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Investing in rural people

Review of IFAD's Participation in the Heavily Indebted Poor Countries Initiative

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For: **Review**

Executive summary

1. This paper aims to provide the Executive Board with an update on IFAD's participation in the Heavily Indebted Poor Countries (HIPC) Initiative, focusing on the development impact of the programme, key challenges and estimated cost to IFAD.

2. IFAD's participation in the HIPC Initiative was decided by IFAD's Governing Council at its twentieth session in February 1997. It has resulted in the provision of debt relief to 35 countries eligible for the programme, amounting to a total of US$510 million as of the end of the Eleventh Replenishment of IFAD's Resources in 2021.

3. While the HIPC Initiative helped eligible countries reduce their debt burden significantly, thereby redirecting resources to poverty reduction, major challenges remain:

   (i) Many countries that successfully reached the HIPC "completion point" are now experiencing a deteriorating debt situation. They are increasing their public borrowing to face the COVID-19 crisis and diversifying their sources of financing to include less concessional debt.

   (ii) Three HIPC-eligible countries – Eritrea, Somalia and Sudan – are at different stages of the Initiative, with future debt relief estimated at about US$155 million, for an amortization period set to last until 2040.

4. IFAD's strong participation in the HIPC Initiative was facilitated by access to the Debt Relief Trust Fund (DRTF) administered by the World Bank Group since 2006 and in turn funded by Member State donations. DRTF access allowed IFAD to cover two thirds of the overall debt relief entitlements of countries at completion point. Nevertheless, IFAD's participation in the HIPC Initiative had significant cost implications, as the debt relief was charged against core replenishment resources (46 per cent of total debt relief provided) due to the lack of full additional compensation from Members.

5. At the same time, IFAD has continued to deliver a programme of loans and grants on the basis of the full compensation expected from Member States. Other international financial institutions have effectively mitigated the risk of a temporary shortfall in compensation through more binding arrangements on HIPC contributions, which were (i) embedded into the call for new donor contributions at the time of replenishment, and/or (ii) paid on a pay-as–you-go basis as maturities fell due.

6. IFAD has been a committed participant in the voluntary HIPC process since its inception. The Fund strongly supports the key principle underlying the HIPC, i.e. that actions should be coordinated among all creditors involved, with broad and equitable participation.

7. Management is ready to explore options with IFAD donor countries to fund future HIPC-related debt relief in a way that protects IFAD's financial sustainability and its disbursement capacity. This would allow IFAD to continue its crucial support to the poorest and most highly indebted countries in responding to COVID-19 and in broader recovery efforts involving increased access to new concessional resources, grants included.

I. IFAD's participation in the Heavily Indebted Poor Countries (HIPC) Initiative

1. The enhanced HIPC Initiative[1] represents a unique, internationally agreed framework for providing debt relief to low-income countries, although creditor participation continues to be voluntary. In this context, the international community agreed to strengthen the links between debt relief and poverty reduction. Multilateral development banks (MDBs) and development finance institutions (DFIs) played a crucial role here.

2. The top multilateral creditors, according to their share in the total cost of HIPC debt relief, are the World Bank Group (WBG); the African Development Bank Group; the International Monetary Fund (IMF); the Inter-American Development Bank; the European Union/European Investment Bank; the Central American Bank for Economic Integration; and IFAD.

3. Debt relief is part of a comprehensive poverty reduction strategy focused on strengthened institutional capacity, higher growth, and better-targeted social programmes. It has thus been linked to progress in preparing and implementing poverty reduction strategies, which are designed to be country-driven and developed with the broad participation of civil society.

4. Through the HIPC Initiative, a percentage of debt is forgiven on a pay-as-you-go basis, by all participating lenders following satisfactory economic reforms. The Initiative is not intended as a mechanism for settling arrears. Rather, the preconditions for HIPC debt relief are: (i) normalization of relations with creditors, including clearance of arrears to multilateral creditors; and (ii) securing necessary resources for creditors to finance their share of the cost of HIPC debt relief.

5. IFAD's Governing Council, at its twentieth session in February 1997, approved IFAD's participation in the HIPC Initiative as an element of IFAD's broader policy framework for managing partnerships with countries that either have arrears with IFAD, or risk going into arrears because of their debt service burden.[2] The Governing Council delegated authority to the Executive Board to approve, on an individual country basis, the debt relief required from IFAD as part of the overall HIPC effort to reduce countries' debts to sustainable levels.

6. Since the HIPC Initiative's inception, MDBs and DFIs have played a leading role in alleviating debt burdens and enabling recipient countries to increase their poverty-reducing expenditures. As of end-July 2019,[3] over 99 per cent of multilateral creditors, ranked by their share in the total cost of HIPC debt relief, participated in the Initiative.

7. To qualify for debt relief under the HIPC Initiative, a country has to meet strict eligibility conditions.[4] To date, IFAD has provided debt service relief to 35 out of 38 eligible countries,[5] 30 of which are in sub-Saharan Africa. IFAD has actively participated, through the HIPC Initiative, in reducing the public debt burden in

[1] The HIPC Initiative was launched in 1996 and enhanced in 1999 to provide broader, deeper and faster debt relief.
[2] EB 96/59/R.73 and GC 20/L.6, resolution 101/XX.
[3] Heavily Indebted Poor Countries (HIPC) and Multilateral Debt Relief Initiative (MDRI)–Statistical Update, prepared by IMF staff and completed on 30 July 2019.
[4] https://www.worldbank.org/en/topic/debt/brief/hipc. To qualify for the HIPC Initiative, a country must:
(i) Face an unsustainable debt situation after the full application of the traditional debt relief mechanisms (such as the application of Naples terms under the Paris Club agreement);
(ii) Be only eligible for highly concessional assistance from the International Development Association (IDA) and from the IMF's Poverty Reduction and Growth Trust;
(iii) Have established a track record of reform and sound policies through IMF and WBG-supported programmes;
(iv) Establish a track record of reform and develop a poverty reduction strategy paper that involves civil society participation.
[5] Please refer to annex I for a list of Member States participating in the HIPC Initiative, by stage.

these 35 post-CP, low-income countries, allowing them to access new development finance resources and increase anti-poverty spending.[6]

8. Under the HIPC Initiative, IFAD provided debt relief when a country reached certain milestones. This triggered a reduction of up to 100 per cent of that country's semi-annual debt service obligations to IFAD (principal, service charges and interest payments), as these obligations fell due.

9. HIPC debt relief is provided when a country reaches the following milestones, which are closely tracked by WBG/IMF:

   (i) **Pre-decision point:** countries are monitored by WBG/IMF to check on arrears settled or about to be settled, as well as for indications of macroeconomic reforms.

   (ii) **Decision point (DP):** WBG/IMF review macroeconomic conditions in the country and, if satisfactory, declare DP and quantify debt relief. Some assumptions like the discount factor and common reduction factor[7] are defined at DP.

   In some cases, after scrutiny and endorsement by WBG/IMF, interim debt relief is provided in the period from DP to completion point (CP).

   The DP is declared following consultations among all creditors, including the Paris Club and the international financial institutions (IFIs). All participating creditors agree to commit to reducing the qualifying country's debt to a sustainable level and to share the burden of settling the debt.

   (iii) **Completion point:** debt relief is provided.

10. Figure 1 below shows that the fiscal space created by the debt relief allowed IFAD to provide additional development financing to eligible countries. This support materialized through a series of grants and loans with significant levels of concessionality. Since the inception of the initiative, IFAD has provided US$1.1 billion to HIPC countries in the periods between their respective DPs and CPs (the first of these DPs took place in 2000 and the related CP took place in 2015). Since 2000, IFAD has been able to provide a total of US$6.3 billion in financing to countries that benefited from the HIPC Initiative (US$2 billion in grants and US$4.3 billion in concessional loans).

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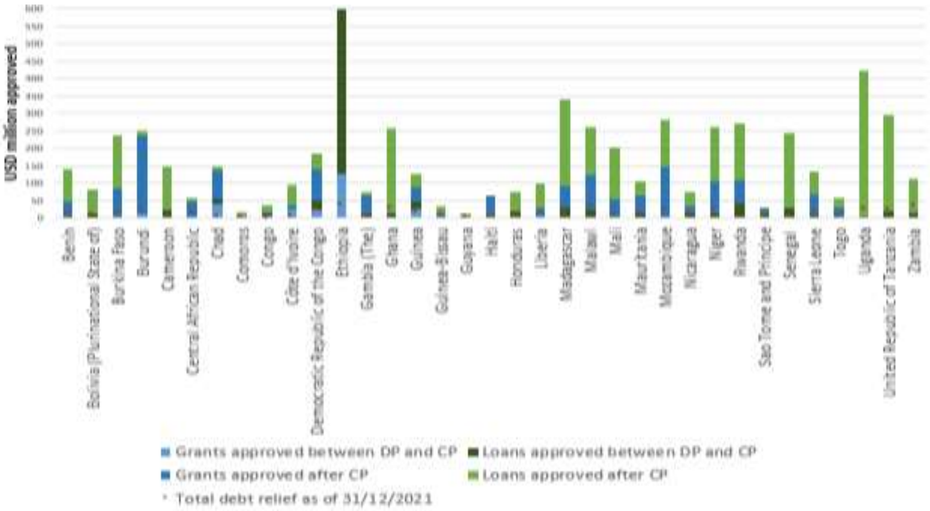
[6] According to an IMF HIPC and MDRI statistical update (August 2019), the poverty-reducing expenditures (7.3 per cent of GDP) were almost four times as great as debt service payments (1.9 per cent of GDP) in 2017.

[7] The "common reduction factor" is defined by the IMF as the level of debt relief needed to get an HIPC back to a sustainable debt situation assuming all creditors take part in the initiative.

Figure 1
Financial resources versus debt relief provided to post-CP countries
As at end-December 2021



11. The last CP was reached in 2012; three countries are still due to finalize the HIPC Initiative: Eritrea, Somalia and Sudan. Over the last two years, Somalia and Sudan have reached DP with MDB creditors:

    (i) Somalia's debt relief will only begin at CP, currently forecast by WBG/IMF as 2023. Somalia reached DP in March 2020. DP HIPC debt relief has not yet been approved at IFAD as Somalia still has to clear some arrears.

    (ii) Sudan reached DP approval by the IDA and African Development Bank Group in 2021 and has benefited from the possibility of interim debt relief. However, this is currently under reassessment following recent political developments in the country. DP approval remains valid.

12. As of today, the DPs of Somalia[8] and Sudan are subject to the approval of IFAD's Executive Board. In addition, one already HIPC-eligible country, Eritrea, is at pre-decision point. Further, despite not being eligible on the basis of the ring-fenced list[9] agreed among multilateral creditors, Zimbabwe faces an unsustainable debt situation and there are recent indications from the WBG of a potential "exceptional" eligibility.[10]

13. IFAD has been a committed participant in the HIPC process since its inception. This voluntary commitment reinforces one of the key principles underlying the HIPC Initiative – the expectation that actions should be coordinated among all creditors involved, with broad and equitable participation.[11] But there is no formal requirement for them to do so.

II. IFAD's financing contribution to HIPC implementation

14. The mobilization of resources for debt relief to the 35[12] countries participating in the HIPC Initiative prompted IFAD, in February 1998, to establish an HIPC Trust Fund for debt relief implementation.

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[8] Subject to arrears clearance with IFAD.
[9] In 2006, the WBG/IMF, together with other bilateral and multilateral creditors, agreed on a ring-fenced list of countries to be eligible for the HIPC Initiative once preconditions were met.
[10] IDA 20 Report from the Executive Directors of the IDA to the Board of Governors stipulated that "the possibility that Zimbabwe could qualify for HIPC has been retained in the relevant HIPC ringfencing exercise. Options for Zimbabwe's re-engagement are under consideration, including via HIPC and non-HIPC routes".
[11] The Governing Council decided at its twenty-third session in February 2000 with resolution 117/XXIII, that IFAD would fully participate in the enhanced debt Initiative.
[12] Out of 38 HIPCs eligible.

15. In addition, since 2006 IFAD has had strong support from its donors for the Trust Fund, which is administered by the WBG. This support has allowed IFAD to cover up to two thirds of the overall debt relief entitlements of countries at CP.

16. As at end-December 2021, the HIPC Trust Fund was financed from:

(i) IFAD's core resources to almost half of the total cost of debt relief (46 per cent);

(ii) The DRTF,[13] which, since 2006, covered two thirds of HIPC entitlements;

(iii) Member State and other donor contributions to IFAD's HIPC Trust Fund as debt relief earmarked for specific HIPC countries or unearmarked debt relief for countries included in the HIPC programme; and

(iv) Investment income received on the resources of the Trust Fund.

Table 1
HIPC Trust Fund resources of financing
(Estimates as at 31 December 2021, amounts expressed in millions of United States dollars)

	Amount	*Percentage*
IFAD core resources from 1998 to 2021	249.3	46
Members' contributions provided until 2006	71.5	13
Transfer from DRTF administered by WBG from 2006 to 2021	215.6	40
Investment income	8.4	2
Total	**544.8**	**100**

17. As at 31 December 2021, the Fund had provided debt relief amounting to US$510 million (97 per cent of total debt relief to be provided) to 35 eligible countries at CP,[14] while future debt relief already approved for CP countries was equivalent to US$15.6 million. Two countries (Somalia and Sudan) are at DP status with other MDBs, to be approved by the Executive Board, while one country (Eritrea) is at pre-decision point.

18. The table below refers to the full HIPC Initiative from its inception up to the very last repayment, currently forecast for 2040 (debt relief provided on a pay-as-you-go basis as per the underlying loan amortization schedules). Debt relief for Somalia and Sudan amounts to 18 per cent of the overall HIPC Initiative due to the significant size of IFAD's portfolio in Sudan.

Table 2
HIPC debt relief in nominal terms
(Special drawing rights [SDR] and millions of United States dollars)

		SDR	*US$*	
Debt relief provided – CP countries		**364.0**	**510.0**	
Future debt relief				
CP countries	*Approved*	*11.1*	*15.6*	
DP countries	*To be approved*	*86.2*	*120.9*	*Somalia and Sudan*
Pre-decision point countries	*To be approved*	*13.6*	*19.1*	*Eritrea*
Subtotal – future debt relief		**110.9**	**155.5**	
Total		**474.9**	**665.6**	

19. The successful implementation of the HIPC Initiative at IFAD, reflected in the very advanced level of debt relief (97 per cent of the total debt relief provided by IFAD), was supported by Members' strong contributions, through direct and external resources provided to cover a cumulative 53 per cent of the total cost of debt relief, and the mobilization of IFAD's core resources.

[13] As agreed at the HIPC information and funding meeting held on 19 November 2006.
[14] See annex II.

20. Nevertheless, IFAD's participation in the HIPC Initiative results in debt relief being charged against core replenishment resources[15] due to the non-binding compensation payments from Members. At the same time, IFAD has continued to deliver a programme of loans and grants on the basis of the expected materialization of such compensation. Other IFIs have effectively mitigated the risk of the temporal shortfall between expected and received compensation through more binding arrangements on HIPC contributions, which were (i) embedded in the call for new donor contributions at the time of replenishment, and/or (ii) paid on a pay-as-you-go basis as maturities fell due.

21. In addition, the overall cost of the HIPC Initiative has increased substantially over time[16] and at present IFAD HIPC Trust Fund resources are fully used to cover debt relief already approved. Therefore, IFAD HIPC Trust Fund resources will not be sufficient to meet the financing requirements of new HIPC debt relief for countries that have yet to reach their completion and/or DPs[17] with IFAD.

22. The future debt relief for DP countries is estimated at approximately US$155.5 million. This relief will be provided based on the underlying amortization schedule expected to run until 2040. Compensation from the DRTF administered by the WBG is estimated at US$103.7 million, leaving a balance of US$51.8 million to be covered. These funding needs, if not met otherwise, would have to be financed through IFAD's core resources. This would result in a reduction in IFAD's capital and thus a reduction in the Fund's short-term financial and commitment capacity.[18]

23. Therefore, in order to avoid IFAD contributing unduly to the debt burden of poor countries while also allocating more resources to eradicating rural poverty, more support from donors is becoming essential. Only then can IFAD participate successfully in the HIPC Initiative alongside other international efforts.

24. Following discussions on this paper, Management will provide the Audit Committee and the Executive Board with a detailed analysis of the financial implications if compensation fails to materialize, and will explore with Members the options for mobilizing additional support.[19]

III. Debt sustainability: remaining challenges and future dynamics for post-CP HIPCs

25. **The evolution of debt in countries that have participated in the HIPC Initiative**. The Initiative aimed to reduce the debt stocks and debt services of eligible countries and allow them to free up fiscal space for more sustainable development including long-run debt sustainability. At the same time, maintaining a sustainable debt trajectory beyond the CP remains a concern.[20] Several countries have seen their debt situation deteriorate and face the risk of falling back into debt distress, a situation made worse by the consequences of the current pandemic.[21]

26. The following figure shows the evolution of debt distress in countries after reaching CP. Only about 6 per cent of post-CP HIPCs have a low risk of debt distress; 46 per cent are at high risk of, or in, debt distress status; and 82 per cent of those at

[15] During the period 1998–2006, IFAD participation in the HIPC debt relief was provided from the Fund's core resources for a total of US$70 million.

[16] Statement of IFAD's President at the WBG/IMF Annual Meeting in Dubai (September 2003): "The initial cost of IFAD's participation was estimated at about US$469 million with a present value of US$308 million".

[17] Somalia and Sudan at decision point.

[18] The absorption of IFAD share of debt relief is, over the years, cash flow neutral because funds are transferred from IFAD to the HIPC Trust Fund and afterwards, based on the amortization schedules, funds are repaid to IFAD.

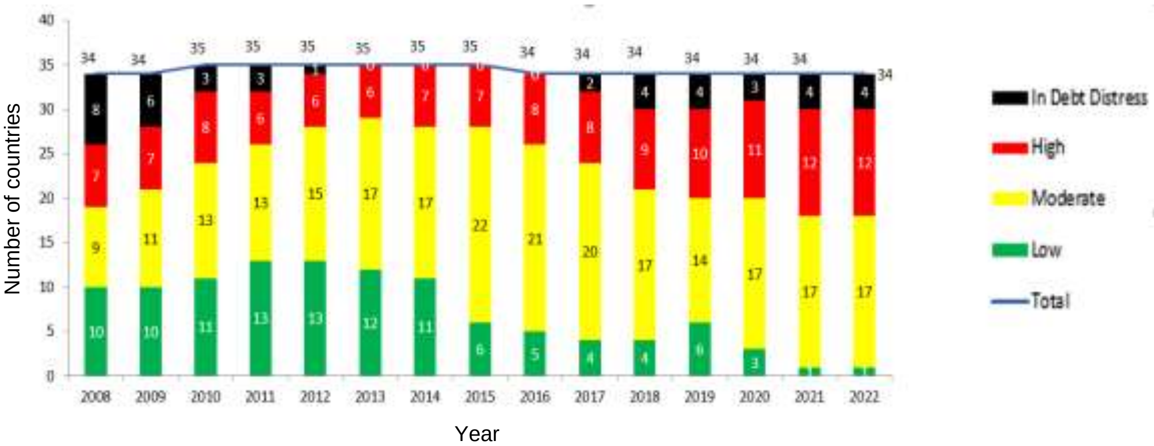
[19] Options could be the reserve set aside from available resources for the Twelfth Replenishment of IFAD's Resources (IFAD12) programmes, or reserves to be agreed in IFAD13, or other funding based on supplementary resources.

[20] Because of fiscal space provided by HIPC debt relief, several post-CP countries had started exploring non-concessional borrowing from capital markets or non-traditional donors to finance national development programmes when sufficient concessional resources were not available.

[21] Sharp declines in GDP and in exports together with reductions in remittance flows, foreign direct investment and trade.

moderate risk (49 per cent of total countries concerned) of debt distress remain highly exposed to debt distress deterioration.

Figure 2
Debt distress status of post-CP HIPCs at IFAD
As at January 2022



27. Nineteen out of the 35 countries beyond CP are low-income countries that risk having to increase their public borrowing to make it through the COVID-19 crisis. In this situation, they are finding it harder to service and repay their public debt, which was already on the rise before the pandemic. This debt has now reached 61 per cent of GDP, due to increased fiscal spending, allowed by the HIPC, and a shift towards less concessional debt, including market-based financing.

28. Capacity to service and repay high levels of public debt is expected to recover only slowly, making it essential that IFAD continues supporting these countries through its COVID-19 response and broader recovery efforts.[22] The Fund should offer them a higher volume of new concessional resources, including grants.

IV. Conclusion

29. The success of the HIPC Initiative depends not only on the participation of all creditors but also on debtor countries' efforts in terms of debt management. IFAD remains committed to participating in the HIPC Initiative and to joining in the coordinated and equitable action of all creditors involved.

30. During the recent IFAD12 discussions, Members stressed the importance of providing concessional resources to IFAD borrowers in order to respond to the substantial financing needs resulting from the pandemic while: (i) preserving the debt sustainability of countries; (ii) ensuring IFAD's active commitment to the HIPC Initiative; and (iii) maintaining the financial sustainability of the Fund.

31. In this regard, Members' continued support will be fundamental to allow IFAD to (i) honour its commitment to participate in the IFI global debt relief and management framework, having assured its own financial sustainability; and (ii) preserve IFAD's ability to play a countercyclical role without creating an additional debt burden on HIPC-eligible countries.

32. Management will present to the Executive Board a recommendation that IFAD support Somalia[23] and Sudan in reaching DP once eligibility criteria for each are met: in addition, Management is ready to explore options with IFAD donors for

[22] As per the January 2020 WBG/IMF report "The Evolution of Public Debt Vulnerabilities in Lower Income Economies", the external financing needs in low-income countries by end fiscal year 2025 is estimated at US$429 billion. It is further estimated that in order to return to convergence with advanced economies, low-income countries would require an additional US$310–376 billion.
[23] Decision point HIPC debt relief has not yet been approved by IFAD as Somalia has to clear arrears of approximately US$6.0 million.

funding debt relief in a way that protects IFAD's financial sustainability as well as its committed programming and disbursement capacity.

Member States participating in the enhanced HIPC Initiative, by stage

1. Under the WBG/IMF HIPC framework, approximately 92 per cent of eligible countries (35 out of 38) have reached CP, actually benefiting from HIPC assistance. Two countries (Somalia and Sudan) are at DP while one (Eritrea) is still at pre-decision point.

Table 1
Member States participating in the HIPC Enhanced Debt Initiative, by stage

CP countries (35)	*DP countries (2)*	*Pre-decision point countries*
Benin	Somalia	Eritrea
Bolivia (Plurinational State of)	Sudan	
Burkina Faso		
Burundi		
Cameroon		
Central African Republic		
Chad		
Comoros		
Congo		
Côte d'Ivoire		
Democratic Republic of the Congo		
Ethiopia		
Gambia (The)		
Ghana		
Guinea		
Guinea-Bissau		
Guyana		
Haiti		
Honduras		
Liberia		
Madagascar		
Malawi		
Mali		
Mauritania		
Mozambique		
Nicaragua		
Niger		
Rwanda		
Sao Tome and Principe		
Senegal		
Sierra Leone		
Togo		
Uganda		
United Republic of Tanzania		
Zambia		

Summary by country of the HIPC debt relief provided by IFAD

As at 31 December 2021

CP countries	*Principal*	*Interest*	*Total*
Benin	4 568	1 643	6 211
Bolivia (Plurinational State of)	5 900	1 890	7 790
Burundi	14 507	3 149	17 656
Burkina Faso	6 769	2 668	9 437
Cameroon	3 074	727	3 801
Central African Republic	9 563	2 935	12 498
Chad	2 708	477	3 185
Comoros	1 682	287	1 969
Congo	0	99	99
Côte d'Ivoire	1 814	326	2 140
Democratic Republic of the Congo	10 676	3 067	13 743
Ethiopia	20 569	5 905	26 474
Gambia (The)	2 508	619	3 127
Ghana	15 585	5 003	20 588
Guinea	11 202	2 168	13 370
Guinea-Bissau	4 227	1 176	5 403
Guyana	1 526	299	1 825
Haiti	1 946	635	2 581
Honduras	1 077	767	1 844
Liberia	9 065	6 252	15 317
Madagascar	7 810	2 096	9 906
Malawi	20 371	4 446	24 817
Mali	6 211	2 431	8 642
Mauritania	8 484	2 601	11 085
Mozambique	12 521	3 905	16 426
Nicaragua	7 259	943	8 202
Niger	11 016	2 812	13 828
Rwanda	16 786	5 211	21 997
Sao Tome	2 111	514	2 625
Senegal	2 247	882	3 129
Sierra Leone	10 956	2 351	13 307
United Republic of Tanzania	12 692	4 292	16 984
Togo	2 009	758	2 767
Uganda	12 449	4 654	17 103
Zambia	19 169	4 921	24 090
31 December 2021 SDR	**281 057**	**82 909**	**363 966**
Total US$ equivalent	**394 050**	**116 241**	**510 291**