United States General Accounting Office

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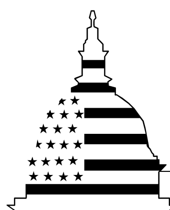
Report to Congressional Requesters

April 2004

DEVELOPING COUNTRIES

Achieving Poor Countries' Economic Growth and Debt Relief Targets Faces Significant Financing Challenges



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GAO-04-405

Highlights of GAO-04-405, a report to congressional requesters

April 2004

DEVELOPING COUNTRIES

Achieving Poor Countries' Economic Growth and Debt Relief Targets Faces Significant Financing Challenges

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).

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-04-405.

To view the full product, including the scope and methodology, click on the link above. For more information, contact Joseph A. Christoff at (202) 512-8979, or e-mail Christoffj@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 more than $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 12 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.

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Abbreviations

AfDB	African Development Bank
AfDF	African Development Fund
DSA	Debt Sustainability Analysis
FSO	Fund for Special Operations
HIPC	Heavily Indebted Poor Country
IBRD	International Bank for Reconstruction and Development
IDA	International Development Association
IaDB	Inter-American Development Bank
IMF	International Monetary Fund
MDB	Multilateral Development Banks

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

April 14, 2004

The Honorable Michael G. Oxley
Chairman
The Honorable Barney Frank
Ranking Minority Member
Committee on Financial Services
House of Representatives

The Honorable Peter T. King
Chairman
The Honorable Carolyn B. Maloney
Ranking Minority Member
Subcommittee on Domestic and International
Monetary Policy, Trade, and Technology
Committee on Financial Services
House of Representatives

The Heavily Indebted Poor Countries (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 bilateral 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 under the initiative.

[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 report 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 the data for 4 other countries are considered unreliable.

You asked us to analyze financing issues concerning this initiative as well as options for providing additional relief to help countries achieve debt targets, including debt sustainability and lower debt service burdens. In response, we assessed (1) the multilateral development banks' projected funding shortfall for the HIPC Initiative and (2) the amount of funding, including development assistance, needed to help countries achieve economic growth and debt relief targets.

The three multilateral development banks (MDB) included in our scope are the World Bank/International Development Association (IDA), the African Development Bank (AfDB)/African Development Fund, and the Inter-American Development Bank (IaDB)/Fund for Special Operations (FSO). Together 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 International Monetary Fund (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. We projected these countries' debt ratios over an 18-year period, examining the impact of realistic export growth rates, various percentages of grants, and varying amounts of debt service assistance. In addition, we analyzed the impact of fluctuations in export growth on the likelihood that these countries will achieve debt sustainability. We performed our work from June 2003 to February 2004 in accordance with generally accepted government auditing standards. (See app. I for the details of our scope and methodology and app. II for the status of each country.)

Results in Brief

The three key multilateral development banks we analyzed face a funding shortfall of $7.8 billion in present value terms, or 54 percent of their total commitment, under the existing HIPC Initiative. The World Bank and the AfDB have not determined how they would close this gap. The World Bank has by far the most significant shortfall—$6 billion. Despite significant assistance from donor governments, the African Development Bank 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 additional assistance from donors to help them achieve their economic growth and debt relief targets by 2020 in present value terms. 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. According to 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 this $375 billion, or approximately $52 billion over 18 years.

We received written comments on a draft of this report from Treasury, World Bank, AfDB, and IaDB. IaDB agreed with our report. The three other organizations said that historical export growth rates are not good predictors of the future because significant structural changes are underway 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.

Background

The World Bank and IMF have classified 42 countries as heavily indebted and poor; three quarters of these are in subSaharan 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.[3] 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.

Under the enhanced HIPC Initiative, countries seeking debt relief must first carry out economic and social reforms under specified programs. At a country's decision point, the World Bank and the IMF assess the country's eligibility to receive debt relief under the initiative. At the completion point, the World Bank and the IMF assess whether the country has continued to implement sound economic policies and is eligible to receive full debt relief. To determine the amount of assistance that is required for each country to achieve debt sustainability, the World Bank and the IMF prepare detailed economic analyses called debt sustainability analyses (DSA), which include economic projections covering 20 years. To date, 27 poor countries have reached their decision points, and 10 of these have reached completion points.[4] (See app. II for the status of each country.)

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. The United States has already paid $600 million of this total.

[3]Efforts to relieve the debt burdens of poor countries have concentrated on the external debt of these countries. Thus, debt sustainability is defined in terms of repaying debt owed to external creditors, with export earnings considered an important source of revenue for repaying this debt.

[4]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 (billion)	Financing identified (billion)	Estimated financing gap (billion)	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 IaDB 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's share of the shortfall is $6 billion, which it will begin addressing in spring 2004. The AfDB needs to secure at least $1.2 billion in additional funding. The IaDB expects to finance its $600 million shortfall by reducing future lending to poor countries.[5] Bilateral donors may be asked to contribute additional funds under the existing initiative; the United States may be called on to contribute an additional $1.8 billion.[6] However, the total projected funding gap of $7.8 billion is understated because the World Bank estimate does not include the costs for four countries that are eligible for debt relief but for which data are unreliable. In addition, the estimates of all three banks do not account for any additional relief that may be provided to countries because their economies deteriorated since they qualified for debt relief.

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. About $8.8 billion of this debt relief cost is for the highly concessional loans made by IDA, which provides financing to the World Bank's poorest member countries. The remaining $700 million in debt relief is for loans made by the International Bank for Reconstruction and Development (IBRD), which provides market-based loans to the World Bank's middle-income member countries.[7] 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.)

[5] The multilateral development banks' financing gap takes into consideration pledges from the HIPC Trust Fund. The HIPC Trust Fund was created to help multilateral creditors meet their share of debt relief cost. The Fund includes money pledged/contributed by member governments and some multilateral creditors.

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

[7] The IBRD does not expect to write off this debt. The IBRD expects the financing for debt relief on IBRD loans to come from HIPC Trust Fund resources and through new credits from IDA to certain affected countries. These HIPC Trust Fund resources and IDA credits are to be funded by resources other than transfers from IBRD's net income.

To cover this gap, we estimate that IDA's financing needs beginning in 2006 for 34 HIPCs will be about $584 million on average per year through 2020.[8] In 2002, donor countries agreed to review the financing gap during the IDA-14 replenishment discussions beginning in spring 2004.[9] 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, which is based on its historical replenishment rate of 20 percent to IDA.[10]

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.[11] Similarly, the U.S.'s potential share decreases by the same percentage, from $1.2 billion to about $700 million.[12] However, transferring more of IBRD's net income to HIPC debt relief could come at the expense of other IBRD priorities. For example, a portion of its net income is retained annually to ensure IBRD's financial integrity. IBRD has also provided substantial resources to IDA for its new lending, representing about 24 percent of its net income over the last 5 years. Moreover, countries that borrow from IBRD have also benefited because this net income provides partial waivers of the interest and commitment fees IBRD charges on its loans.

[8]This is a nominal dollar estimate.

[9]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.

[10]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.

[11]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 through 2035.

[12]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.: January 24, 2003) for a discussion of implicit exposures.

AfDB Has a Financing Gap of at Least $1 Billion

The total cost of debt relief to the AfDB for its 32 member countries is estimated at about $3.5 billion (see table 1).[13] 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.

Taking into account the total funds the AfDB has identified thus far from the HIPC Trust Fund, its internal resources, and its annual cash flow projections, AfDB estimates that it would have sufficient funds to cover its share of HIPC commitment to its 23 current decision and completion point countries up to 2007.[14] 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.[15]

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. First, assuming that the United States contributes at its historical replenishment rate of 11 percent, we estimate the U.S. share of AfDB's financing shortfall could be at least $132 million.[16] However, as of October 2002, the United States had contributed or pledged approximately 29 percent of the bilateral donors' resources committed to the HIPC Trust Fund. Under that contribution rate, the U.S. share of the AfDB's financing shortfall would be about $348 million.

[13]Most of the debt of these countries is owed to the African Development Fund, the concessional lending arm of the bank.

[14]AfDB's annual cash flow projection covers the period 2000 through 2038.

[15]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.

[16]According to AfDB's Articles of Agreement, the authorized capital stock of the AfDB may be increased when the Board of Governors deems it advisable. The decision of the board is adopted by a two-thirds majority of the total number of governors, representing not less than three-quarters of the total voting power of the members. No member is obligated to subscribe to any part of a capital stock increase, but not participating in an increase could affect a country's voting power and influence in AfDB.

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 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 lending resources in its FSO lending program for the years 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 for the years 2009 through 2013. To eliminate this shortfall, donor countries may be asked to provide the necessary funds through a future replenishment contribution.[17] 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 based on the 50-percent rate at which the U.S. historically contributes to the FSO.

Financing Shortfall Is Understated

The $7.8 billion shortfall for the three MDBs is understated for two reasons. First, data for four eligible countries are unreliable. 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. The World Bank and IMF estimate that this additional relief could range from $877 million to $2.3 billion.

Four Countries' Data Are Unreliable

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

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

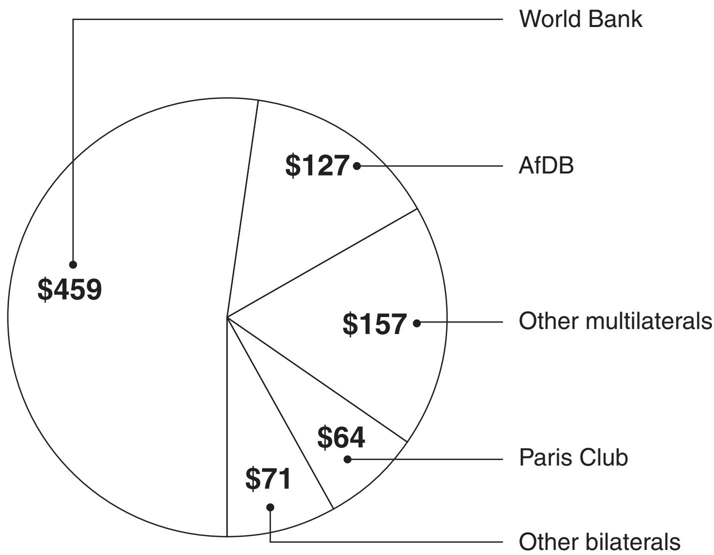
debt relief for three of AfDB's countries—Liberia, Somalia, and Sudan—are likely understated due to data reliability concerns.

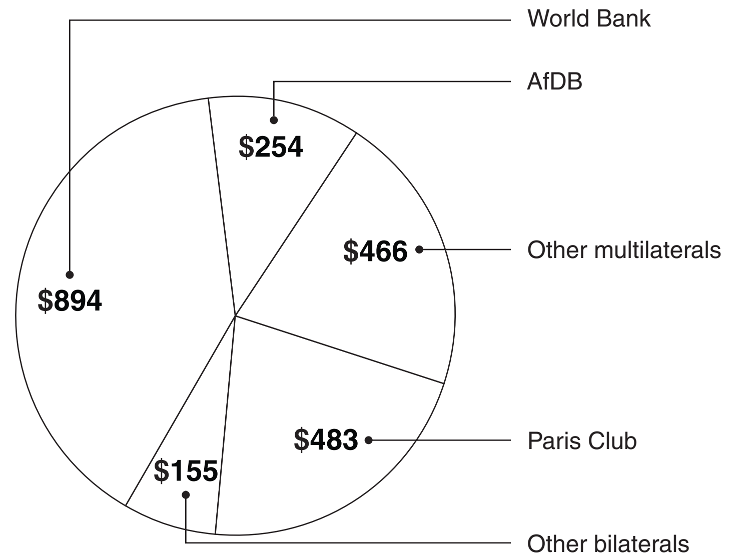
Additional Relief at Countries' Completion Points Poses Additional Costs to MDBs and Donor Governments

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.[18] Our estimate of the likely funding shortfalls confronting the MDBs, discussed above, does not account for this potential additional debt relief. The World Bank and IMF made a preliminary estimate that this additional relief could cost from $877 million to about $2.3 billion, depending on whether additional bilateral relief is included or excluded from the calculation. (See fig. 1.)

[18]The current HIPC framework allows for topping up of relief only in exceptional cases where a country's debt ratios have worsened as a result of exogenous shocks, leading to a fundamental change in its economic circumstances.

Figure 1: Potential Cost of Topping-up Assistance by Creditor (millions of dollars)





Source: World Bank and IMF estimates based on data in their latest debt sustainability analyses, August 2003.

Note: The Paris Club is a group of bilateral creditor countries that meets to negotiate sovereign debt rescheduling and debt relief. Commercial creditors' costs are grouped with other bilaterals and account for about 10 percent of this subgroup's costs.

Furthermore, the topping-up estimate considered only the 27 countries that have reached their decision or completion point; the estimate may rise as additional countries reach their decision points.

Donor countries currently disagree on whether bilateral debt relief provided outside the HIPC framework should be counted as part of the debt relief needed for countries to achieve their debt sustainability targets. Donors that support including additional bilateral relief in topping-up calculations would benefit through lower additional costs. For instance, most Paris Club countries would not have additional costs for relieving their bilateral debt because they have already pledged 100-percent debt relief,[19] but they could be asked to fund the multilateral creditors' debt relief. In contrast, if additional bilateral relief were excluded from topping-up calculations, creditors' HIPC costs would increase substantially. In this case, Paris Club creditors would be faced with higher HIPC bilateral costs, as well as potential contributions to cover higher multilateral creditors' costs. Donors that support this method intend to provide HIPCs with a cushion against external shocks by ensuring that additional bilateral relief results in debt ratios below the targets.

Using the lower cost methodology and limiting the analysis to the countries that have qualified but have yet to receive final debt relief,[20] the World Bank and the IMF project that at their completion points seven countries would exceed the debt-to-export ratio calculated at their decision points.[21] In addition, if the lower cost methodology were to consider countries that have already reached their completion points and received topping up, the total estimate would increase to about $877 million. The World Bank's share would be $459 million, and the AfDB's share would be $127 million. (See fig. 1.)

[19]Under the first methodology, the current bilateral cost is associated with Russia and non-Paris Club bilateral and commercial creditors, which did not provide additional bilateral assistance above the enhanced HIPC agreement.

[20]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, 10 countries have reached their decision points, and 17 are between decision and completion points.

[21]The seven countries are Chad, Ethiopia, Malawi, Niger, Rwanda, The Gambia, and São Tomé and Príncipe.

If the additional bilateral relief is excluded from the topping up calculation, as some donor countries advocate, the amount of additional debt relief increases from $877 million to $2.3 billion, including the cost for countries that have already reached their completion points.[22] Under this methodology, the cost to the World Bank and AfDB for topping-up would approximately double.[23] (See fig. 1.) Depending on the method used to calculate topping up, 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.[24]

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. 2). If the United States decides to help fund the $375 billion, we estimate it would cost approximately $52 billion over 18 years.

[22]This figure includes $149 million for Burkina Faso and Benin under methodology I and $326 million for Benin, Burkina Faso, and Mauritania under methodology II. Burkina Faso has already received topping up of $129 million, and the IMF and World Bank boards decided in March 2003 that Benin did not qualify for topping up at its completion point. According to the World Bank and IMF, the estimates for these countries are provided for information purposes and do not necessarily imply that methodology II would be applied retroactively.

[23]Declines in discount rates and the U.S. dollar exchange rate since these preliminary cost estimates were calculated could increase total costs. The World Bank and IMF estimate that the cost in the baseline scenario could rise to about $1.5 billion under methodology I and about $3.4 billion under methodology II, 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). For example, methodology I estimates of topping up costs for Ethiopia increased from $334 million to $618 million, and from $71 million to $103 million for Niger.

[24]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.

Figure 2: 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, bilateral donors and multilateral creditors are expected to provide $153 billion in development assistance to 27 HIPCs from 2003 to 2020. These estimates assume that the countries will follow their World Bank and IMF development programs, including undertaking recommended reforms and achieving economic growth rates consistent with reducing poverty and maintaining long-term debt sustainability.[25] 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.

[25]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.

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 if their exports grow at an average of 7.7 percent each year, they receive debt relief under the HIPC Initiative, and donors provide their expected assistance. However, as we have previously reported, the projected export growth rates are overly optimistic.[26] We estimate that export earnings are more likely to grow at the historical annual average of 3.1 percent—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.[27]

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

[27]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.[28]

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. For countries to achieve the economic growth rates consistent with their development goals, donors would need to fund the $215 billion shortfall. Without this additional assistance, countries would grow slower, 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.[29] We estimate that these countries will require $8.5 to $19.8 billion more to achieve debt sustainability and debt service goals.[30] In considering strategies for future debt relief, we examined (1) switching various percentages of multilateral loans to grants and (2) paying each country's debt service-to-fiscal revenue ratio in excess of 5 percent of government revenue. A country's debt service-to-fiscal revenue ratio more closely links the country's debt burden to the ability of the public sector to generate income. Many HIPC countries

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

[29]Under historical export growth rates, more than half of the 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.

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

are suffering public health crises, most notably HIV/AIDS, which could put an additional burden on government revenue.

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 sustainability,[31] (2) paying debt service in excess of 5 percent of government revenue, and (3) combining strategies (1) and (2).[32] We chose these strategies because they maximize the number of countries achieving debt sustainability while minimizing costs to donors.[33] We found that, with this debt relief, as many as 25 countries could become debt sustainable[34] and all countries achieve a debt service-to-revenue ratio below 5 percent over the entire 18-year projection period (see table 3).

[31]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 to debt relief.

[32]See appendix IV for a more detailed discussion of the different strategies examined.

[33]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.

[34]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.

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.[35] The average percentage of loans switched to grants for all countries under this strategy would be 33.5 percent.[36] 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 (see table 4). 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.

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

[36]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 appendix IV.

Table 4: Percentage of Loans Switched to Grants to Achieve Debt Sustainability[a]

Country	Loans switched to grants (percentage)
Benin	1.7
Bolivia	32.7
Burkina Faso	86.9
Cameroon	42.7
Chad	0.0
Congo (Dem. Rep.)	89.0
Ethiopia	42.4
The Gambia	0.0
Ghana	0.0
Guinea	39.5
Guinea-Bissau	3.3
Guyana	0.0
Honduras	0.0
Madagascar	0.0
Malawi	0.0
Mali	0.0
Mauritania	57.3
Mozambique	0.0
Nicaragua	0.0
Niger[b]	100.0
Rwanda[b]	100.0
São Tomé and Príncipe	95.9
Senegal	0.0
Sierra Leone	93.6
Tanzania	0.0
Uganda	57.1
Zambia	61.3
Average	**33.5**

Source: GAO analysis of World Bank and IMF data.

[a]This assumes countries receive grants to fund their export shortfall.

[b]Niger and Rwanda do not achieve debt sustainability, even with 100-percent grants.

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

Potential U.S. Costs Are Significant

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 billon 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

The export earnings of HIPC countries experience large year-to-year fluctuations due to their heavy reliance on primary commodities, weather extremes, natural disasters, and other factors.[37] 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. See appendix VI for a detailed discussion of the impact of fluctuations in export earnings on debt sustainability.

Agency Comments and Our Evaluation

We received written comments on a draft of this report from the Department of the Treasury, the World Bank, AfDB, and IaDB. These comments and our evaluation of them are reprinted in appendixes VI, VII, VIII, and IX. The organizations also provided technical comments that we discussed with relevant officials and have included in this report where appropriate.

The Treasury stated that the report leaves the impression that very large amounts of money will be needed in the future; the HIPC Trust Fund has a financing gap; and the HIPC Initiative was never intended to ensure an exit from unsustainable debt burdens. We agree that the challenge of achieving high economic growth rates, while maintaining debt sustainability, will likely require a substantial commitment of resources from the donors beyond what the World Bank and IMF project. Our report refers to financing challenges over the life of the initiative, not specifically to the HIPC Trust Fund at this point in time. Under the current pay-as-you-go approach, we did not identify a gap in the HIPC Trust Fund. However, as Treasury recognized in its letter, there are several factors that are likely to result in the need for additional resources in the future. Our report provides estimates of those and other emerging costs. Numerous official World Bank and IMF documents, as recent as 2003, affirm that a permanent, lasting, or durable exit from unsustainable debt remains a

[37]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.

central objective of the HIPC Initiative. While the Treasury may have retreated from this objective, the World Bank and IMF have not.

The World Bank disagreed with the assumption that deviations from projected debt profiles would be offset only through additional debt relief or compensatory financing, and not through other forms of adjustments. We disagree with this characterization. The report explicitly states that donors have the option of not financing the export shortfalls, however, this will reduce the funds available for poverty reduction and hamper countries' economic growth. The World Bank concurred with our finding that long-term projections of export growth rates need to be more realistic and the report's emphasis on pursuing a sustainable development finance strategy for countries that have received debt relief.

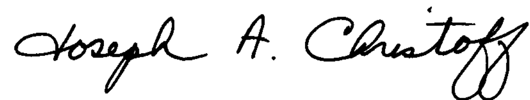
AfDB said that our estimate of the financing shortfall for the 23 countries that have already qualified for debt relief is overstated. We disagree with this assessment. We consider our estimate to be more accurate because it accounts for the actual amount of resources the AfDB has identified to contribute to the initiative and converts the estimate into 2003 dollars. The AfDB also said that our finding that countries are likely to need considerable assistance in the future to meet their debt relief and economic growth targets is likely to be correct.

All three institutions said that our use of historical export growth rates are not good predictors of the future because significant structural changes are underway 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.

IaDB agreed with our report.

As agreed with your office, unless you publicly announce the contents of this report earlier, we plan no further distribution until 30 days from the report date. At that time, we will send copies of this report to the Honorable John Snow, Secretary of the Treasury, and to appropriate congressional committees. We are also sending copies to the World Bank, AfDB, IaDB, and IMF. Copies will be made available to others upon request and at no charge on the GAO Web site at http://www.gao.gov.

If you or your staff have any questions regarding this report, please contact me on (202) 512-8979. Other GAO contacts and staff are acknowledged in appendix X.



Joseph A. Christoff, Director
International Affairs and Trade

Objectives, Scope, and Methodology

The Chairman and Ranking Member of the House Financial Services Committee and the Chairman and Ranking Member of the Subcommittee on Domestic and International Monetary Policy, Trade, and Technology of the House Financial Services Committee asked us to conduct a review of the Heavily Indebted Poor Countries (HIPC) Initiative. In response, we assessed (1) the multilateral development banks' 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. The scope of our work involved three key multilateral development banks (MDB)—the World Bank/International Development Association (IDA), African Development Bank (AfDB)/African Development Fund (AfDF), and the Inter-American Development Bank (IaDB)/Fund for Special Operations (FSO), as well as the 42 potentially eligible HIPCs.[1] (See app. II for the status of the 42 countries potentially eligible for HIPC and their membership in the MDBs.)

Methodology for Assessing the Financing Shortfall of the Existing Initiative

To determine the MDBs' financing shortfall in present value terms, we analyzed each bank's cost and the total funding each institution has identified. This analysis covered 34 countries for the World Bank, 32 for the AfDB, and 4 for the IaDB. To determine the amount of debt relief each bank has committed to under the initiative, we reviewed documents prepared by the World Bank, AfDB, IaDB, and the International Monetary Fund (IMF).[2] To determine the amount of internal and external resources available for each bank, we reviewed their implementation status reports and financial statements. This information included the amount of money that each MDB has already received or expects to receive from the HIPC Trust Fund. We also determined the amount of funds each bank currently has and expects to receive annually to calculate the present value of these commitments. This analysis also enabled us to determine the magnitude and timing of financing shortfalls for the three banks. To determine the amount of financing the U.S. government may be asked to pay for the MDBs' financing shortfall, we obtained and reviewed information from U.S. Treasury

[1]Yemen, Angola, Kenya, and Vietnam are not included in our analysis because they are not expected to qualify for the HIPC Initiative. The World Bank and IMF expect the countries' debt level to be sustainable after they receive traditional debt relief.

[2]*Heavily Indebted Poor Countries Initiative – Status of Implementation*, IMF and World Bank, (Washington, D.C.: September 12, 2003); from AfDB-List of Countries Approved by the African Development Bank Group's Boards Under the Enhanced HIPC Initiative; from IaDB-Enhanced HIPC Debt Relief Profile for Bolivia, Honduras, Guyana, and Nicaragua.

officials regarding the U.S.'s historical rates of replenishment for each MDB, as well as the amount of funds the U.S. government has provided and plans to provide to each bank through the HIPC Trust Fund. We discussed our analysis with officials from the three banks and the U.S. Treasury.

Methodology for Assessing the Amount of Funding Needed to Achieve Targets

General Approach

We analyzed World Bank and IMF staff projections contained within the debt sustainability analyses (DSA) to assess the impact of historical export growth rates[3] on countries' debt burdens and the funding needed to achieve economic growth and debt relief targets for the 27 countries that have reached their decision or completion points.[4] According to our analysis of the DSAs, the World Bank and IMF project these countries will receive $153 billion in development assistance through 2020. Our analysis builds on prior work that examined the HIPC Initiative, including the World Bank and IMF DSAs.[5] The DSAs contain 20-year economic projections for each country's exports, national income, government revenue, debt stock, debt service, and other economic variables. Most countries' DSAs also provide projections of expected future loans, grants, and balance of payment gaps. These projections provided us with the basis for creating a database to assess the impact of changing key assumptions such as export growth rates, percentage of multilateral assistance in the form of grants, and debt service assistance payments on countries' debt targets.

[3]For most countries, historical export growth rates are lower than the DSA projections.

[4]While 42 countries are potentially eligible for assistance under the HIPC Initiative, only 27 countries thus far have qualified for debt relief.

[5]See U.S. General Accounting Office, *Debt Relief Initiative for Poor Countries Faces Challenges*, GAO/NSIAD-00-161 (Washington, D.C.: June 29, 2000) and *Switching Some Multilateral Loans to Grants Lessens Poor Country Debt Burdens*, GAO-02-593 (Washington, D.C.: April 19, 2002).

While the countries' DSAs are publicly available, data inconsistencies among countries, gaps in information, and missing variables presented challenges in constructing a database for our analyses. Since few DSAs provided annual data for the entire 20-year projection period, and several DSAs were missing key economic variables,[6] we used a variety of methodologies and statistical techniques to interpolate these missing data and compute missing variables. Consistent with the World Bank and IMF estimates, our analysis used the December 2002 Commercial Interest Reference Rate (CIRR) for the Special Drawing Rights (SDR).[7] We reviewed the underlying methodology of the DSAs, vetted key assumptions, and discussed country-specific questions with IMF staff. We supplemented our analysis with additional information from IMF, World Bank, AfDB, and IaDB officials.

Assessing the Impact of Lower Export Growth

To illustrate the impact of lower export growth on the cost to donors and on countries' debt burdens, we substituted each country's DSA export growth rate with its historical growth rate. The difference between the export earnings projected in the DSA and the export earnings projected using the historical rates is defined as the export earnings shortfall. In order to keep countries on their projected gross domestic product growth paths, we assume that donors will need to make up this shortfall. The present value of this shortfall for these 27 countries is $215 billion. We also analyzed how the form of financing the shortfall impacts countries' debt burdens. If the shortfall is made up by grants only, each country's debt remains the same. However, the countries' debt-to-export ratios will increase due to lower export earnings. If the shortfall is made up by a mix of grants and loans,[8] countries' debt will increase. To determine the countries' new debt burden, we calculated the debt service and the net present value of the debt from these new loans.

[6]Key economic variables such as IMF purchases, loan disbursements, grants, or additional finance were not provided or could be deduced only by making reasonable assumptions. For example, while most countries' DSAs contained a balance of payments table indicating official grants and loans, Mauritania had no balance of payments table and Rwanda's did not have official grant and loan information.

[7]The SDR is a unit of account of the IMF. It is comprised of a weighted average of the values of four currencies: the U.S. dollar, yen, euros, and pound sterling.

[8]We assume the same loans-to-grants ratio as indicated in each country's DSA.

Assessing 40 Strategies for Increasing Debt Relief

To determine the amount of funding needed to achieve debt relief targets under projected and historical growth rates, we analyzed 40 different strategies for providing debt relief. These strategies included financing the export earnings shortfalls with grants only or a combination of loans and grants, switching the minimal percentage of loans to grants for each country to achieve debt targets, switching a constant percentage of loans to grants for all countries, and paying debt service in excess of 5 percent of government revenue. For each of these strategies, we calculated the potential costs to donors to help countries achieve the debt targets. These costs include foregone MDB loan receipts from switching baseline DSA loans to grants and the debt service assistance needed to achieve the 5 percent debt service-to-revenue target. Finally, we compared the results of the various strategies, highlighting those strategies that maximized the number of countries achieving debt targets while minimizing costs to donors.

Assessing the Impact of Export Volatility

To assess how export volatility would affect the likelihood of achieving debt sustainability we used a Monte Carlo process that randomly drew 18,000 export growth rates (for each of 1,000 runs, 18 simultaneous draws, one for each year) from a distribution that reflects the historic growth volatility of each country. The distribution was based on the annual export growth rates from 1981 to 2000 for each country. In our Monte Carlo process, the 18 growth intervals of each country were assigned an equal probability of reoccurrence in the future. Projected export levels were then extrapolated with the growth rates randomly drawn from the country's export growth distribution. To ensure that positive and negative growth rates were treated the same (or with equal weight) we incorporated growth rates into our model in a multiplicative fashion rather than in an additive form. The probability of achieving debt sustainability in 2020 was determined by the percentage of outcomes in 2020 with a debt-to-export ratio below 150 percent.

Methodology for Assessing Data Reliability

We used three key variables—debt stock, historical rates of export growth, and MDBs funding sources—to assess both objectives. To assess the reliability of the debt stock data, we (1) discussed the data with the IMF and (2) reviewed their accounting process to determine outstanding country debt. Every alleged debt is vetted by both the country and the creditor and then independently reviewed by the IMF and the World Bank on behalf of the Paris Club. As we found this process to be rigorous, we determined that the debt stock data are sufficiently reliable for the purposes of our engagement. To assess the reliability of the historical rates of export growth, we reviewed the IMF and World Bank's published

documentation and records from our prior work that utilized these data. While these data have a number of limitations due to differences in data collection procedures in the 27 countries we reviewed, they are (1) used by the IMF to determine debt relief; (2) widely used by other acknowledged experts in this area; and (3) the only source of available data. Therefore, we determined that they are sufficiently reliable to use for examining the impact of debt relief on countries' debt sustainability. To assess the reliability of the internal and external funding sources of the three MDBs, we (1) reviewed their debt relief financing plans; (2) reviewed the audited financial statements of the HIPC Trust Fund; and (3) corroborated the funding sources through interviews with knowledgeable MDB staff in budget, accounting, and finance. We determined the funding sources were sufficiently reliable for the purposes of this review.

We performed our work from June 2003 to February 2004 in accordance with generally accepted government auditing standards.

Status of HIPCs and Their Membership in Three Multilateral Development Banks

Forty-two countries are potentially eligible to receive debt relief under the existing enhanced HIPC Initiative. Since the enhanced initiative was launched in 1999, 10 countries have reached their completion points, meaning that the World Bank and IMF have determined that the countries have completed HIPC and are eligible to receive full debt relief. Seventeen are currently at their decision points, meaning the World Bank and IMF have determined they are eligible to receive debt relief under the initiative (see table 5).

Table 5: Countries' Membership in Key Multilateral Development Banks

	World Bank/IDA	AfDB	IaDB
Completion point countries (10)			
Benin	X	X	
Bolivia	X		X
Burkina Faso	X	X	
Guyana	X		X
Mali	X	X	
Mauritania	X	X	
Mozambique	X	X	
Nicaragua	X		X
Tanzania	X	X	
Uganda	X	X	
Decision point countries (17)			
Cameroon	X	X	
Chad	X	X	
Congo (Dem. Rep.)	X	X	
Ethiopia	X	X	
The Gambia	X	X	
Ghana	X	X	
Guinea	X	X	
Guinea-Bissau	X	X	
Honduras	X		X
Madagascar	X	X	
Malawi	X	X	
Niger	X	X	
Rwanda	X	X	
São Tomé and Príncipe	X	X	

(Continued From Previous Page)

	World Bank/IDA	AfDB	IaDB
Senegal	X	X	
Sierra Leone	X	X	
Countries still to be considered (11)			
Burundi	X	X	
Central African Republic	X	X	
Comoros	X	X	
Congo (Rep. of)	X	X	
Cote d'Ivoire	X	X	
Lao People's Democratic Republic	X		
Liberia	X	X	
Myanmar	X		
Somalia	X	X	
Sudan	X	X	
Togo	X	X	
Potentially debt-sustainable countries (4)			
Angola	X	X	
Kenya	X	X	
Vietnam	X		
Yemen, Republic of	X		
Total	**42**	**34**	**4**

Source: IMF and International Development Association.

Alternative Strategies for Providing Debt Relief to Poor Countries

We analyzed 40 strategies for providing debt relief to poor countries. We highlighted three of these strategies in this report because we found they were the most cost effective. This appendix discusses some of the other strategies we analyzed and shows why they are less cost effective. These strategies included using a combination of multilateral loans and bilateral grants to fill the export shortfall and switching a constant percentage of loans to grants for all countries. In each case, donors face a series of costs, including $153 billion in expected development assistance, $215 billion to cover lower export earnings, and between $0 and $29.1 billion in debt relief.

Using a Combination of Loans and Grants to Fill the Export Shortfall

If donors choose to fill the $215 billion export shortfall with a combination of loans and grants, rather than grants alone, we found that countries will need $15.3 billion to $27.8 billion to achieve debt sustainability and debt-service goals (see table 6). If donors provide grants alone, we estimate that 12 of 27 countries would achieve debt sustainability, while only 6 would achieve sustainability if donors used a combination of loans and grants. We also found that the optimal percentage of loans switched to grants necessary for each country to achieve debt sustainability increases from 33.5 percent when grants fill the shortfall to 55.6 percent when loans and grants fill the shortfall, thus increasing the cost to donors. Providing grants alone is more cost effective because it avoids the build up of debt, improving countries' likelihood of achieving debt sustainability and reducing the need for more debt relief in the future. The range in total cost of debt relief reflects the variation in additional costs, from $8.5 billion to $27.8 billion, in addition to the $153 billion in expected baseline development assistance donors provide and the $215 billion needed to cover the shortfall in countries' export earnings.

Table 6: Cost and Impact of Three Strategies for Providing Debt Relief to 27 Poor Countries (Grants and Loans Fill the Export Shortfall)

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
Switch the minimum percentage of loans to grants for each country to achieve debt sustainability	$15.3	25	2
Pay debt service in excess of 5 percent of government revenue	$19.5	6	27
Switch the minimum percentage of loans to grants and then pay debt service in excess of 5 percent of revenue	$27.8	25	27

Source: GAO analysis of World Bank and IMF data.

Switching a Constant Percentage of Loans to Grants for All Countries

The strategies we examined in this report determined the minimum percentage of grants necessary for each country to achieve debt sustainability and resulted in a different percentage of grants for each country. While the provision of a consistent percentage of grants to each country may be the most equitable, we found that it would not be as cost effective as tailoring the percentage of grants to each country since some countries would not receive enough grants to achieve debt sustainability, while others would receive more than was required. For example, we estimate that switching 50 percent of new loans to grants would result in seven fewer countries achieving debt sustainability than would providing the minimum percentage of grants. Switching 50 percent of new loans to grants would cost over $6 billion more (see table 7). These options, therefore, are not the most cost-effective means of maximizing debt sustainability.

Table 7: Cost and Impact of Switching a Constant Percentage of Loans to Grants

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 (2003-2020)
Switch 0 percent of loans to grants	$0.0	12	2
Switch 20 percent of loans to grants	$5.8	14	2
Switch 50 percent of loans to grants	$14.6	18	2
Switch 100 percent of loans to grants	$29.1	25	2
Switch the minimum percentage of loans to grants for each country to achieve debt sustainability	$8.5	25	2

Source: GAO analysis of World Bank and IMF data.

In addition to the strategies mentioned in the report, you asked us to analyze the cost and impact of four specific options for increasing debt relief to poor countries. These options included switching 20 or 50 percent of loans to grants and reducing each country's debt-service burden to 5 or 10 percent of revenue. With 20-percent grants, we estimate that 14 countries would achieve debt sustainability, while 18 would do so with 50-percent grants (see table 8). In each option, all countries would also reach the 5- or 10-percent debt service goal, as specified. The cost of these options ranges from $7.6 billion to $24.5 billion, in addition to assistance to fund the export shortfall. Consistent with the previous analysis, these options resulted in higher costs and/or fewer countries achieving debt sustainability.

Table 8: Cost and Impact of Four Options Requested by Congress for Increasing Debt Relief to 27 Poor Countries

Options	Cost of debt relief (billions of dollars)	Number of countries reaching debt sustainability in 2020	Number of countries achieving debt service goal
Switch 20 percent of new loans to grants and reduce debt service to 5 percent of government revenue	$17.3	14	27
Switch 20 percent of new loans to grants and reduce debt service to 10 percent of government revenue	$7.6	14	27
Switch 50 percent of new loans to grants and reduce debt service to 5 percent of government revenue	$24.5	18	27
Switch 50 percent of new loans to grants and reduce debt service to 10 percent of government revenue	$16.0	18	27

Source: GAO analysis of World Bank and IMF data.

Costs and Impact of Various Strategies for Providing Debt Relief

As described earlier in this report, we focused our analysis on three specific strategies for providing debt relief. The cost of these three strategies varies by country, as does their impact. Tables 9 to 11 below summarize these results.

Table 9: Cost and Impact of Strategy 1: Switching the Minimum Percentage of Loans to Grants for Each Country to Achieve Debt Sustainability in 2020

Country	Future loans switched to grants (percentage)	Cost of debt relief (millions of dollars)	Total cost, including export shortfall (millions of dollars)	NPV debt-to-exports in 2020 (percentage)	Average debt service-to-revenue, 2003-2020 (percentage)
Benin	1.7%	$8.8	**$3,712.3**	150.0%	4.7%
Bolivia	32.7	830.3	**14,422.0**	150.0	9.4
Burkina Faso	86.9	615.5	**5,065.4**	150.0	5.3
Cameroon	42.7	1,196.4	**30,936.4**	150.0	6.3
Chad	0.0	0.0	**8,236.7**	137.0	8.1
DRC	89.0	1,755.3	**23,539.5**	150.0	12.6
Ethiopia	42.4	436.6	**12,133.7**	150.0	2.3
The Gambia	0.0	0.0	**0.0**	75.9	11.8
Ghana	0.0	0.0	**46.8**	81.1	10.8
Guinea	39.5	456.0	**9,123.6**	150.0	7.1
Guinea-Bissau	3.3	6.0	**433.8**	150.0	8.5
Guyana	0.0	0.0	**30.6**	48.7	9.5
Honduras	0.0	0.0	**24,241.3**	41.3	8.5
Madagascar	0.0	0.0	**5,889.4**	111.0	6.2
Malawi	0.0	0.0	**444.4**	132.5	4.1
Mali	0.0	0.0	**0.0**	119.0	7.5
Mauritania	57.3	222.2	**4,099.7**	150.0	8.3
Mozambique	0.0	0.0	**21,131.8**	79.7	7.5
Nicaragua	0.0	0.0	**6,914.7**	94.3	7.7
Niger	100.0	544.3	**4,314.9**	179.1	3.3
Rwanda	100.0	392.0	**4,640.2**	516.4	2.1
São Tomé and Príncipe	95.9	43.9	**397.1**	150.0	5.6
Senegal	0.0	0.0	**11,177.6**	98.7	7.9
Sierra Leone	93.6	244.1	**3,149.1**	150.0	6.5
Tanzania	0.0	0.0	**5,295.5**	149.2	5.2
Uganda	57.1	872.2	**10,473.6**	150.0	5.5
Zambia	61.3	839.1	**13,138.0**	150.0	8.2
Average/Total	**33.5%**	**$8,462.7**	**$222,988.0**	**141.3%**	**7.1%**

Source: GAO analysis of World Bank and IMF data.

Table 10: Cost and Impact of Strategy 2: Paying Debt Service Over 5 Percent of Government Revenue

Country	Cost of debt relief (millions of dollars)	Total cost, including export shortfall (millions of dollars)	NPV debt-to-exports in 2020 (percentage)	Average debt service-to-revenue, 2003-2020 (percentage)
Benin	$10.5	**$3,714.0**	150.9%	4.6%
Bolivia	2,507.1	**16,098.8**	225.7	5.0
Burkina Faso	172.2	**4,622.1**	477.9	5.0
Cameroon	818.4	**30,558.3**	228.5	4.9
Chad	182.6	**8,419.3**	137.0	5.0
DRC	1,268.0	**23,052.2**	625.9	5.0
Ethiopia	0.0	**11,697.2**	199.0	2.5
The Gambia	125.8	**125.8**	75.9	5.0
Ghana	1,622.4	**1,669.1**	81.1	5.0
Guinea	337.3	**9,004.9**	217.2	5.0
Guinea-Bissau	55.5	**483.3**	153.7	5.0
Guyana	247.8	**278.4**	48.7	5.0
Honduras	1,735.7	**25,977.0**	46.0	5.0
Madagascar	213.7	**6,103.2**	111.0	4.9
Malawi	11.6	**456.0**	132.5	4.0
Mali	394.7	**394.7**	119.0	5.0
Mauritania	241.2	**4,118.7**	236.1	5.0
Mozambique	348.1	**21,479.9**	79.7	5.0
Nicaragua	474.5	**7,389.2**	94.3	5.0
Niger	52.8	**3,823.4**	643.2	4.5
Rwanda	0.0	**4,248.2**	1,403.7	3.6
São Tomé and Príncipe	14.5	**367.6**	946.3	5.0
Senegal	623.9	**11,801.5**	98.7	5.0
Sierra Leone	117.4	**3,022.4**	831.8	4.9
Tanzania	164.0	**5,459.6**	149.2	4.6
Uganda	228.1	**9,829.4**	263.8	5.0
Zambia	616.4	**12,915.3**	270.3	5.0
Average/Total	**$12,584.1**	**$227,109.4**	**298.0%**	**4.8%**

Source: GAO analysis of World Bank and IMF data.

Table 11: Cost and Impact of Strategy 3: Switching Loans to Grants to Maximize Debt Sustainability and Paying Debt Service in Excess of 5 Percent of Government Revenue

Country	Cost of debt relief (millions of dollars)	Total cost, including export shortfall (millions of dollars)	NPV debt-to-exports in 2020 (percentage)	Average debt service-to-revenue, 2003-2020 (percentage)
Benin	$19.0	**$3,722.5**	150.0%	4.6%
Bolivia	3,125.5	**16,717.2**	150.0	5.0
Burkina Faso	658.2	**5,108.1**	150.0	4.8
Cameroon	1,905.6	**31,645.5**	150.0	4.7
Chad	182.6	**8,419.3**	137.0	5.0
DRC	2,622.3	**24,406.5**	150.0	4.8
Ethiopia	436.6	**12,133.7**	150.0	2.3
The Gambia	125.8	**125.8**	75.9	5.0
Ghana	1,622.4	**1,669.1**	81.1	5.0
Guinea	725.6	**9,393.2**	150.0	4.8
Guinea-Bissau	60.1	**487.9**	150.0	5.0
Guyana	247.8	**278.4**	48.7	5.0
Honduras	1,735.7	**25,977.0**	41.3	5.0
Madagascar	213.7	**6,103.2**	111.0	4.9
Malawi	11.6	**456.0**	132.5	4.0
Mali	394.7	**394.7**	119.0	5.0
Mauritania	393.7	**4,271.2**	150.0	5.0
Mozambique	348.1	**21,479.9**	79.7	5.0
Nicaragua	474.5	**7,389.2**	94.3	5.0
Niger	576.7	**4,347.3**	179.1	2.6
Rwanda	392.0	**4,640.2**	516.4	2.1
São Tomé and Príncipe	49.7	**402.8**	150.0	3.7
Senegal	623.9	**11,801.5**	98.7	5.0
Sierra Leone	326.3	**3,231.3**	150.0	3.6
Tanzania	164.0	**5,459.6**	149.2	4.6
Uganda	1,031.2	**10,632.5**	150.0	4.5
Zambia	1,331.8	**13,630.7**	150.0	4.5
Average/Total	**$19,798.9**	**$234.324.2**	**141.3%**	**4.5%**

Source: GAO analysis of World Bank and IMF data.

How Volatility in Export Earnings Affects the Likelihood that Countries Will Achieve Debt Sustainability

While the analysis in this report 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. The export earnings of these countries experience large year-to-year fluctuations due to their heavy reliance on primary commodities, weather extremes, natural disasters, and other factors. We found that higher export volatility, along with lower average growth rates, lowers a country's likelihood of achieving debt sustainability. For example, under the World Bank and IMF export growth assumptions, which are usually higher than historical growth rates, all 27 HIPC countries are projected to be debt sustainable in 2020. However, we found that negative shocks tend to have greater impact on debt sustainability than positive shocks. After factoring in the impact of export growth volatility, we found that countries will not consistently achieve debt sustainability, with the average likelihood of achieving sustainability at 84 percent, despite the assumption of high export growth.[1] We estimate that 10 countries have less than an 80-percent likelihood of achieving debt sustainability due to export volatility, with Rwanda having the lowest probability at 57 percent (see table 12). Countries with low export volatility, such as Honduras, tend to have a high likelihood of achieving debt sustainability under the high World Bank and IMF growth rates.

[1]To build in volatility in export projection, we used software that randomly drew 18,000 export growth rates (for each 1,000 runs, 18 simultaneous draws, one for each year) from a distribution that reflects the historic growth volatility of each country. A detailed description of our methodology is contained in appendix I.

Table 12: Likelihood of Achieving Debt Sustainability under Different Scenarios in 2020

Country	Probability using World Bank/IMF growth rates (percentage)	Probability using historical growth rates (percentage)
Benin	89.3	42.3
Bolivia	75.7	11.0
Burkina Faso	76.0	1.7
Cameroon	95.9	63.2
Chad	62.3	51.3
Congo (Dem. Rep.)	84.4	1.5
Ethiopia	93.1	37.3
Ghana	89.4	81.0
Guinea	97.2	37.6
Guinea-Bissau	70.0	65.1
Guyana	97.7	93.2
Honduras	99.5	98.7
Madagascar	99.0	86.7
Malawi	72.3	44.0
Mali	75.4	59.9
Mauritania	98.3	25.3
Mozambique	97.8	77.3
Nicaragua	95.7	72.3
Niger	65.9	2.7
Rwanda	57.3	10.0
São Tomé and Príncipe	66.5	12.4
Senegal	98.7	78.9
Sierra Leone	81.3	1.5
Tanzania	83.2	35.9
The Gambia	91.7	94.2
Uganda	67.4	28.3
Zambia	85.3	5.4
Average	**83.9**	**45.1**

Source: GAO analysis of World Bank and IMF data.

Note: For this analysis, we assumed that grants alone are used to cover the balance of payments shortfall.

Under historical export growth rates, which are usually lower than assumed in the World Bank and IMF projection, volatility reduces these countries' likelihood of achieving debt sustainability even further. On average, we estimate that the likelihood of achieving debt sustainability is only 45 percent for the 27 HIPC countries, under historical export growth rates. Five countries, all of which had on average negative historic growth, are estimated to have less than a 10-percent likelihood of achieving debt sustainability.[2] Since volatility in export earnings reduces countries' likelihood of achieving debt sustainability, it is also likely to further increase donors' cost, as countries will require an even greater than expected level of debt relief to achieve debt sustainability.

[2]The five countries are Burkina Faso, Democratic Republic of Congo, Niger, Sierra Leone, and Zambia. Historic growth is calculated using the geometric mean of the annual growth rates.

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. 20220

APR 2 2004

Mr. Joseph A. Christoff
Director, International Affairs and Trade
U.S. General Accounting Office
441 G Street, N.W.
Washington, D.C. 20548

Dear Mr. Christoff:

Thank you for giving us the opportunity to comment on your recent report related to international debt issues, developing country economic growth, and international financial institutions and bilateral donors' participation in these issues. While acknowledging the analysis that has gone into producing this report, we find many aspects that concern us. In our view, the report brings too little clarity to a very complex topic. It tends to be aggressive and sensationalistic in its claims. It leaves the impression to a reader that very large amounts of money, substantially above previously projected costs, will be required to be paid in substantial part by American taxpayers in future years.

See comment 1.

Multilateral Development Bank Financing of the Enhanced HIPC Initiative

See comment 2.

We believe the report should have clearly reported the existence of international agreements for the financing of the Enhanced HIPC Initiative as it relates to the concessional loan windows of the Multilateral Development Banks (MDBs): the International Development Association of the World Bank (IDA), the Fund for Special Operations of the Inter-American Development Bank (FSO) and the African Development Fund of the African Development Bank (AFDF). In these areas and as related to the much smaller MDB hard loan debts of HIPC countries, international financing frameworks have been agreed for some time and basically are being followed. To date it is fair to say that the contributions have been coming in largely consistent with commitments donors made and at a rate that for the most part has not slowed HIPC program action due to lack of international financing.

The report also fails to explain that there is a regular international process for review and discussion of financing for the HIPC program. These discussions have mostly taken place alongside IDA Deputies meetings over the past several years and often have been based on regular IDA Trustee papers analyzing the financial status of the HIPC Trust Fund. The analysis looks at any gaps that may exist from two sources: (1)What donors promised and what they have actually provided; and (2) What additional resources are needed due to new decisions related to the HIPC program or due to various cost increases. The financing gap analysis in October 2002 showed the need for an additional $650 million for the HIPC Trust Fund. Donors subsequently made further pledges including an additional pledge of $150 million from the United States. There has been no indication since that time of any further financing gap in the HIPC Trust Fund.

See comment 3.

Of course, there are factors that have and could in the future result in a need for additional resources for the HIPC Trust Fund: (1) adjustments in cost estimates for existing countries caused by delays in the timing of "Decision Points"; also, adjustments necessary over time because HIPC Trust Fund pledges are made in nominal terms but costs are measured in NPV terms; (2) additional countries: Sudan, Liberia, and Somalia, while technically eligible for HIPC, were not included in the original financing framework because it was not expected they would be able to take advantage of the program; (3) topping up: there is a possibility of "topping up", additional debt reduction provided at "Completion Point", under the HIPC framework if a country has encountered exceptional exogenous shocks that cause a fundamental change in economic circumstances. There will be continuing reviews of the status of HIPC Trust Fund financing, but since October, 2002 there have been no calls for additional donor pledges.

See comment 4.

In the context of this report, we have discussed the stated additional HIPC costs related to the AFDB. At this time, we remain unconvinced that these AFDB related cost projections are accurate.

Objectives of the Enhanced HIPC Initiative

See comment 5.

This report, similar to the prior GAO report on HIPC, continues to assert that the Enhanced HIPC Initiative was intended to ensure an "exit" from unsustainable debt burdens. We again disagree. Fundamentally, the Enhanced HIPC Initiative was aimed at eliminating the extraordinary debt overhangs of the poorest most debt burdened countries and *at the HIPC decision point* achieving a debt to export ratio of 150 percent for those countries. The Initiative did not contain elements aimed at controlling lending or over-lending to these countries. It did not contain elements capable of ensuring economic or export growth, and it did not contain elements to ensure that a 150 percent debt to exports ratio for individual countries would be maintained into the future. The Enhanced HIPC Initiative policy structure has three primarily elements: (1) deep debt reduction applied to both multilateral and bilateral sources, (2) new money to sustain resource transfer levels, and (3) economic and governance policy reform. While enthusiastic supporters of the program may well have claimed that it was intended to achieve "debt sustainability", and while that goal is admirable, the program itself was created as a one time event to address the accumulation of unsustainable debt overhangs by the poorest countries.

See comment 6.

Achieving the aspiration of "debt sustainability" for developing poor countries requires productive investment, economic growth, continuing significant economic and governance reforms and disciplined lending and borrowing, a combination of elements far beyond those contained in the Enhanced HIPC Initiative.

Projections of Future Development Assistance

See comment 7.

The report contains various cost projections largely unrelated to the Enhanced HIPC Initiative as it exists today, but rather related to possible increases in the need for official development assistance in the future. The goal of achieving and particularly of maintaining "debt sustainability", however it is defined, like most other development

goals, fundamentally is the responsibility of the developing countries. There exists no international agreement on maintaining this goal nor on how such costs would be paid.

See comment 8.

We acknowledge the valuable work GAO did in a prior report to point out overly optimistic export growth projections of the IMF and World Bank staffs. It should be noted however that a recent World Bank/IMF paper compares anticipated export growth and actual export growth for HIPC countries between their decision and completion points. The finding is that, while overall the projections were optimistic, almost half the countries have exceeded their original export projections.

See comment 9.

We would caution that the very large numbers in this report are a confusing speculative mix of long-term estimates of the "cost" of achieving debt reduction and providing increases to official development assistance in order to achieve projected economic growth rates and maintain a debt to export ratio of 150 percent for HIPC countries. Making long-term projections is a highly uncertain business and results are volatile to basic assumptions. We remain unconvinced that utilization of an export growth average for the past twenty years is the best way to project future export growth, albeit it is a conservative base that has the effect of significantly increasing estimated resource needs.

In closing, we believe that this report continues to build the substantial analytic base supporting the United States pursuit of substantial increases in grant financing in MDB development funds for the poorest developing countries. Grant programs, if adopted at sufficient levels, would provide a stronger basis for economic growth and would avoid the significant risk of a future and largely MDB-focused debt crisis among the poorest developing countries.

We appreciate the GAO's contributions to the deliberations on how to assist countries in achieving long-term economic growth and debt sustainability, and we look forward to continuing to collaborate together.

Sincerely,

William E. Schuerch
Deputy Assistant Secretary for Debt Policy
and Trade Finance

The following are GAO's comments on the Department of the Treasury letter, dated April 2, 2004.

GAO Comments

1. Treasury said the report leaves the impression that very large amounts of money, substantially above previously projected costs, will be required to be paid in substantial part by American taxpayers in future years. We agree that the challenge of achieving high economic growth rates, while maintaining debt sustainability, will likely require a substantial commitment of resources from the donors, including the United States, beyond what is currently projected by the World Bank and IMF.

2. Treasury said the report should have clearly reported the existence of international agreements for financing HIPC as they relate to the multilateral development banks and that contributions have thus far largely met commitments. We recognized throughout the report the donor community's commitment to financing HIPC. However, under the agreed upon pay-as-you-go financing arrangement, funding has not been identified for large emerging financing shortfalls. We consider it to be fiscally prudent to estimate the full magnitude of the donor's financial commitment.

3. Treasury said there has been no indication since October 2002 of any further financing gap in the HIPC Trust Fund. Our report refers to financing challenges over the life of the initiative, not specifically to the HIPC Trust Fund at this point in time, as reflected by the donor's pay-as-you-go approach. Under the current pay-as-you-go approach, we did not identify a gap in the HIPC Trust Fund. However, as Treasury recognizes in its letter, there are several factors that are likely to result in the need for additional resources in the future. Our report provides estimates of those and other emerging additional costs.

4. Treasury said it is not convinced that our cost estimates for the AfDB are correct. We consider our estimate to be more accurate because it accounts for the actual amount of resources the AfDB has identified to contribute to the initiative and converts the estimate into 2003 dollars. For example, although the AfDB expects to provide $662 million (nominal) as it share of the HIPC Initiative it has only identified $370 million (nominal) thus far.

5. Treasury disagrees with the assertion that the enhanced HIPC Initiative was intended to ensure an exit from unsustainable debt burdens. We disagree. Numerous official World Bank and IMF documents as recent as 2003 affirm that a permanent, lasting, or durable exit from unsustainable debt remains a central objective of the HIPC Initiative.[1] While the Treasury may have retreated from this objective, the World Bank and IMF have not.

6. Treasury also said achieving the aspiration of debt sustainability for poor countries requires a combination of elements. The report states that our estimates assume that the countries will follow their World Bank and IMF development programs, including undertaking recommended reforms and achieving economic growth rates consistent with reducing poverty and maintaining long-term debt sustainability

7. The Treasury said the report contains various cost projections largely unrelated to the current Enhanced HIPC Initiative. We disagree. At least 95 percent of our cost projections directly pertain to achieving the goals of the initiative—helping countries achieve economic growth and maintain long-term debt sustainability. The remaining amount is our estimate of the cost of achieving a second debt target—a debt service-to-government revenue of less than 5 percent—requested by the committee.

8. Treasury said that a recent World Bank/IMF study demonstrates that, while overall the projections were optimistic, almost half the countries have exceeded their original export projections. We do not believe that strong short-term (2 to 3 years) export growth necessarily constitutes a long-term trend. HIPC countries have historically experienced great volatility in their export earnings. It is not uncommon to see substantial increases in their export earnings for a few years followed by substantial declines. Although some countries have experienced high growth in recent years, sustaining that growth over 20 years or more is a difficult challenge.

9. Treasury said that it remains unconvinced that using an export growth average for the past 20 years is the best way to project future export

[1] See for example, *Debt Relief for the Poorest: An OED Review of the HIPC Initiative*, World Bank, (Washington, D.C.: February 24, 2003).

growth. As noted in our previous reports, World Bank/IMF projected export growth rates have been optimistic—overall, more than double historical rates. We consider historical export growth rates to be more realistic, given these countries' reliance on highly volatile commodities and other vulnerabilities. For example, the increasing prevalence of HIV/AIDS in many poor countries will likely have substantial negative effects on a broad range of economic variables, including export growth.

Comments from The World Bank

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

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

SHENGMAN ZHANG
Managing Director

March 31, 2004

Mr. Joseph Christoff
Director
International Affairs and Trade
U.S. General Accounting Office
Washington, DC 20548

Dear Mr. Christoff:

Thank you for the opportunity to comment on the General Accounting Office's draft report, "Developing Countries–Achieving Poor Countries' Economic Growth and Debt Relief Targets Faces Significant Financing Challenges" (GAO-04-405, April 2004).

The draft report rightly reminds us of the challenges of channeling adequate resources to the Heavily Indebted Poor Countries (HIPCs), including the assistance committed under the HIPC Initiative, in support of their long-term development strategy and efforts toward meeting the Millennium Development Goals (MDGs) by 2015. As you know, during the development and adoption of the enhanced HIPC Initiative in 1999, the World Bank's Management and shareholders held extensive discussions on the financing of the Bank's cost of HIPC debt relief. The conclusion of these discussions was to adopt a pay-as-you-go approach to ensure prompt delivery of debt relief. Subsequently, the financing of IDA's debt relief costs on IBRD debt was included in the overall IDA13 replenishment resources. Also, during the IDA13 replenishment IDA donors agreed to address the financing of IDA's HIPC debt relief costs during the IDA14 replenishment.

We take to heart the report's recommendation that long-term projections on export growth rates made by the Bank and the Fund need to be more realistic. Indeed, the Bank's independent Operations Evaluations Department produced a review of the HIPC Initiative last year that made the same recommendation. Staff have adopted this recommendation, including by systematically providing a low-case scenario based on historical growth trends and country-specific risk scenarios to stress test the long-term projections. Nevertheless we would like to emphasize that economic projections over a 20-year period contain a high degree of uncertainty, not only around economic conditions that may prevail over that period but also around policy changes that may occur in developed and developing countries.

We also support the GAO report's emphasis on the need for HIPCs to strive for sustainable development financing strategies even after they reach their completion

-2- March 31, 2004

points under the HIPC Initiative. In this vein, the Bank and Fund staffs are working with their low-income member countries, including the HIPCs, and the international community to develop strategies that would contribute toward achieving debt sustainability while in pursuit of the MDGs (IDA and IMF, *Debt Sustainability in Low-Income Countries—Proposal for an Operational Framework and Policy Implications*, February 3, 2004).

See comment 1.

Debt relief has never been considered or presented as a panacea that would alone overcome the towering challenge of long-term development and poverty reduction in HIPCs. We therefore do not agree with the report's implicit assumption that any deviation from a projected debt profile would be offset only by additional debt relief or compensatory financing. Other elements of an effective development strategy have to be in place, including a stable and growth-friendly macroeconomic environment, good governance and institutional capacity, and widespread participation including the poor in the design and implementation of poverty reduction strategies. These can be reinforced by concurrent changes in the policies of developed countries, particularly in their effort to increase aid flows in a more predictable manner and to create greater market access for low-income countries to benefit from increased exports.

See comment 2.

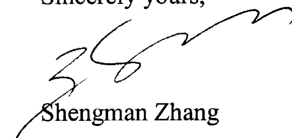
See comment 3.

See comment 4.

While we agree with the GAO report's finding that significantly more resources will be needed to help countries achieve the MDGs, we would like to clarify that the HIPC Initiative has never specified nor committed to "debt relief targets" in 2020. We find the hypothetical exercise contained in the report interesting, but also believe that GAO's methodology to assess the financing needs of HIPCs can be improved to recognize the very important efforts made by these countries themselves. In particular, GAO needs to re-examine its key assumption that holds constant countries' policies even during periods of exogenous shocks. Furthermore, GAO makes an arbitrary assumption that historical growth rates are a good guide to future performance, even though significant structural and policy changes are taking place in HIPCs through ongoing reforms. In fact, studies of recent HIPC graduates provide encouraging evidence that growth has accelerated in recent years.

Again, let me thank you for the opportunity to comment on this draft report on the challenges we face together in meeting the debt relief costs at the multilateral development banks and in securing adequate long-term financing in support of the MDGs in the world's poorest, most heavily indebted countries.

Sincerely yours,



Shengman Zhang

The following are GAO's comments on the World Bank letter, dated March 31, 2004.

GAO Comments

1. The World Bank disagreed with the assumption that any deviation from a projected debt profile would be offset only by additional debt relief or compensatory financing. We disagree with the Bank's characterization of the report. The report explicitly states that donors have the option of not financing the export shortfalls; however, this will hamper countries' economic growth and reduce the funds available for poverty reduction. We assume, consistent with World Bank and IMF projections, that countries are following their reform and development programs. Hence we assumed that the other key elements of an effective development strategy are in place.

2. The World Bank said that the HIPC Initiative has never committed to debt relief targets in 2020. While we agree with this technical distinction, we note that debt sustainability analyses project all HIPC countries to have net present value debt-to-export ratios at or below 150 percent in 2020. Therefore, we chose 2020 because it represented the final year in World Bank and IMF projections.

3. The World Bank said that our methodology to assess the financing needs of HIPCs can be improved to recognize the very important efforts made by these countries themselves. As the report states, our analysis assumes that government revenue and GDP will grow at the optimistic rates projected by the World Bank and IMF because countries are expected to be undertaking recommended structural and policy reforms.

4. The World Bank said that we make an arbitrary assumption that historical growth rates are a good guide to future performance. As noted in our previous reports, World Bank/IMF projected export growth rates have been optimistic—overall, more than double historical rates. We consider historical export growth rates to be more realistic, given these countries' reliance on highly volatile commodities and other vulnerabilities. While policy reforms may improve export growth, other factors may hinder growth. For example, the increasing prevalence of HIV/AIDS in many poor countries will likely have substantial negative effects on a broad range of economic variables, including export growth. 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.

Comments from the African Development Bank

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

AFRICAN DEVELOPMENT BANK GROUP

13 RUE DU GHANA
ANGLE AV. HEDI NOUIRA ET PIERRE DE COUBERTIN
B.P. 323 – 1012 TUNIS BELVEDERE
TUNISIE
Téléphone : (216) 71 352 246
Fax : (216) 71 352 577
Web Site : www.afdb.org

REF : PRST/LTR/2004/04/001

DATE : 2nd April, 2004

PRESIDENT

Mr. John W. Snow
Secretary Of The Treasury
Department Of The Treasury
1500 Pennsylvania Avenue, N.W.
Room 3419
Washington D.C. 20220
U.S.A

Dear Mr. Snow,

I am writing in response to the GAO request for our comments on its recent draft of its study on debt relief, entitled, *"Developing Countries: Achieving Poor Countries' Debt Relief Targets Faces Significant Financing Challenges."* Our comments relate to two issues raised by the GAO Report: (1) Financing Gap for the Debt Relief of the African Development Bank Group (AfDB), and (2) Achieving Debt Sustainability in the Medium to Long Term.

With respect to the first issue, GAO estimates that the AfDB faces a financing gap of around $400 million for the 23 countries that have qualified and $800 million for the remaining nine countries – most of which are post-conflict countries. GAO's estimate for AfDB of its total financing gap thus stands at $1.2 billion. The GAO Report also states "Neither (the World Bank or the ADB) has determined how it would close the gap."

See comment 1.

African Development Bank Group
President

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With respect to the 23 African countries that have qualified to date, AfDB's current estimate of its costs for debt relief, including for the Democratic Republic of Congo, is $2.56 billion in present value terms. From the information provided to us by the HIPC Trust Fund regarding donor contributions and including the projected Bank contributions, the resources mobilized by the Bank Group as of the end of 2003 is $2.43 billion. The current shortfall is thus in the order $130 million, although this may increase due to differences inevitably created by net present value estimates for the debt, the timing of donor contributions, and the returns on the funds once received. Moreover, this estimate does not take into account any 'topping up' of debt relief that may be required when the 15 African countries that have only achieved their decision point reach their completion points. As the GAO study indicates this could vary between $127 to $254 million for the AfDB depending on the approach to be taken by the donor community with respect to calculating topping up requirements.

With respect to the resources required for the remaining 9 countries, the GAO report is correct when it states that the financing of the AfDB's HIPC contribution has yet to be determined. In this regard, it is important to emphasize, first, that the actual amounts involved are not precise. The $800 million quoted by the GAO is likely to be an underestimate given that most of these countries in the remaining group 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.

More broadly, with respect to the financing of AfDB HIPC costs, I wish to bring to your kind attention the two important agreements that the donor community had reached. First, at the June 2000 meeting of ADF donors, State Participants pledged to finance the Bank's HIPC costs and agreed that the maximum the Bank Group could mobilize from its own resources was $370 million. Second, donor countries essentially adopted a pay-as-you-go approach, making part of the debt relief costs of the AfDB available at the decision point and the remaining amount at the completion point.

In the light of these agreements, we expect additional debt relief financing for the AfDB Group to be covered by donor contributions. In this connection, it is evident that the US government would undoubtedly be asked to make additional contributions to cover future AfDB HIPC costs. I

African Development Bank Group
President

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wish to emphasize that unless it reaches agreement with its donors on financing, the AfDB cannot, on its own, decide to provide debt relief to the remaining countries.

Turning to the issue of long-term debt sustainability, as the GAO study clearly points out, this would depend on the growth performance of HIPC countries, the growth of their exports, and the degree to which these countries succeed in diversifying their exports. The record to date is indeed not very encouraging. As the need to 'top up' debt relief at the completion point has shown, projections on growth and export performance have proved to be too optimistic. And recent adverse terms of trade and volatility in commodity prices have also made it difficult for countries to achieve the HIPC debt targets.

The GAO conclusion that these countries are likely to need considerable assistance in the future to meet the debt sustainability targets – and as important their economic growth and social development targets -- is therefore likely to be correct. There can, however, be some differences of views on the actual amounts that will be involved.

See comment 2.

The use of historical data to project export performance, as the GAO study does, would imply limited progress in the future. While African countries in general have yet to raise their growth rates to desirable levels and as many have yet to diversify their export base, caution on this score is warranted. Nonetheless, it is also important to note that some HIPC countries, such as Mozambique, are making important strides in terms of sustaining higher growth rates and diversifying their exports. Other African countries are also beginning to boost their exports to the US in the context of the AGOA initiative.

In the light of these developments, a closer look at the recent performance of individual cases may provide a more accurate basis for projecting future ODA needs. It would also indicate some of the other policy measures that the US government could consider in other critical areas such as trade to help African countries accelerate their growth rates and diversify their exports.

African Development Bank Group
President

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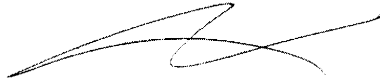
I trust that you will find these comments useful.

Sincerely yours,



Omar Kabbaj

The following are GAO's comments on the African Development Bank letter, dated April 2, 2004.

GAO Comments

1. The AfDB said its current shortfall for the 23 African countries that have qualified to date is $130 million. We consider our estimate of about $400 million to be more accurate because it accounts for the actual amount of resources the AfDB has identified to contribute to the initiative and converts the estimate into 2003 dollars. For example, although the AfDB expects to provide $662 million (nominal) as it share of the HIPC Initiative, it has only identified $370 million (nominal) thus far.

2. The AfDB said the use of historical export data would imply limited progress in the future. As noted in our previous reports, World Bank/IMF projected export growth rates have been optimistic—overall, more than double historical rates. We consider historical export growth rates to be more realistic, given these countries' reliance on highly volatile commodities and other vulnerabilities. For example, the increasing prevalence of HIV/AIDS in many poor countries will likely have substantial negative effects on a broad range of economic variables, including export growth.

Comments from the Inter-American Development Bank

INTER-AMERICAN DEVELOPMENT BANK
WASHINGTON, D. C. 20577

PRESIDENT

April 5, 2004

Mr. Joseph A. Christoff
Director
International Affairs and Trade
General Accounting Office
441 G Street, NW, Room 4767
Washington, D.C. 20548

Dear Mr.Christoff:

Thank you for giving us an opportunity to comment on the draft report titled "Developing Countries: Achieving Poor Countries' Economic Growth and Debt Relief Targets Faces Significant Financing Challenges".

Attached, please find our comments, which we understand will be reflected in the final report.

Yours sincerely,

Dennis Flannery
for Enrique V. Iglesias, President

Encl.

Comments from the Inter-American Development Bank

The IDB generally agrees with the report prepared by GAO, which accurately reflects the Bank's participation in the HIPC Initiative.

The IDB is providing debt relief to four countries: Bolivia, Guyana, Honduras and Nicaragua. Of these countries, three have already reached completion without significant completion point DSA or topping-up adjustments; therefore, the fully financed framework of debt relief remains unchanged.

As indicated in the report, the IDB estimates there could be a shortage of resources available for lending in the FSO in future years. The current Governors' mandate established a lending program for 2000-2008, which the Bank expects to be able to achieve. IDB Management is reviewing its lending capacity in the FSO for 2009 and thereafter to determine what actions may be required for the FSO to continue providing concessional loans to the Bank's poorest borrowing member countries.

GAO Contacts and Staff Acknowledgments

GAO Contacts

Thomas Melito (202) 512-9601
Cheryl Goodman (202) 512-6571

Acknowledgments

In addition to the individuals named above, Bruce Kutnick, Barbara Shields, R.G. Steinman, Ming Chen, Rob Ball, and Lynn Cothern made key contributions to this report.

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