ACHIEVING DEBT SUSTAINABILITY IN LOW-INCOME COUNTRIES PAST PRACTICES, OUTSTANDING RISKS, AND POSSIBLE APPROACHES

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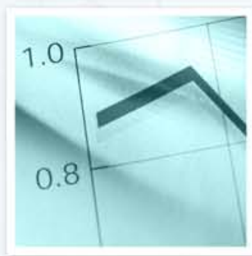

BY BEN LEO, SETH SEARLS, AND LUKAS KOHLER

DEPARTMENT OF THE TREASURY • OFFICE OF INTERNATIONAL AFFAIRS

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OVERVIEW

In recent years, donor governments have directed significant attention toward low-income country debt issues, culminating in the high profile G-8 and Paris Club[1] agreements last year for Heavily Indebted Poor Countries (HIPCs) and Nigeria. This paper places these events in the context of the international donor community's past engagement with low-income countries and ongoing efforts to promote long-term debt sustainability. It shows that large volumes of development lending, based on overoptimistic GDP and export growth projections, reduced the benefits of debt relief efforts and perpetuated a "lend and forgive" cycle. While concerted donor action and important country reforms have led to a marked reduction in external debt ratios, significant risks to debt sustainability in low-income countries remain. The paper argues for a more cautious approach – with respect to the rate of accumulation of debt, growth projections, and risks from export concentration in primary commodities – in determining the appropriate terms of development assistance. It also argues for incentives to deter "free-riding" – i.e., non-concessional (market rate) lending to countries receiving debt relief or grants.

HISTORIC LEND-AND-FORGIVE APPROACH

Over the last twenty-five years, the international community has pursued a series of measures to address debt burdens in low-income countries. Early actions focused on debt relief for official bilateral claims, initially via rescheduling, followed by increasing levels of debt reduction. Continued debt distress necessitated treating credits from the international financial institutions (IFIs) in an effort to achieve long-term debt sustainability.[2]

1. The Paris Club is an informal group of official bilateral creditors that seeks coordinated, sustainable solutions to the payment difficulties of debtor countries.

The following chronology shows the increasingly generous debt treatments offered to low-income countries:

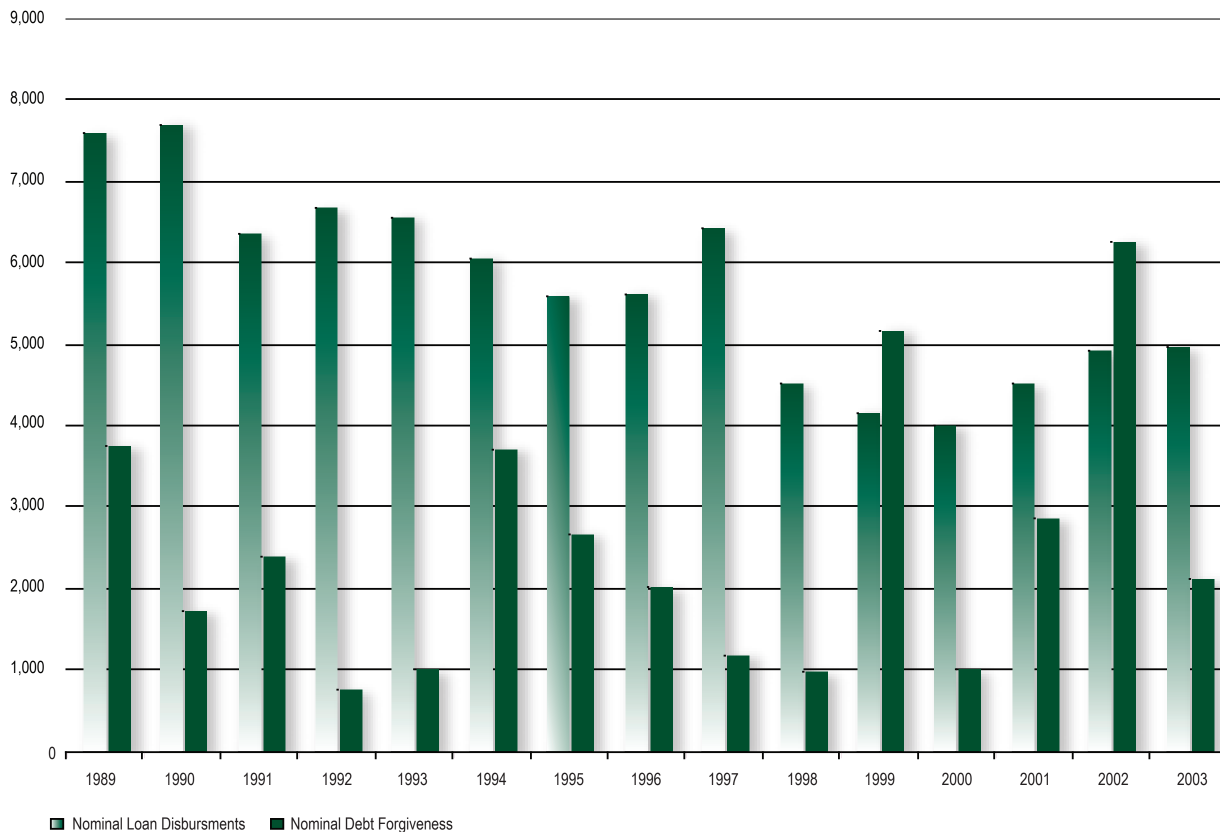
- From the 1960s through the mid-1980s, Paris Club debt relief for low-income countries was limited to rescheduling of claims.
- In 1987, the Group of Seven countries (G-7) called for interest rate relief on low-income countries' debt, creating the "Venice terms."
- In 1988, the Paris Club agreed on partial debt reduction (33 percent) and more generous rescheduling terms, creating "Toronto terms."
- In 1991, the Paris Club applied "Enhanced Toronto Terms," which deepened the level of debt reduction to 50 percent.
- In 1994, the Paris Club announced "Naples Terms" with even deeper levels of debt reduction (67 percent) and more generous rescheduling terms on remaining debt.
- In 1996, members of the IMF and World Bank agreed on the Heavily Indebted Poor Country Debt Initiative (HIPC). For the first time IFI credits were reduced. Paris Club creditors agreed to "Lyon Terms," which increased debt reduction on eligible non-concessional bilateral claims to 80 percent.
- In 1999, the international donor community agreed to the Enhanced HIPC Initiative, providing faster and even deeper debt relief, for more countries. Paris Club creditors agreed to the "Cologne Terms," canceling up to 90 percent of eligible non-concessional bilateral obligations. Some G-7 creditors, including the United States, went as far as 100 percent debt reduction.

During the period up to the Enhanced HIPC Initiative, the Paris Club repeatedly reduced or rescheduled the debts of a number of countries, including good performers. In fact, between 1976 and 2002, low-income countries restructured their Paris Club debt nearly 250 times, with twelve countries restructuring eight or more times (see Appendix 1).

Even as debt was relieved, the debt sustainability of HIPCs was eroded by even greater *new* official (primarily IFI) lending.[3] Between 1989 and 2003, new lending to HIPCs ($85 billion) more than doubled the amount of nominal debt relief provided ($38 billion). Figure 1 illustrates how this assistance counteracted debt relief efforts.

3. The following countries are classified as HIPCs: Benin, Bolivia, Burkina Faso, Burundi, Cameroon, Central African Republic, Chad, Comoros, Democratic Republic of the Congo, Republic of Congo, Cote d'Ivoire (Ivory Coast), Ethiopia, the Gambia, Ghana, Guinea, Guinea-Bissau, Guyana, Honduras, Lao PDR, Liberia, Madagascar, Malawi, Mali, Mauritania, Mozambique, Myanmar (Burma), Nicaragua, Niger, Rwanda, Sao Tome and Principe, Senegal, Sierra Leone, Somalia, Sudan, Tanzania, Togo, Uganda, and Zambia. In 2006, four additional countries were added to the list of countries potentially eligible for HIPC debt relief: Eritrea, Haiti, Kyrgyz Republic, and Nepal. The HIPC figures cited in this paper do not include these new countries.

Figure 1: Debt Relief and New Lending Disbursements to HIPCs, 1989-2003



Source: World Bank - 2005 Global Development Finance

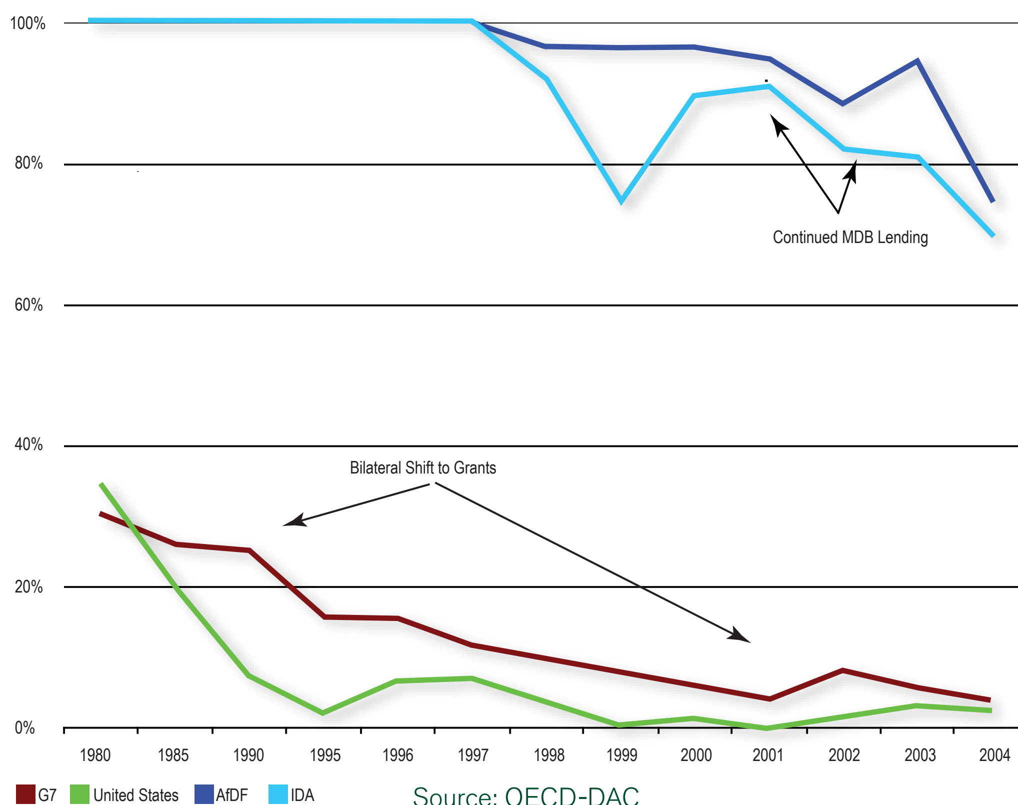
There were several reasons for excessive multilateral lending. First, the incentive structure in the delivery of MDB assistance favored gross volumes. There were bureaucratic incentives to increase volumes, political incentives to approve large, visible transactions, and institutional incentives to ignore debt sustainability consequences since – until recently – MDB debt was not subject to reduction. Some studies also suggest that the IFIs engaged in defensive lending practices, rolling over amounts due from countries that could not afford to repay in order to avert default.[4] Moreover, the IFIs filled financing gaps created by sudden declines in non-concessional, often speculative lending from commercial and official creditors, based their lending decisions on temporary commodity price increases and short-term growth prospects.[5] The IFI loans subsidized the repayment of these non-concessional lenders and contributed to moral hazard, while doing little to lower poor country indebtedness. Finally, in the countries themselves, excessive borrowing with less than full intention of repayment facilitated poor economic management and corruption, further diminishing repayment capacities.

While multilateral loan volumes increased over

4. Birdsall, Nancy, Stijn Claessens, and Ishac Diwan, "Will HIPC Matter?: The Debt Game and Donor Behavior in Africa." Center for Economic Policy Research, April 2002.
5. Easterly, William, "How did the heavily indebted poor countries become heavily indebted? Reviewing 2 decades of debt relief," World Development,Volume 30(10), October 2002, 1677-1696.

time[6] , OECD bilateral donors largely abandoned long-term concessional lending in favor of grants, resulting in significant increases in net resource flows over recent years.[7] The shift to grants by bilateral donors, which began in the late 1970s, was largely due to the inability of poor countries to meet mounting repayment obligations. Concessional lending from the United States as part of U.S. Agency for International Development (USAID) programs ceased in the mid-1980s and gave way overwhelmingly to grant-financed programs. United Nations development programs, meanwhile, have always been grant-financed. Today the only truly significant official development assistance (ODA) lending to the poorest countries is from the concessional loan windows of the multilateral development banks (MDBs). Figure 2 displays this trend for HIPCs.

Figure 2: Loan Disbursements to HIPCs by Creditor (as % of disbursements)



Source: OECD-DAC

RECENT IFI REFORMS

In 2001, the U.S. called on the MDBs to provide 50 percent of their assistance to the poorest countries in the form of grants. This call coincided with donor negotiations for replenishing the International Development Association (IDA) and the African Development Fund (AfDF). After eighteen months of discussions, donors agreed that between 18 and 21 percent of total IDA and AfDF assistance would be in the form of grants.

6. For example, International Development Association (IDA) loans to HIPCs increased from approximately $430 million in 1980 to $2.8 billion in 2003. Source: OECD-DAC.
7. Although most bilateral development assistance shifted to grants, export credit agencies (ECAs) continued to provide loans to low-income countries.

Individual countries could receive up to 40 percent grants if they met certain criteria, such as being defined as "debt vulnerable" or "post-conflict." This agreement explains the decline in the ratio of MDB loans provided to HIPCs following 2002, as illustrated in Figure 2 above.

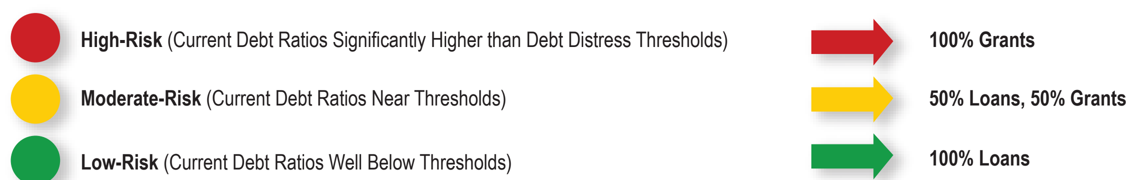
During the most recent IDA and AfDF replenishment negotiations (2004-05), donors took a further step forward by agreeing to use the joint World Bank/IMF debt sustainability framework (DSF) to guide IDA and AfDF grant allocation decisions.[8] Policy-dependent debt distress thresholds underpin the framework's definition of debt sustainability. The World Bank and IMF conducted empirical studies designed to identify the levels at which debt burdens in low-income countries lead to debt distress. They concluded that countries with weaker institutions and policies were likely to experience debt distress at lower external debt ratios. These debt distress thresholds are shown below in Table 1. Debt stock figures are measured in net present value (NPV) terms since the majority of existing debt for low-income countries is provided on concessional (sub-market rate) terms. Country performance is measured according to the World Bank's Country Policy and Institutional Assessment (CPIA), which tracks annual performance on 16 indicators related to macroeconomic, social, and legal/governance issues.

Table 1: Joint World Bank/IMF Debt Sustainability Framework

	Assessment of Institutional Strength and Quality of Policies (CPIA)		
	Poor	Medium	Strong
External Debt Indicators	**(4th Quartile)**	**(2nd and 3rd Quartiles)**	**(1st Quartiles)**
NPV Debt-to-Exports	100	150	200
NPV Debt-to-GDP	30	40	50
Debt Service-to-Exports	15	20	25

Comparing these debt distress thresholds against current and projected debt ratios generates risk classifications according to the "traffic light" system below. These classifications in turn determine the composition of assistance (grants versus concessional loans) provided by IDA and the AfDF.

Under this framework, IDA and AfDF were expected to provide roughly 47 percent of their assistance to the poorest countries (roughly 60 percent for HIPCs) in the form of grants. Out of the 62 IDA-only countries[9], 47 will receive grant assistance during the IDA-14 period (July 2005



8. This framework, which was developed by the World Bank and IMF, is based upon the analytical framework and findings of Nehru and Kraay (2004).
9. Countries that are not considered creditworthy by the International Bank for Reconstruction and Development (IBRD). This term is used widely to characterize the world's poorest and most vulnerable countries.

- June 2008) – with 37 receiving 100 percent of their assistance as grants. Prior to 2001, they received less than 1 percent as grants.

The IMF also has undertaken reforms that should reduce incentives for excessive lending to low-income countries. It recently introduced access norms, which provide for a tapering off of IMF lending in successive programs. In 2005, the IMF established a non-borrowing Policy Support Instrument, which presents a framework for structured policy advice and a signal to donors and markets of the quality of policies without requiring IMF borrowing. In addition, deep debt relief (see below) has reduced the pressure to continually roll over old loans. Lending through its Poverty Reduction and Growth Facility (PRGF) has declined significantly in recent years: presently there are 27 PRGF programs totaling $2.6 billion in lending versus about 36 programs totaling an average of about $5-6 billion in lending during the early 2000s.

Shareholders of the World Bank, African Development Bank, and IMF recently agreed to take additional steps on debt relief to promote long-term debt sustainability and progress toward achieving countries' development objectives. These efforts culminated in the Multilateral Debt Relief Initiative (MDRI), which will provide up to $60 billion in debt cancellation to 42 countries. This initiative includes the following components:

- *100 percent IDA, AfDF, and IMF Debt Stock Relief*: For IDA and AfDF, 100 percent debt stock cancellation will be delivered by offsetting gross assistance flows by the amount forgiven. IMF debt relief will be financed from existing IMF resources.

- *Additional Donor Contributions to IDA and AfDF*: Donors would provide additional contributions, based on agreed burden shares, to offset foregone debt repayments (principal and interest) to IDA and AfDF. Additional funds will be made available immediately to cover the IDA-14 and AfDF-10 period and through regular replenishments for subsequent periods.

- *Focus on Strong Performance*: The additional donor contributions would be allocated to all low-income countries based upon the existing IDA and AfDF performance-based allocation systems. This approach ensures equity between HIPCs and non-HIPCs – since all countries receive additional assistance commensurate with performance – and creates an incentive for countries to pursue responsible, pro-growth policies. Based upon existing performance levels, roughly half of the additional contributions would be allocated to non-HIPC countries.

MDRI has several objectives. First, the large-scale forgiveness seeks to eliminate the debt overhang that has plagued these countries for decades and free up scarce domestic resources required for critical social services, infrastructure investments, and macroeconomic priorities. MDRI also creates a golden opportunity to achieve long-term debt sustainability and end the current lend-and-forgive approach to multilateral assistance. By wiping the slate clean, MDRI will help countries build a long-term credit culture (i.e., a culture consistent with sustainable borrowing and full expectation of repayment.) Finally, MDRI aims to create greater accountability at the IFIs for past poor lending decisions and to encourage more prudent lending behavior going forward.

CONTINUED RISKS TO DEBT SUSTAINABILITY

A. Debt Sustainability Framework Shortcomings and MDB Loan Volumes: As noted, international donors have made meaningful progress toward providing development assistance more responsibly. Basing concessionality decisions on a country's risk of experiencing debt distress – and using a forward-looking analytical framework to assess such risk – represents a significant step forward in facilitating long-term sustainability.

Outstanding questions remain, however, particularly in the context of debt relief measures that will dramatically shrink debt burdens. According to World Bank estimates, MDRI is projected to reduce the average NPV debt-to-export ratio of the 19 post-completion point HIPCs (i.e., those that have completed the HIPC Initiative) from 140 percent to 52 percent. Under the IDA and AfDF frameworks, lower debt ratios will transform countries with high- and moderate-risk of debt distress into low-risk countries – regardless of whether underlying economic conditions have improved. Lower risk ratings will reduce IDA and AfDF grant assistance for many countries, and in some cases will preclude them from receiving any grants.

This is problematic for several reasons. First, while lower levels of indebtedness inevitably increase a country's debt-bearing capacity, HIPC and MDRI recipients have not achieved low debt burdens through strong growth or prudent debt management. In many cases, significant structural weaknesses and vulnerable export sectors remain. These weaknesses contribute to a debt intolerance that continues to constrain the debt-bearing capacity of MDRI countries, even after relief. A recent Fitch Ratings report on sub-Saharan Africa acknowledged that MDRI would substantially improve debt ratios but that debt relief alone would not be sufficient for rating upgrades. The report warned that "on other measures of creditworthiness, such as the quality of their institutions, vulnerability to shocks, income per capita, and human and social capital indicators, the sub-Saharan African countries remain weak."[10]

Second, MDB assistance volumes are very large relative to the size of recipient economies. As a result, short-term volumes can overwhelm a given country's repayment capacity. Even if the country is considered low-risk or moderate-risk for a short period of time, such as a single three-year IDA/AfDF replenishment period, the magnitude of MDB lending can lead to a rapid escalation of external debt indicators (see Box 1).

Box 1: Rwanda Case Study – Managing MDB Loan Volumes

Rwanda's situation illustrates the need for carefully managed official development assistance (ODA) loans and increased grant assistance. Following debt relief, Rwanda runs the risk of a rapid return to unsustainable debt levels as a result of excessive ODA loans. In 2004, donors financed nearly 70 percent of Rwanda's total government expenditures. Financing Rwanda's substantial development needs with loans will lead to a higher debt service burden and fewer domestic resources for poverty reducing activities, thus erasing the gains derived from the recent debt relief.

According to IMF estimates, Rwanda's NPV of external debt-to-exports ratio will decline to 59 percent from 140 percent following full delivery of official sector debt relief (HIPC and MDRI). Because of this lower ratio, the IMF and World Bank are expected to upgrade Rwanda from high- to moderate-risk of experiencing debt distress under the current debt sustainability framework, thereby reducing the percentage of IDA and AfDF assistance provided as grants from 100 to 50 percent. Despite extensive debt relief, the most recent debt sustainability assessment by the World Bank and IMF projects that new lending will cause Rwanda to breach the debt sustainability threshold (150 percent debt-to-exports ratio) by 2014. However, this "base-case" scenario does not take into consideration the shift by IDA and the AfDF to 50 percent grants (from 100 percent). Taking into consideration a higher share of loans, the IMF projects that the debt sustainability threshold could be breached by 2010, or even sooner in the event of lower-than-expected export growth.

Source: Rwanda- Sixth Review Under the Three-Year Arrangement Under the PRGF, (EBS/06/69), Appendix VI.

10. Fitch Ratings, "Sub-Saharan Africa – 2006 Report," May 9, 2006

The current framework's heavy reliance on World Bank and IMF growth projections to determine country debt distress rankings is also problematic. It is unclear whether these institutions have adequately addressed the problem of overoptimistic projections, which has been a leading cause of unsustainable MDB lending in the past. The World Bank's independent evaluation department estimates that export projections used to determine the amount of debt relief provided under the HIPC Initiative have been significantly higher than actual historical export performance – twice the levels from 1990-2000 and almost six times those from 1980-2000.[11] Radelet and Chiang (2003) also compare staff projections for export and GDP growth and find similar results.[12] A more recent World Bank evaluation department study finds that the accuracy of growth projections has slightly improved since this period, but upward biases continue to undermine the validity of the World Bank and IMF debt sustainability framework.[13]

Recent experience with HIPC "topping up" cases demonstrates the link between optimistic growth projections and unsustainable MDB lending. Four HIPCs – Burkina Faso, Niger, Ethiopia, and Rwanda – required additional debt relief ("topping up") upon completing the initiative. This excess assistance was required to reduce debt ratios below the HIPC sustainability thresholds. In each case, optimistic growth projections led to excessive MDB lending as the country was moving through the HIPC process. In Rwanda, new MDB lending caused a staggering 96 percentage point increase in its debt ratio, leading to $240 million in additional debt relief. New lending was responsible for increases of 36 and 29 percentage points, respectively, in the debt ratios of Ethiopia and Niger.

Lastly, the debt sustainability framework could make it harder for low-income countries to access financing from the International Bank for Reconstruction and Development (IBRD) once they graduate from IDA-only assistance.[14] A recent World Bank paper revealed that the average "high-risk" IBRD borrower had an NPV of external debt-to-exports ratio of 175 percent, which is below the debt sustainability framework threshold of 200 percent for strong-performers.[15] Given the institutional incentives to continue borrowing up to thresholds, some countries would be considered "high-risk" by IBRD once they lose access to IDA assistance. Because IBRD imposes strict limits on lending to "high-risk" countries, these countries would suffer external financing shortfalls during the transition from IDA to IBRD.

B. Free Riding: Another threat to low-income debt sustainability comes from lenders who fill the borrowing space created by realized or anticipated debt relief and the provision of grants. These lenders have been termed "free riders" because they indirectly obtain financial gain from international debt forgiveness and grant assistance – through improved country repayment prospects – without paying for it. In addition to these violations of inter-creditor equity, lending on inappropriate terms to debt relief and grant recipients also threatens donors' ef-

11. Gautam, Madhur, "Debt Relief for the Poorest: An OED Review of the HIPC Initiative," World Bank Operations Evaluation Department, 2003.
12. Radelet, Steve and Hanley Chiang, "Providing New Financing to Low-Income Countries with High Levels of Debt: Some Considerations," Issue Paper on Debt Sustainability, HIPC Unit, World Bank, Washington DC, August 2003.
13. The World Bank Independent Evaluation Group, "Debt Relief for the Poorest: An Evaluation of the HIPC Initiative," 2006.
14. With a few exceptions, developing countries must have an income per capita of less than $1,025 to be eligible for IDA assistance. Other institutions that provide concessional assistance have similar eligibility criteria.
15. World Bank, Issues Related to IBRD Lending to Blend Countries, September 2001.

forts to maintain debt sustainability. The World Bank currently is considering an approach to discourage countries from simultaneously borrowing on non-concessional terms while receiving IDA grants. In the event of non-compliance, IDA would reduce the nominal amount of gross assistance provided by roughly 40 percent. For most countries, these incentives will create a powerful deterrent against free-riding in the context of grant assistance. The World Bank also is considering an approach for deterring recent debt relief recipients from borrowing on non-concessional terms. In the event of non-compliance, a recipient country would receive "hardened terms" from IDA. "Hardened terms" entails a shortening of the repayment period for a prospective IDA loan from 40 years to 20 years, which would reduce the grant element from approximately 65 percent to roughly 45 percent. While the underlying objective – to deter imprudent borrowing behavior – is laudable, this approach likely would be insufficiently robust to produce the desired results.

Commercial Lending: Since the start of Enhanced HIPC in 1999, official sector loans have constituted approximately 95 percent of the total external debt of HIPCs. During this time, banks and other commercial lenders have provided very limited amounts of new loans to HIPCs due to their lack of political stability and hard currency-earning capacity. In addition, high existing indebtedness has left little room for new borrowing. The combination of HIPC and MDRI relief, however, will reduce debt burdens dramatically, eliminating one of the key deterrents to commercial lending in these countries. A recent Standard & Poor's report on sub-Saharan Africa notes that the "renewed debt-bearing capacity thanks to MDRI" increases the likelihood that African HIPCs will be able to raise funds through private commercial channels. Although countries should not borrow on non-concessional terms while receiving MDB grants, non-concessional borrowing from commercial sources should not be discouraged in all circumstances. Some HIPCs have significantly improved policies, institutions, and growth prospects and may be able to successfully absorb small amounts of non-concessional borrowing (see Box 2). Specific projects could also be justified on a case-by-case basis according to their commercial and economic viability. Creditors should, however, be very conservative in these case-by-case determinations since the promise of growth has been used irresponsibly in the past to rationalize excessive lending on commercial terms.

Box 2: Ghana Case Study – Managing Commercial Loan Volumes

With a GDP per capita of roughly $500, Ghana will remain eligible for concessional lending from IDA and other official sources for the foreseeable future. But due to improved macroeconomic management and debt relief, Ghana has caught the attention of commercial lenders seeking higher yields. Ghana highlights the need for a cautious strategy of transitioning toward commercial borrowing in order to prevent a return to debt distress.

Under three successive IMF programs and significant World Bank assistance, Ghana took steps that helped increase economic growth and consolidate macroeconomic stability. Real GDP growth has averaged 5 percent since 2001, inflation has declined from 30 percent in 2001 to 10 percent (year-on-year) most recently, and international reserves have risen to 4 months of imports. Under HIPC and MDRI, Ghana will receive almost $8 billion in nominal debt relief, reducing Ghana's NPV debt-to-export ratio to roughly 30 percent in 2006. As a result, Fitch raised its outlook from B+ "stable" to "positive", and Standard & Poor's has identified Ghana as one of the few sub-Saharan African countries where commercial lending is feasible.

At the same time, Ghana's most recent IMF debt sustainability analysis (DSA) forecasts quickly eroding debt ratios – particularly if the concessionality of new lending is lower than expected. The DSA identifies $2.8 billion worth of additional external borrowing by Ghana between 2007 and 2010 – equivalent to 66 percent of annual exports – needed to finance an ambitious capital investment program. These figures assume unrealistic commercial interest rates averaging 0.9 percent. In the likely case of lower concessionality, Ghana could breach its debt distress threshold (NPV debt-to-exports ratio of 150 percent) as early as 2010. In countries where borrowing space has been increased primarily due to debt relief as opposed to sustained growth, non-concessional borrowing should be taken only in the context of: (1) prudent debt management practices on an aggregate-level; (2) growth- and revenue-enhancing projects; and (3) a conservative transition to market-based borrowing over time in line with fundamental debt-bearing capacity.

Source: Ghana- Fourth and Fifth Reviews Under the Three-Year Arrangement Under the Poverty Reduction and Growth Facility (EBS/06/72), May 26, 2006.

Bilateral and Non-MDB Lending: Increased lending from non-OECD creditors (so-called "emerging creditors") likely will be the largest free-riding danger. Export promotion activities from these countries are expected to increase dramatically over the next several years. For example, China is already very active in sub-Saharan Africa – channeling billions of dollars in non-concessional loans to countries eligible for, or undergoing, debt relief. In 2005, China lent $814 million on non-concessional terms to Sudan – a country with an external debt burden more than four times the sustainable thresholds (see Box 3). China has recently signed memoranda of understanding for several large-scale infrastructure projects, such as $2.6 billion for two dams in Mozambique and $500 million for Ghana's Bui Dam. In addition, China's commitments at the UN Millennium Review Summit include the provision of $10 billion in concessional loans and preferential export buyer's credit to developing countries over the next three years. It is unclear how much of this assistance actually will be concessional.[16] India, meanwhile, has committed $500 million in Export-Import Bank lines of credit to West African countries under its Techno-Economic Approach for Africa-Indian Movement.[17] With significant oil revenue windfalls, Middle East and OPEC coun-

16. Concessionality definitions can vary significantly. OECD-DAC rules, for example, consider any loan with a minimum 25% grant element using a fixed 10% discount rate to be concessional. Under this definition, many loans that charge market-based rates would qualify as concessional. The IMF's more appropriate definition requires currency-specific commercial interest reference rates (CIRR) as discount rates and a minimum 35% grant element.
17. Manning, Richard. ODI Lecture, March 9, 2006: Will "Emerging Donors" Change the Face of International Cooperation?

tries also are expected to significantly ramp up their development assistance activities in low-income countries largely in the form of loans.

Although increased export-based lending from OECD bilateral creditors is also cause for concern, efforts are currently underway within the OECD's Working Party on Export Credits and Credit Guarentees (ECG) to adopt guidance contained in the debt sustainability framework. In addition, some OECD donors have "cover" policies that restrict loans to countries receiving debt relief. For example, the U.S. government prevents export credit agencies (e.g., Export-Import Bank, U.S. Department of Agriculture) from providing non-concessional loans to recipients of Paris Club debt reductions. The U.S. moratorium, which excludes short-term trade credits and asset-backed financing, lasts from one to three years, depending on whether the country meets certain credit-worthiness criteria. Furthermore, the U.S. Export-Import Bank will only engage in public sector transactions if the loans conform with IMF program limits on non-concessional debt.

Box 3: Sudan Case Study – Free Riding

Although Sudan is a heavily indebted country on the path to debt reduction through the HIPC Initiative and MDRI, it has been borrowing on non-concessional terms from bilateral and multilateral creditors for several years. The magnitude of new non-concessional borrowing in 2005, however, showed a dramatic increase. From $310 million in 2004, Sudan ratcheted up its non-concessional borrowing to $935 million, nearly $800 million more than permitted under its IMF Staff-Monitored Program (SMP). In 2005, non-concessional loans from China totaled $814 million, while loan contracts with the Islamic Development Bank and the Arab Monetary Fund amounted to $102 million. Non-concessional loans of similar magnitude from China are planned for 2006.

These loans are problematic for three reasons. First, the promise of forgiveness represents a subsidy to China and other creditors that presumably expect to be repaid in full from donors providing debt relief to Sudan. Second, the increase in Sudan's debt burden as a result of the new lending increases the amount of relief required to meet target HIPC debt thresholds. In essence, parliamentarians from traditional donor countries would be asked to increase debt relief funding to help guarantee repayment of recent non-concessional loans from China, OPEC countries, and others in excess of IMF SMP guidelines. Third, these loans directly threaten the future external sustainability of Sudan, whose current debt burden is more than four times HIPC target thresholds. If new lending continues unabated in advance of HIPC relief – and these debts are not reduced – Sudan's external debt could remain near or in breach of debt distress thresholds even after delivery of HIPC and MDRI.

Source: Sudan: Staff Report for the 2006 Article IV Consultation and Staff-Monitored Program, (EBS/06/59), April 19, 2006.

C. Repayment Capacity (Growth Prospects): An additional risk to debt sustainability is the persistence of disappointing economic growth in low-income countries. Among the HIPCs, average per capita real income of US$375 in 2003 has fallen more than 25 percent since 1980, and poverty has continued to grow in absolute terms even subsequent to debt relief measures.[18] However, some studies suggest that debt relief will enhance HIPCs' growth prospects. For example, Pattillo et al. (2002) find that the average impact of external debt on per capita GDP growth is negative for NPV debt levels above *160* to *170* percent of exports.[19] Clements et al.

18. Lerrick, Adam. "The Debt of the Poorest Nations: A Gold Mine for Development Aid," Carnegie Mellon Gailliot Center for Public Policy, June 2005.
19. Pattillo, Catherine A., Helen Poirson, and Luca Ricci, 2002, "External Debt and Growth," IMF Working Paper 02/69.

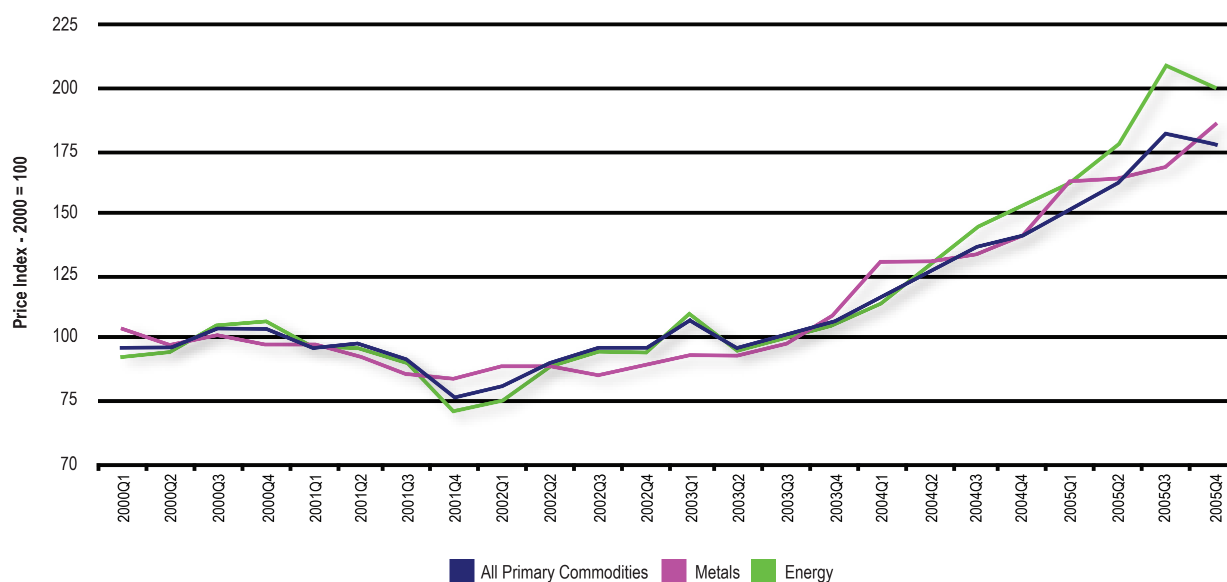
(2002), utilizing a dataset of only low-income countries, find that the average impact of external debt on per capita income growth is negative for NPV debt levels above only *100* to *105* percent of exports.[20] Recent evidence is mixed. According to a 2006 World Bank Independent Evaluation Group report, average export growth in countries that completed the HIPC Initiative between 2000 and 2004 was approximately double the growth in the 1990s. However, most of this increase was attributable to low starting points, and the growth rates still fell well short of projections. As previously noted, overoptimistic growth rate projections make future debt burdens appear much more manageable than they really are. In this case, the difference between actual and projected growth rates results in an underestimation of the NPV debt-to-exports ratio by close to a third over a 10-year period.[21]

In addition, low revenue mobilization continues to impair repayment capacity in many low-income countries. While some governments – such as Ghana, Malawi, and Guinea-Bissau – have successfully improved revenue collection efforts in recent years, overall levels remain low relative to other developing countries. As a group, HIPCs' government revenue-to-GDP ratio averaged just over 16 percent in 2004. By comparison, a recent UN study revealed that the median government revenue-to-GDP ratio (from 1996 to 2002) was 25 percent in transitional countries and 31 percent in developed countries.[22] Continuing to improve government capacity and efficiency in mobilizing revenues will be an important component of increasing repayment prospects going forward.

D. Commodity Prices: Many low-income countries' exports are highly concentrated in primary commodities and, therefore, are very vulnerable to price volatility. In recent years, surging primary commodity prices (see Figure 3 below) have contributed to strong export performance. The most extreme cases include oil-exporting countries (e.g., Angola, Chad, and Nigeria), and metal producers (e.g., Zambia, Ghana, and Tanzania). Despite improved terms of trade, many countries still experienced a deterioration in their external indebtedness indicators during the same time period. In addition, studies have shown that export price shocks have an asymmetric impact on growth in developing countries, i.e., negative shocks hurt growth more than positive shocks enhance it. Part of this is likely attributable to insufficient savings and investment of windfall gains when commodity prices are rising.[23] Given extreme export concentration in one or two commodity sectors, a reversal in the price of specific commodities could cause a serious deterioration in low-income countries' external indebtedness indicators. Recognizing this risk, international creditors – including IDA and AfDF – should act prudently to avoid a rapid accumulation of external debt, which would be exacerbated by any reduced performance of their export sectors. Additionally, short-term, value-based improvements in export data should not justify reduction in the grant component of MDB assistance for high- or medium-risk low-income countries.

20. Clements, Benedict, Rina Bhattacharya, and Toan Quoc Nguyen, 2003, "External Debt, Public Investment, and Growth in Low-Income Countries," IMF Working Paper 03/249.
21. The World Bank Independent Evaluation Group, "Debt Relief for the Poorest: An Evaluation of the HIPC Initiative," 2006.
22. United Nations Economic and Social Council, "Basic Data on Government Expenditure and Taxation," Feb 17, 2004.
23. Gautam, Madhur, "Debt Relief for the Poorest: An OED Review of the HIPC Initiative," World Bank Operations Evaluation Department, 2003.

Figure 3 – Commodity Price Indices, 2000-2005



Source: IMF, International Financial Statistics

CONCLUSIONS

Over the last two decades, the international donor community has taken important incremental steps toward rationalizing the way financial assistance is provided to low-income countries. The initial shift in bilateral assistance from concessional loans to grants provided a significant benefit to countries' debt sustainability prospects. The recent shift in MDB assistance from loans to grants represents a further step in the right direction. In addition, HIPC and MDRI debt cancellation will generate marked improvements in external debt ratios and vulnerability.

The international community needs to take additional steps to address remaining risks, including: (1) shortcomings in the World Bank/IMF debt sustainability framework, which governs concessionality decisions for IDA and the AfDF; (2) free-riding by emerging creditors; (3) uncertain country growth prospects and insufficient revenue mobilization; and (4) eliminating pro-cyclical lending practices. In addition, further research and analysis are needed to better assess the risks posed by domestic borrowing practices and debt levels.

We suggest the following general policy recommendations:

(1) Increase coordination with emerging creditors (e.g., China and India), including: collaboration and cooperation with the Paris Club, interaction with the, and collaboration with the World Bank and IMF on country-specific debt sustainability analyses.

(2) Impose "free-riding" penalties to deter opportunistic lending that takes advantage of official grants and debt relief. The World Bank is considering measures in the case of IDA grants, which is an important first step. However, the World Bank also should consider measures in the context of recent debt relief. Other official and bilateral creditors should implement comparable policies.

(3) Encourage low-income countries to institute policies and pursue projects that enhance revenue mobilization, export diversification, and macroeconomic stability, which collectively will

increase economic growth and increase government repayment capacity.

(4) Reform the World Bank/IMF debt sustainability framework to include country-specific benchmarks, which would restrict the rate of debt accumulation. These benchmarks would be accompanied by penalties to promote country compliance. This would help to address several ongoing risks by: (i) ensuring that countries maintain a cushion for absorbing the economic impact of exogenous shocks; and (ii) controlling for overoptimistic DSA projections. Upcoming IDA and AfDF donor meetings provide a good opportunity to take appropriate measures in this area.

APPENDIX I

Paris Club Reschedulings and Deferrals for IDA-Eligible Countries, 1976 - December 2002

Country	Number of Reschedulings	Date of Agreement (plus amendments)
Angola	1	1989
Benin	5	1989, 1991, 1993, 1996, 2000 (followed by amendments in 2001, 2002, 2002)
Bolivia	8	1986, 1988, 1990, 1992, 1995, 1995, 1998, 2001
Bosnia	1	1998 (followed by amendment in 2000)
Burkina Faso	5	1991, 1993, 1996, 2000 (followed by amendments in 2001 and 2002), 2002 (followed by amendment in 2002)
Cambodia	1	1995
Cameroon	6	1989, 1992, 1994, 1995, 1997, 2001
CAR	7	1981, 1983, 1985, 1988, 1990, 1994, 1998
Chad	4	1989, 1995, 1996, 2001
Congo, Rep.	4	1986, 1990, 1994, 1996
Congo, DRC	11	1976, 1977, 1977, 1979, 1981, 1983, 1985, 1986, 1987, 1989, 2002
Cote d'Ivoire	9	1984, 1985, 1986, 1987, 1989, 1991, 1994, 1998, 2002
Djibouti	1	2000
Ethiopia	3	1992, 1997, 2001 (followed by amendment in 2002)
Gabon	8	1978, 1987, 1988, 1989, 1991, 1994, 1995, 2000
Gambia	1	1986
Georgia	1	2001
Ghana	3	1996, 2001, 2002
Guinea	6	1986, 1989, 1992, 1995, 1997, 2001
Guinea-Bissau	4	1987, 1989, 1995, 2001
Guyana	5	1989, 1990, 1993, 1996, 1999
Haiti	1	1995
Honduras	4	1990, 1992, 1996, 1999
Indonesia	3	1998, 2000, 2002
Kenya	2	1994, 2000
Kyrgyz Republic	1	2002
Liberia	4	1980, 1981, 1983, 1984
Madagascar	9	1981, 1982, 1984, 1985, 1986, 1988, 1990, 1997 (followed by two amendments in 2000), 2001
Malawi	4	1982, 1983, 1988, 2001
Mali	5	1988, 1989, 1992, 1996, 2000 (followed by amendments in 2001, 2002)
Mauritania	8	1985, 1986, 1987, 1989, 1993, 1995, 2000, 2002
Mozambique	7	1984, 1987, 1990, 1993, 1996, 1999 (followed by amendment in 2000), 2001
Nicaragua	4	1991, 1995, 1998 (followed by amendment in 1999), 2002
Niger	10	1983, 1984, 1985, 1986, 1988, 1988, 1990, 1994, 1996, 2001
Nigeria	4	1986, 1989, 1991, 2000
Pakistan	3	1999, 2001, 2001
Rwanda	2	1998, 2002
Sao Tome	1	2000
Senegal	13	1981, 1982, 1983, 1985, 1986, 1987, 1989, 1990, 1991, 1994, 1995, 1998, 2000 (followed by amendment in 2002)
Sierra Leone	8	1977, 1980, 1984, 1986, 1992, 1994, 1996, 2001 (followed by amendment in 2002)
Somalia	2	1985, 1987
Sudan	4	1979, 1982, 1983, 1984
Tanzania	7	1986, 1988, 1990, 1992, 1997, 2000, 2002
Togo	10	1979, 1981, 1983, 1984, 1985, 1988, 1989, 1990, 1992, 1995
Uganda	8	1981, 1982, 1987, 1989, 1992, 1995, 1998, 2000
Vietnam	1	1993
Yemen	3	1996, 1997, 2001
Zambia	8	1983, 1984, 1986, 1990, 1992, 1996, 1999, 2002

Source: IMF, Official Financing and Recent Developments, December 2003

APPENDIX II

AVAILABILITY OF GRANT ASSISTANCE

Examining the historical OECD-DAC[24] data on volumes and terms of official development assistance, we find that the overwhelming majority of assistance (measured in net terms)[25] is provided on grant terms. This suggests that borrowing constraints would have an immaterial impact on low-income countries' ability to access available external resources. This evidence argues against recent claims that limiting new borrowing through a shift to greater grant assistance – such as through the World Bank-IMF Debt Sustainability Framework[26] (DSF) – would decrease the amount of development assistance available for low-income countries.

The amount of bilateral ODA provided each year in the form of loans or grants is tied to parliamentary or congressional appropriations. With a few small exceptions, the same is true for multilateral ODA providers since they depend upon donor contributions to finance commitment capacity. [27] This fixed amount of resources then is channeled to recipient countries through a variety of mechanisms based on country performance or other criteria. Importantly, the only way a low-income country can access additional external resources for development purposes is through: (1) supplemental donor appropriations; or (2) non-concessional borrowing. Yet, the IMF has included a zero ceiling on non-concessional borrowing for low-income countries that borrow from the Poverty Reduction and Growth Facility (PRGF). Therefore, barring noncompliance, access to additional development assistance is limited to supplemental appropriations.

In 2004, nearly 90 percent of net ODA to poor countries was provided on grant terms. Of the roughly 60 traditional creditors monitored by the OECD-DAC, 48 provided grant financing accounting for more than 95 percent of their total net ODA. Several of those creditors providing less than 95 percent grant financing, such as the Asian Development Fund (AsDF) and International Fund for Agricultural Development (IFAD), have joined or are expected to join IDA and AfDF in implementing the World Bank/IMF debt sustainability framework. Under this framework, these creditors could provide up to 100 percent of available assistance to low-income countries in the form of grants if warranted by long-term debt sustainability considerations. Therefore, only a handful of official creditors are expected to have constraints on their ability to promote long-term debt sustainability through grant financing. Collectively, they accounted for less than 5 percent of net ODA provided in 2004.

24. The OECD-DAC, or Development Assistance Committee, is the principal body through which the OECD deals with issues related to cooperation with developing countries.
25. This paper focuses on net ODA – equal to disbursements minus loan repayments – since it reflects the real financial contribution to countries' capital stock.
26. These institutions accounted for approximately 20 percent of net ODA provided in 2004.
27. A relatively modest amount of multilateral ODA is financed through institutions' internal resources, such as loan repayments and investment income.

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