue to receive substantial external aid. The leaders that have agreed on the HIPC Initiative have underscored the importance of the principle of additionality – namely that the resources released through debt relief should be additional to current aid levels. Otherwise, if for example debt relief were accompanied by a reduction in new aid flows, the potential benefits from debt relief would not be realized. For this reason, we have emphasized the importance for donors to maintain their flow of aid to HIPCs, in line with the report's findings.

The report draws attention to the risks of a re-emergence of debt problems in countries benefiting from debt relief. We strongly agree with the need for countries to pursue prudent debt management policies and for lenders to follow responsible lending

The Honorable Secretary L. H. Summers. -2- June 8, 2000

policies, if debt problems are to be avoided over the long term. Otherwise, the benefits of the HIPC Initiative could be eroded, as the analysis of the report indicates. A durable exit from unsustainable debt remains a central objective of the HIPC Initiative.

The report also points to the tension between quick debt relief and the longer time that is needed for countries to prepare comprehensive poverty reduction strategies with broad public participation. The requirement for these strategies was introduced with the enhanced HIPC Initiative as a way to better link debt relief with the achievement of poverty reduction. As the report indicates, the use of such strategies is an innovation. The risk that countries might rush to prepare poverty reduction strategies is mitigated through interim debt relief which most countries will receive while they develop their full strategies.

Finally, the report has made an important contribution in its analysis of the costs of the HIPC Initiative, the ways in which the major creditor countries are arranging to meet these costs through their own budgetary processes, and the difficulties faced by a number of multilateral institutions in financing the costs of providing the debt relief. The success of the HIPC Initiative will hinge crucially on successfully meeting these financing challenges.

To conclude, while the report itself does not draw any explicit policy conclusions, we believe that it supports a strong call for financing of the HIPC Initiative, a maintenance of aid flows to poor countries, and the need for recipient countries to pursue sound economic management and poverty reduction strategies.

Sincerely yours,

James D. Wolfensohn

cc: Mr. Henry L. Hinton, Jr., Assistant Comptroller (GAO);
Ms. J. Piercy, Executive Director (US)

GAO Contact and Staff Acknowledgments

GAO Contact

Thomas Melito, (202) 512-9601

Acknowledgments

In addition to the name above, Cheryl L. Goodman, Bruce L. Kutnick, R.G. Steinman, Barbara R. Shields, Nima Patel Edwards, Katharine H. Woodward, Gezahegne Bekele, and Rona H. Mendelsohn made key contributions to this report.

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