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DEVELOPING COUNTRIES

Challenges in Financing Poor Countries' Economic Growth and Debt Relief Targets

Statement of Mr. Thomas Melito
Acting Director
International Affairs and Trade

April 20, 2004

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Highlights

Highlights of GAO-04-688T, a testimony before the Subcommittee on Domestic and International Monetary Policy, Trade, and Technology, Committee on Financial Services, House of Representatives

Why GAO Did This Study

The Heavily Indebted Poor Countries (HIPC) Initiative, established in 1996, is a bilateral and multilateral effort to provide debt relief to poor countries to help them achieve economic growth and debt sustainability. Multilateral creditors are having difficulty financing their share of the initiative, even with assistance from donors. Under the existing initiative, many countries are unlikely to achieve their debt relief targets, primarily because their export earnings are likely to be significantly less than projected by the World Bank and International Monetary Fund (IMF).

In a recently issued report, GAO assessed (1) the projected multilateral development banks' funding shortfall for the existing initiative and (2) the amount of funding, including development assistance, needed to help countries achieve economic growth and debt relief targets.

The Treasury, World Bank, and African Development Bank commented that historical export growth rates are not good predictors of the future because significant structural changes are under way in many countries that could lead to greater growth. We consider these historical rates to be a more realistic gauge of future growth because of these countries' reliance on highly volatile primary commodities and other vulnerabilities such as HIV/AIDS.

www.gao.gov/cgi-bin/getrpt?GAO-04-688T.

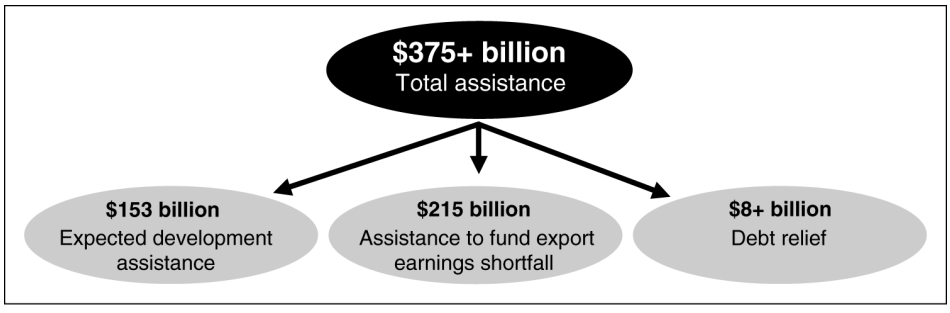
To view the full product, including the scope and methodology, click on the link above. For more information, contact Thomas Melito at (202) 512-9601, or e-mail Melitot@gao.gov.

What GAO Found

The three key multilateral development banks we analyzed face a funding shortfall of $7.8 billion in 2003 present value terms, or 54 percent of their total commitment, under the existing HIPC Initiative. The World Bank has the most significant shortfall—$6 billion. The African Development Bank has a gap of about $1.2 billion. Neither has determined how it would close this gap. The Inter-American Development Bank is fully funding its HIPC obligation by reducing its future lending resources to poor countries by $600 million beginning in 2009. We estimate that the cost to the United States, based on its rate of contribution to these banks, could be an additional $1.8 billion. However, the total estimated funding gap is understated because (1) the World Bank does not include costs for four countries for which data are unreliable and (2) all three banks do not include estimates for additional relief that may be required because countries' economies deteriorated after they qualified for debt relief.

Even if the $7.8 billion gap is fully financed, we estimate that the 27 countries that have qualified for debt relief may need an additional $375 billion to help them achieve their economic growth and debt relief targets by 2020. This $375 billion consists of $153 billion in expected development assistance, $215 billion to cover lower export earnings, and at least $8 billion in debt relief. Most countries are likely to experience higher debt burdens and lower export earnings than the World Bank and IMF project, leading to an estimated $215 billion shortfall over 18 years. To reach debt targets, we estimate that countries will need between $8 billion and $20 billion, depending on the strategy chosen. Under these strategies, multilateral creditors switch a portion of their loans to grants and/or donors pay countries' debt service that exceeds 5 percent of government revenue. Based on its historical share of donor assistance, the United States may be called upon to contribute about 14 percent of this $375 billion, or approximately $52 billion over 18 years.

Estimated Cost to Achieve Economic Growth and Debt Relief Targets for 27 Countries through 2020 in 2003 Present Value Terms



Source: GAO analysis of World Bank and IMF data.

Mr. Chairman and Members of the Committee:

I am pleased to be here today to discuss the funding of the existing Heavily Indebted Poor Countries (HIPC) Initiative and the amount of further assistance needed to help countries achieve economic growth and debt targets.

The HIPC Initiative is a joint bilateral and multilateral effort to provide debt relief to up to 42 poor countries to help them achieve long-term economic growth and debt sustainability.[1] The current cost for the initiative is projected at about $41 billion in present value terms, funded almost equally between bilateral and multilateral creditors.[2] Although the initiative was launched in 1996, multilateral creditors are still having difficulty financing their share of the initiative, even with assistance from donors. GAO and others have reported that the existing initiative is unlikely to provide sufficient debt relief to achieve long-term debt sustainability, primarily because export earnings are likely to be significantly less than projected by the World Bank and the International Monetary Fund (IMF).

My remarks will focus on two key areas, as discussed in our recently released report:[3] (1) the multilateral development banks' (MDB) projected funding shortfall for the existing HIPC Initiative and (2) the amount of funding, including development assistance, needed to help countries achieve economic growth and debt relief targets. I will highlight the key financing challenges in these two areas.

[1]Under the HIPC Initiative a country is considered to be "debt sustainable" if, in most cases, the ratio of a country's debt (in present value terms) to the value of its exports is at or below the150-percent threshold, which is believed to contribute to countries' ability to make their future debt payments on time and without further debt relief.

[2]All figures in this statement are stated in 2003 present value terms, unless otherwise noted. The present value of debt is a measure that takes into account the concessional, or below market, terms that underlie most of these countries' loans. The present value is defined as the sum of all future debt-service obligations (interest and principal) on existing debt, discounted at the market interest rate. The nominal value of the debt is greater than the present value. The cost estimate is for 34 countries, because 4 countries are not likely to need relief under the initiative and data for 4 other countries are considered unreliable.

[3]U.S. General Accounting Office, *Developing Countries: Achieving Poor Countries' Economic Growth and Debt Relief Targets Faces Significant Financing Challenges*, GAO-04-405 (Washington, D.C.: Apr. 14, 2004).

Our analysis of the funding shortfall focused on the three key MDBs—the World Bank/International Development Association (IDA), the African Development Bank (AfDB)/African Development Fund (AfDF), and the Inter-American Development Bank (IaDB)/Fund for Special Operations (FSO)—because they account for about 70 percent of multilateral creditors' debt relief costs. To determine the amount and timing of funding shortfalls, we analyzed the banks' total and annual cost estimates and funding sources for 34 countries. To determine the amount of funding needed to achieve economic growth and debt relief targets, we analyzed World Bank and IMF projections through 2020 for the 27 countries that have qualified for debt relief thus far, focusing on estimates of key economic variables including debt stock, debt service, donor assistance, government revenue, and exports. In addition, we analyzed the impact of fluctuations in export growth on the likelihood of these countries achieving debt sustainability. We performed our work from June 2003 to February 2004 in accordance with generally accepted government auditing standards.

Summary

The three key MDBs we analyzed face a funding shortfall of $7.8 billion in present value terms, or 54 percent of their total commitment, under the debt relief initiative. The World Bank and the AfDB have not determined how they would close this gap. The World Bank has the most significant shortfall—$6 billion. Despite significant assistance from donor governments, the AfDB has a financing gap of about $1.2 billion. The IaDB is fully funding its HIPC obligation by reducing its future lending resources to poor countries by $600 million beginning in 2009. Based on the rates at which the United States contributes to these three multilateral development banks, we estimate that the United States could be asked to contribute an additional $1.8 billion to close the known financing shortfall for debt relief. However, the total estimated funding gap is understated because the World Bank does not include costs for four countries that are eligible for debt relief but for which data are unreliable. In addition, all three banks do not include estimates for additional relief that may be provided due to deterioration in the countries' economic circumstances since they qualified for debt relief under the existing initiative. The World Bank and the IMF project that this additional relief could cost from $877 million to $2.3 billion.

Even if donors fully fund the current initiative, we estimate that the 27 countries that have qualified for debt relief may need more than $375 billion, in present value terms, in additional assistance from donors to help them achieve their economic growth and debt relief targets by 2020. This

$375 billion consists of $153 billion in expected development assistance, $215 billion in assistance to cover lower export earnings, and at least $8 billion in relief to reach debt targets. Based on our analysis of World Bank and IMF projections, these countries will need $153 billion to help them achieve their economic growth projections and debt sustainability. However, we consider that amount to be an underestimate because it assumes that countries will achieve overly optimistic export growth rates. Under lower, more realistic historical export growth rates, 23 of the 27 countries are likely to experience higher debt burdens and lower export earnings, leading to an estimated $215 billion shortfall over 18 years. In addition, we estimate that countries will need between $8 billion and $20 billion in debt relief to achieve their debt targets, depending on the strategy chosen. Under these strategies, multilateral creditors switch a portion of their loans to grants and/or donors pay countries' debt service that exceeds 5 percent of government revenue. Based on its historical share of bilateral and multilateral assistance, the United States may be asked to contribute about 14 percent of the $375 billion in additional assistance, or approximately $52 billion over 18 years.

Background

The World Bank and IMF have classified 42 countries as heavily indebted and poor; three quarters of these are in Africa. In 1996, creditors agreed to create the HIPC Initiative to address concerns that some poor countries would have debt burdens greater than their ability to pay, despite debt relief from bilateral creditors. In 1999, in response to concerns about the continuing vulnerability of these countries, the World Bank and the IMF agreed to enhance the HIPC Initiative by more than doubling the estimated amount of debt relief and increasing the number of potentially eligible countries. A major goal of the HIPC Initiative is to provide recipient countries with a permanent exit from unsustainable debt burdens. To date, 27 poor countries have reached their decision points, and 11 of these have reached their completion points.[4] In 1996, to help multilateral creditors meet the cost of the HIPC Initiative, the World Bank established a HIPC Trust Fund with contributions from member governments and some multilateral creditors. The HIPC Trust Fund has received about $3.4 billion (nominal) in bilateral pledges and contributions, including $750 million in pledges from the U.S. government.

[4]The 11th country, Niger, reached its completion point just prior to the publication of our full report. Eligibility for the HIPC Initiative is scheduled to expire at the end of calendar year 2004. However, previous sunset dates have been extended.

Key Multilateral Development Banks Face Significant Challenges to Financing the Existing Initiative

The World Bank, AfDB, and IaDB face a combined financing shortfall of $7.8 billion in present value terms under the existing HIPC Initiative (see table 1).

Table 1: Financing Challenges Facing Key Multilateral Creditors (U.S. dollars in 2003 present value terms)

Institution	Estimated amount of debt relief (billions)	Financing identified (billions)	Estimated financing gap (billions)	Estimated U.S. share of financing gap
World Bank (34 countries)[a]	IDA 8.8 IBRD 0.7 **Total 9.5**	IDA 2.8 IBRD 0.7 **Total 3.5**	IDA 6.0	1.2 billion
African Development Bank Group (32 countries)[b]	3.5	2.3	1.2	Between 132 and 348 million
Inter-American Development Bank (4 countries)[c]	1.4	0.8	0.6[d]	300 million
Total	**14.4**	**6.6**	**7.8**	**Between 1.6 and 1.8 billion**

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

Notes:

IDA = International Development Association

IBRD = International Bank for Reconstruction and Development

[a]Of the 42 countries potentially eligible for debt relief, 4 countries are not likely to need relief under the initiative. Of the remaining 38 countries, the World Bank does not include estimates for 4 countries whose data it considers unreliable.

[b]Of the 42 countries potentially eligible for debt relief, 34 countries are members of the AfDB. Of these 34 countries, 2 countries are not likely to need relief under the initiative.

[c]Of the 42 countries potentially eligible for debt relief, only 4 countries are members of the IaDB.

[d]The IaDB's estimated financing includes a reduction in future lending resources in the Fund for Special Operations, its concessional lending arm.

The World Bank Has An Estimated Financing Gap of $6 Billion

Financing the enhanced HIPC Initiative remains a major challenge for the World Bank. The total cost of the enhanced HIPC Initiative to the World Bank for 34 countries is estimated at $9.5 billion. As of June 30, 2003, the World Bank had identified $3.5 billion in financing, resulting in a gap of about $6 billion (see table 1). Donor countries will be reviewing the financing gap during the IDA-14 replenishment discussions beginning in spring 2004.[5] If donor countries close the financing gap through future replenishments, we estimate that the U.S. government could be asked to contribute $1.2 billion,[6] which is based on its historical replenishment rate of 20 percent to IDA.[7]

Over 70 percent of the funds IDA has identified thus far come from transfers of IBRD's net income to IDA. Although IBRD has not committed any of its net income for HIPC debt relief beyond 2005, we estimate that the financing gap of $6 billion could be reduced to about $3.5 billion, or by about 42 percent, if the net income transfers from the IBRD continue.[8] Similarly, the U.S.'s potential share decreases by the same percentage, from $1.2 billion to about $700 million.[9] However, transferring more of IBRD's net income to HIPC debt relief could come at the expense of other IBRD priorities.

[5]Replenishment refers to periodic contributions by member countries that are agreed upon by the institution's board of governors to fund concessional lending operations over a specified period of time, normally every 3 years. IDA's next replenishment (the 14th) is expected to take effect in July 2005.

[6]Factors such as changes in the foreign exchange value of the U.S. dollar could substantially alter total costs.

[7]According to IDA's Articles of Agreement, the Association shall review the adequacy of its resources and authorize an increase in members' subscriptions. All decisions to increase members' subscriptions are made by a two-thirds majority of the total voting power. No member is obligated to subscribe; however, not participating in an increase may affect a country's voting power and influence in the Association.

[8]For this analysis, we assumed that IBRD's net income transfers continue until 2021 at the maximum rate of $240 million per year beginning in 2006 and decline thereafter to cover all remaining scheduled HIPC relief though 2035.

[9]While the U.S. government is not legally obligated to help close the HIPC financing shortfall of the MDBs, the United States may have an implicit fiscal exposure, which is an implied commitment embedded in the government's current policies or in the public's expectations about the role of the government. See U.S. General Accounting Office, *Fiscal Exposures: Improving the Budgetary Focus on Long-Term Costs and Uncertainties*, GAO-03-213 (Washington, D.C.: Jan. 24, 2003) for a discussion of implicit exposures.

AfDB Has a Financing Gap of at Least $1 Billion

The total cost of the enhanced HIPC Initiative to the AfDB for its 32 member countries is estimated at about $3.5 billion (see table 1).[10] As of September 2003, the AfDB has identified financing of approximately $2.3 billion, including $2 billion from the HIPC Trust Fund and about $300 million from its own resources. Thus, AfDB is faced with a financing shortfall of about $1.2 billion in present value terms. We estimate that AfDB will need about $400 million to cover its shortfall for its 23 eligible countries, as well as about $800 million for its 9 potentially eligible countries.[11] In addition, we estimate that the U.S. share of the AfDB's financing shortfall is between $132 and $348 million, depending on the method used to close the $1.2 billion shortfall.

IaDB Expects to Finance HIPC Commitments at the Expense of Future Lending

The IaDB expects to provide about $1.4 billion for HIPC debt relief to four countries—Bolivia, Guyana, Honduras, and Nicaragua. Most of the relief is for debt owed to the Fund for Special Operations (FSO), the concessional lending arm of the IaDB that provides financing to the bank's poorer members. As of January 2004, the IaDB has identified financing for the full $1.4 billion, about $200 million from donor contributions through the HIPC Trust Fund and $1.2 billion through its own resources. Although the IaDB is able to cover its full participation in the HIPC Initiative, the institution faces about a $600 million reduction in the lending resources of its FSO lending program from 2009 through 2019 as a direct consequence of providing HIPC debt relief. According to IaDB officials, the FSO will not have enough money to lend from 2009 through 2013. To eliminate this shortfall, donor countries may be asked to provide the necessary funds through a future replenishment contribution.[12] Assuming that donor countries agree to close the financing gap, we estimate that the U.S. government could be asked to contribute about $300 million so that the FSO can continue lending to poor countries after 2008. This estimate is

[10]Most of the debt of these countries is owed to the AfDF, the concessional lending arm of the bank.

[11]According to the AfDB, the $800 million is likely to be an underestimate, given that most of the nine remaining countries are post-conflict countries that will require high levels of debt relief when the international community determines that they are ready to become eligible for HIPC debt relief.

[12]According to the IaDB's Articles of Agreement, the FSO shall be increased through additional contributions by a three-fourths majority of the total voting power of the member countries when the Board of Governors considers it advisable. No member, however, is obligated to contribute any part of such increase, although not contributing may affect a country's voting power and influence in the Bank.

based on the 50-percent rate at which the United States historically contributes to the FSO.

Financing Shortfall Is Understated

The $7.8 billion shortfall for the three MDBs is understated for two reasons. First, the estimated financing shortfall for two institutions—IDA and the AfDB—is understated because the data for four likely recipient countries—Laos, Liberia, Somalia, and Sudan—are unreliable. The World Bank considers existing estimates of the countries' total debt and outstanding arrears to be incomplete, subject to significant change, and it is uncertain when the countries will reach their decision points. Similarly, the estimated costs of debt relief for three of AfDB's countries—Liberia, Somalia, and Sudan—are likely understated due to data reliability concerns.

Second, the financing shortfall does not include any additional relief that may be provided to countries because their economies deteriorated since they originally qualified for debt relief. Under the enhanced HIPC Initiative, creditors and donors could provide countries with additional debt relief above the amounts agreed to at their decision points, referred to as "topping up." This relief could be provided when external factors, such as movements in currency exchange rates or declines in commodity prices, cause countries' economies to deteriorate, thereby affecting their ability to achieve debt sustainability. The World Bank and IMF project that seven to nine countries may be eligible for additional debt relief, and their preliminary estimates range from $877 million to about $2.3 billion, depending on whether additional bilateral relief is included or excluded from the calculation.[13] The additional cost to the U.S. government could range from $106 million to $207 million for assistance to the World Bank and AfDB, based on the U.S. historical replenishment rates to these banks.[14] Furthermore, the topping-up estimate considered only the 27

[13]Declines in discount rates and the U.S. dollar exchange rate since these preliminary cost estimates were calculated could further increase total costs. The World Bank and IMF estimate that the cost in the baseline scenario could rise to between $1.5 billion and $3.4 billion, using lower exchange and discount rates prevailing as of June 30, 2003 (end-December 2002 for those countries likely to reach completion point in 2003).

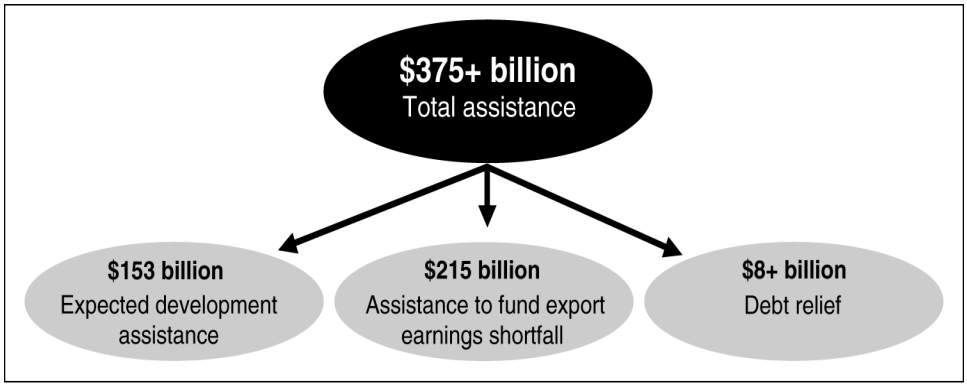
[14]Using updated exchange and discount rates, the estimated additional cost to the U.S. government could range from $179 million to $316 million for assistance to the World Bank and AfDB.

countries that have reached their decision or completion point; the estimate may rise as additional countries reach their decision points.[15]

Achieving Economic Growth and Debt Relief Targets Requires Substantial Financial Assistance

Even if the $7.8 billion shortfall is fully financed, we estimate that, if exports grow slower than the World Bank and IMF project, the 27 countries that have qualified for debt relief may need more than $375 billion in additional assistance to help them achieve their economic growth and debt relief targets through 2020. This $375 billion consists of $153 billion in expected development assistance, $215 billion in assistance to fund shortfalls from lower export earnings, and at least $8 billion for debt relief (see fig. 1). If the United States decides to help fund the $375 billion, we estimate it would cost approximately $52 billion over 18 years.

Figure 1. Estimated Cost to Achieve Economic Growth and Debt Relief Targets for 27 Countries through 2020 in 2003 Present Value Terms



Source: GAO analysis of World Bank and IMF data.

Countries Projected to Receive Development Assistance through 2020

According to our analysis of World Bank and IMF projections, the expected level of development assistance for the 27 countries is $153 billion through 2020. This estimate assumes that the countries will follow their World Bank and IMF development programs, including undertaking recommended reforms. It also assumes that countries achieve economic

[15]When IDA performed the analysis, 19 countries were between the decision and completion points, and 8 had reached their completion points for a total of 27 countries. Currently, 11 countries have reached their decision points, and 16 are between decision and completion points.

growth rates consistent with reducing poverty and maintaining long-term debt sustainability.[16] These conditions will help countries meet their development objectives, including the Millennium Development Goals that world leaders committed to in 2000. These goals include reducing poverty, hunger, illiteracy, gender inequality, child and maternal mortality, disease, and environmental degradation. Another goal calls on rich countries to build stronger partnerships for development and to relieve debt, increase aid, and give poor countries fair access to their markets and technology.

Countries Face a Substantial Financial Shortfall in Export Earnings

We estimate that 23 of the 27 HIPC countries will earn about $215 billion less from their exports than the World Bank and IMF project. The World Bank and IMF project that all 27 HIPC countries will become debt sustainable by 2020 because their exports are expected to grow at an average of 7.7 percent per year. However, as we have previously reported, the projected export growth rates are overly optimistic.[17] We estimate that export earnings are more likely to grow at the historical annual average of 3.1 percent per year—less than half the rate the World Bank and IMF project. Under lower, historical export growth rates, countries are likely to have lower export earnings and unsustainable debt levels (see table 2). We estimate the total amount of the potential export earnings shortfall over the 2003 to 2020 projection period to be $215 billion.[18]

[16]Debt sustainability under the current HIPC standard is defined as a present value external debt stock-to-export ratio less than or equal to 150 percent. The World Bank and IMF established a different debt sustainability indicator for countries with very open economies. Because these countries have a large export base compared with other measures of debt servicing capacity, the fiscal criterion of present value debt-to-fiscal revenues (250 percent) is considered a more appropriate debt sustainability measure. The four countries that qualify under this criterion are Ghana, Guyana, Honduras, and Senegal.

[17]U.S. General Accounting Office, *Developing Countries: Status of the Heavily Indebted Poor Countries Debt Relief Initiative*, GAO/NSIAD-98-229 (Washington, D.C.: Sept. 30, 1998); *Developing Countries: Debt Relief Initiative for Poor Countries Faces Challenges*, GAO/NSIAD-00-161 (Washington, D.C.: June 29, 2000); *Developing Countries: Switching Some Multilateral Loans to Grants Lessens Poor Country Debt Burdens*, GAO-02-593 (Washington, D.C.: Apr. 19, 2002); and *Developing Countries: Challenges Confronting Debt Relief and IMF Lending to Poor Countries*, GAO-01-745T (Washington, D.C.: May 15, 2001).

[18]If future export growth rates exceed historical levels, the projected export earnings shortfall would be lower. We estimate that for every percentage point increase (decrease) in export growth rates from the historical average, the export earnings shortfall would decrease (increase) by about $35 billion.

Table 2: World Bank/IMF and Historical Export Growth Rates, Debt-to-Export Ratios, and Export Earnings Shortfall

	Debt-to-export ratios in 2020 (percentage)		Export growth rates (percentage)		
	Under World Bank/IMF growth rate	Under historical growth rate[a]	World Bank/IMF (projected)	Historical (1981-2000)	Export earnings shortfall (billions of dollars)
Benin	80.6	150.9	8.3	5.1	3.7
Bolivia	122.5	225.7	7.6	4.0	13.6
Burkina Faso	118.3	477.9	9.0	1.4	4.4
Cameroon	71.1	228.5	6.3	-0.1	29.7
Chad	119.5	137.0	11.9	7.9	8.2
DRC	90.6	625.9	9.4	-3.2	21.8
Ethiopia	75.5	199.0	8.0	2.9	11.7
The Gambia	83.2	75.9	6.3	7.5	0.0
Ghana	94.5	81.1	6.6	8.0	0.0
Guinea	90.3	217.2	6.6	1.7	8.7
Guinea-Bissau	120.1	153.7	8.8	7.8	0.4
Guyana	49.8	48.7	3.7	4.2	0.0
Honduras	31.3	46.0	9.4	7.2	24.2
Madagascar	79.0	111.0	7.7	6.0	5.9
Malawi	121.6	132.5	4.8	4.3	0.4
Mali	139.7	119.0	6.3	6.9	0.0
Mauritania	82.9	236.1	6.3	1.3	3.9
Mozambique	40.6	79.7	10.3	5.2	21.1
Nicaragua	59.6	94.3	8.0	5.7	6.9
Niger	137.5	643.2	7.0	-1.6	3.8
Rwanda	131.6	1,403.7	10.7	-3.6	4.2
São Tomé and Príncipe	144.0	946.3	7.4	-4.2	0.4
Senegal	56.9	98.7	6.0	3.0	11.2
Sierra Leone	104.3	831.8	9.1	-3.4	2.9
Tanzania	117.1	149.2	7.0	6.2	5.3
Uganda	104.3	263.8	9.5	4.3	9.6
Zambia	100.7	270.3	6.6	0.6	12.3
Average	**95.1**	**298.0**	**7.7**	**3.1**	**Total 214.5**

Source: GAO analysis of IMF and World Bank debt sustainability analyses.

[a]This analysis assumes countries incur no further debt as a result of their export earnings shortfall. Under this assumption, 12 countries are projected to be sustainable: Chad, The Gambia, Ghana, Guyana, Honduras, Madagascar, Malawi, Mali, Mozambique, Nicaragua, Senegal, and Tanzania.

High export growth rates are unlikely because HIPC countries rely heavily on primary commodities such as coffee, cotton, and copper for much of their export revenue. Historically, the prices of these commodities have fluctuated, often downward, resulting in lower export earnings and worsening debt indicators. A 2003 World Bank report found that the World Bank/IMF growth assumptions had been overly optimistic and recommended more realistic economic forecasts when assessing debt sustainability.[19]

Since HIPC countries are assumed to follow their World Bank and IMF reform programs, any export shortfalls are considered to be caused by factors outside their control such as weather and natural disasters, lack of access to foreign markets, or declining commodity prices. Although failure to follow the reform program could result in the reduction or suspension of development assistance, export shortfalls due to outside factors would not be expected to have this result. Therefore, if countries are to achieve economic growth rates consistent with their development goals, donors would need to fund the $215 billion shortfall. Without this additional assistance, countries would grow more slowly, resulting in reduced imports, lower gross domestic product (GDP), and lower government revenue. These conditions could undermine progress toward poverty reduction and other goals.

Additional Assistance Will Lead to Debt Sustainability in Most Countries

Even if donors make up the export earnings shortfall, more than half of the 27 countries will experience unsustainable debt levels.[20] We estimate that these countries will require $8.5 to $19.8 billion more to achieve debt sustainability and debt-service goals.[21] After examining 40 strategies for providing debt relief, we narrowed our analysis to three specific strategies: (1) switching the minimum percentage of loans to grants for future multilateral development assistance for each country to achieve debt

[19]World Bank, Operation Evaluations Department, *The Heavily Indebted Poor Countries Debt Initiative, An OED Review*, February 20, 2003.

[20]Under historical export growth rates, countries experience unsustainable debt levels. These debt levels can be reduced regardless of whether donors address the export earnings shortfall. However, if donors do not fund the export earnings shortfall, countries will likely experience significant reductions in economic growth.

[21]This estimate assumes that donors fund the $215 billion export shortfall with grants only, as grants avoid the build up of new debt.

sustainability,[22] (2) paying debt service in excess of 5 percent of government revenue, and (3) combining strategies (1) and (2). We chose these strategies because they maximize the number of countries achieving debt sustainability while minimizing costs to donors.[23] We found that, with this debt relief, as many as 25 countries could become debt sustainable[24] and all countries would achieve a debt service-to-revenue ratio below 5 percent over the entire 18-year projection period (see table 3).

Table 3: Cost and Impact of Three Strategies for Providing Debt Relief to 27 Poor Countries

	Strategy	Cost of debt relief (billions of dollars)	Number of countries achieving debt sustainability in 2020	Number of countries paying 5 percent or less of revenue in debt service every year 2003-2020
1.	Switch the minimum percentage of loans to grants for each country to achieve debt sustainability	$8.5	25	2
2.	Pay debt service in excess of 5 percent of government revenue	$12.6	12	27
3.	Switch the minimum percentage of loans to grants and then pay debt service in excess of 5 percent of revenue	$19.8	25	27

Source: GAO analysis of World Bank and IMF data.

In the first strategy, multilateral creditors switch the minimum percentage of loans to grants for each country to achieve debt sustainability in 2020. We estimate that the additional cost of this strategy would be $8.5 billion.[25] The average percentage of loans switched to grants for all countries under

[22]Of the $153 billion in expected future development assistance, $75 billion is comprised of loans from the multilateral development banks. This strategy would switch the minimum amount of these loans to grants to achieve debt sustainability. Because these loans would raise a country's debt to an unsustainable level under historical growth rates, we consider switching them to grants to be the equivalent of debt relief.

[23]Our analysis assumes that under historical export growth rates, countries will have difficulty repaying their future debt burdens. As such, we did not take into account any reduction in future costs to bilateral donors that could arise if HIPCs were able to repay their multilateral loans.

[24]Niger and Rwanda do not achieve debt sustainability, even with 100-percent grants, because their historical export growth rates are negative and their existing debt levels are high.

[25]This cost represents loan receipts from 2003 to 2060 that are forgone after switching a percentage of new loans to grants.

this strategy would be 33.5 percent.[26] Twelve countries are projected to be debt sustainable with no further assistance. In addition, 13 countries would achieve sustainability by switching between 2 percent (Benin) and 96 percent (São Tomé and Príncipe) of new loans to grants. A total of 25 countries could be debt sustainable by 2020, although only 2 countries would achieve the 5-percent debt service-to-revenue target over the entire period.

The second strategy is aimed at reducing each country's debt-service burden. Under this strategy, donors would provide assistance to cover annual debt service above 5 percent of government revenue. We estimate that this strategy would cost an additional $12.6 billion to achieve the goal of 5-percent debt service to revenue for all countries throughout the projection period. Under this strategy, no additional countries become debt sustainable other than the 12 that are already projected to be debt sustainable with no further assistance. While this strategy would free significant resources for poverty reduction expenditures, it could provide an incentive for countries to pursue irresponsible borrowing policies. By guaranteeing that no country would have to pay more than 5 percent of its revenue in debt service, this strategy would separate the amount of a country's borrowing from the amount of its debt repayment. Consequently, it could encourage countries to borrow more than they are normally able to repay, increasing the cost to donors and reducing the resources available for other countries.

The third strategy combines strategies 1 and 2 to achieve both debt sustainability and a lower debt-service burden. Under this strategy, multilateral creditors would first switch the minimum percentage of loans to grants to achieve debt sustainability, and then donors would pay debt service in excess of 5 percent of government revenue. We estimate that this strategy would cost an additional $19.8 billion, including $8.5 billion for switching loans to grants, and $11.3 billion for reducing debt service to 5 percent of revenue. Under this strategy, 25 countries would achieve debt sustainability in 2020—that is, 13 countries in addition to the 12 that are projected to be debt sustainable with no further assistance. All 27 countries would reach the 5-percent debt-service goal for the duration of

[26]The percentage of loans switched to grants necessary to achieve debt sustainability varies by country and results in different costs and impacts for each country. For a breakdown of costs and impact by country, see U.S. General Accounting Office, *Developing Countries: Achieving Poor Countries' Economic Growth and Debt Relief Targets Faces Significant Financing Challenges*, GAO-04-405 (Washington, D.C.: Apr. 14, 2004).

the projection period. However, similar to the debt-service strategy above, this strategy dissociates borrowing from repayment and could encourage irresponsible borrowing policies.

If the United States decides to help fund the $375 billion, we estimate that it could cost approximately $52 billion over 18 years, both in bilateral grants and in contributions to multilateral development banks. This amount consists of $24 billion, which represents the U.S. share of the $153 billion in expected development assistance projected by the World Bank and IMF, as well as approximately $28 billion for the increased assistance to the 27 countries. Historically, the United States has been the largest contributor to the World Bank and IaDB, and the second largest contributor to the AfDB, providing between 11 and 50 percent of their funding. The U.S. share of bilateral assistance to the 27 countries we examined has historically been about 12 percent.

Volatility in Export Earnings Likely to Further Increase the Cost of Achieving Debt Sustainability

We also analyzed the impact of fluctuations in export growth on the likelihood of these countries achieving debt sustainability. The export earnings of HIPC countries experience large year-to-year fluctuations due to their heavy reliance on primary commodities, as well as weather extremes, natural disasters, and other factors.[27] We found that the higher a country's export volatility, the lower its likelihood of achieving debt sustainability. For example, Honduras has low export volatility, resulting in little impact on its debt sustainability. In contrast, Rwanda has very high export volatility, which greatly lowers its probability of achieving debt sustainability. Since volatility in export earnings reduces countries' likelihood of achieving debt sustainability, it is also likely to further increase donors' cost as countries may require an even greater than expected level of debt relief to achieve debt sustainability.

Mr. Chairman and Members of the Committee, this concludes my prepared statement. I will be happy to answer any questions you may have.

[27]While the previous analysis assumed constant export growth rates, consistent with the projections of the World Bank and IMF, the export earnings of HIPC countries are in fact highly volatile.

Contacts and Acknowledgments

For additional information about this testimony, please contact Thomas Melito, Acting Director, International Affairs and Trade, at (202) 512-9601 or Cheryl Goodman, Assistant Director, International Affairs and Trade, at (202) 512-6571. Other individuals who made key contributions to this testimony included Bruce Kutnick, Barbara Shields, R.G. Steinman, Ming Chen, Robert Ball, and Lynn Cothern.

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