Distribution: Restricted | EB 2002/77/R.11/Rev.1 | 11 December 2002
Original: English | Agenda Item 6 | English

IFAD

INTERNATIONAL FUND FOR AGRICULTURAL DEVELOPMENT

Executive Board – Seventy-Seventh Session

Rome, 10-11 December 2002

IFAD'S PARTICIPATION IN THE DEBT INITIATIVE FOR HEAVILY INDEBTED POOR COUNTRIES: PROGRESS REPORT 2002

Document #: 302990
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I. INTRODUCTION

1. The objective of this progress report for 2002 is to:

- inform the Executive Board of the status of implementation of the Debt Initiative for Heavily Indebted Poor Countries (HIPCs) and of IFAD's participation in the Initiative;
- inform the Executive Board of the further policy developments in the Initiative;
- update the Executive Board on the Fund's efforts to mobilize additional external resources to help finance IFAD's participation in the Initiative, and seek the Executive Board's further support to pursue this objective; and
- seek the Executive Board's approval for submitting the substance of this progress report to the forthcoming Governing Council for its information.

II. IMPLEMENTATION OF THE INITIATIVE

Progress to Date and Outlook

2. During 2002 Burkina Faso (topping up at completion point), Ethiopia, Ghana and Sierra Leone became eligible for debt relief under the enhanced Debt Initiative. This brings the total number of approved country cases to 26.[1] Bolivia, Burkina Faso, Mauritania, Mozambique, the United Republic of Tanzania, and Uganda have reached their completion points under the enhanced Initiative; and Guyana and Mali have reached their completion points under the original Initiative.

3. Looking ahead, in the next months Benin and Mali could reach their completion points under the enhanced Initiative; and preliminary documents have been issued for the Democratic Republic of The Congo and Côte d'Ivoire, which could therefore reach their decision points under the enhanced Initiative. Preliminary documents could also be issued for the Central African Republic and The Comoros. Guyana and Niger are expected to reach their completion points in the second quarter of 2003; Guinea and Zambia in the third quarter of 2003; and Cameroon, Ethiopia, The Gambia and Rwanda in the fourth quarter of 2003. Thus by end-2003 the total number of completion-point cases could be 16.

Table 1: The 42 Heavily Indebted Poor Countries

Countries with Enhanced Initiative Decision Point (26) as of March 2002	Countries Not Yet at Decision Point (12)	Possibly Sustainable Country Cases
Benin, Cameroon, Chad, Ethiopia, The Gambia, Ghana, Guinea, Guinea-Bissau (with interim relief from IFAD), Guyana, Honduras, Madagascar, Malawi, Mali, Nicaragua, Niger, Rwanda, Senegal, Sao Tome and Principe, Sierra Leone (with interim relief from IFAD), Zambia **With Decision Point and Completion Point (6):** Bolivia, Burkina Faso, Mauritania, Mozambique, United Republic of Tanzania, Uganda	Burundi, Central African Republic, Comoros, Congo, D.R. Congo, Côte d'Ivoire, Laos, Liberia, Myanmar (no IFAD exposure), Somalia, The Sudan, Togo	Angola, Kenya, Viet Nam, Yemen

[1] In addition, Côte d'Ivoire has been declared eligible for debt relief under the original Debt Initiative framework, but completion point has been delayed.

4. For the 26 countries that have reached their decision points under the enhanced Initiative, debt relief worth USD 25 billion in net-present-value (NPV) terms has been committed to date. This amounts to about USD 40 billion in nominal debt-service relief over time. Taken as a whole, the debt stocks for these countries will decline from around USD 62 billion in NPV terms to USD 27 billion after the full application of traditional debt-relief treatment and assistance under the Debt Initiative, and to USD 22 billion after bilateral debt relief beyond the Initiative committed by several bilateral donors – an overall reduction of nearly two thirds. Overall annual debt service paid during 2001-05 is expected to be cut by about 30% relative to annual debt-service payments made in 1998-99. This translates into an annual average decline in debt-service payments of 1.3% of gross domestic product (GDP). Debt service as a percentage of exports is projected to fall from an annual average of 16.1% in 2001 to 8.8% in 2005 (notwithstanding the recent declines in export revenues due to exogenous factors), and debt service relative to government revenue is projected to fall from an annual average of 24.3% in 1998-99 to 13.1% in 2001-05. Debt relief will enable governments to increase resources devoted to poverty reduction substantially. Social spending as a percentage of government revenue in the 26 decision-point countries increased from 37 to 47% between 1999 and 2001; and, on average, in 2002-05 they will spend on social sectors more than three times what they plan to spend on debt service over the same period. Social expenditures are expected to rise from 6% of GDP in 1999 to 9% in 2002. Social spending as a share of government revenue will increase from 37% before debt relief to an average of 55% afterwards.

Achievements of the 26 Decision-Point Countries
(as of July 2002)

- Debt relief has been approved for 26 out of 38 countries projected to require relief. The countries yet to reach decision points face serious challenges as most are conflict-affected and/or have substantial arrears problems.
- Six countries have reached completion points where debt relief is released unconditionally. Creditor participation is high but not complete.
- Twenty countries are receiving interim debt relief.
- Average NPV of external debt has been cut by approximately two thirds (with other forms of debt relief).
- Debt service as a percentage of exports in 2001-05 will be half what is was in 1998-99 (8% instead of 16.5%), compared with an average for other developing countries of over 20%.
- Debt service as a percentage of GDP has declined from 4% in 1998-99 to 2%.
- Debt service as a percentage of government revenue is projected to fall from 24% in 1998-99 to about 10% by 2005.
- Social expenditures are projected to increase substantially, in part financed by resources freed up by Debt Initiative relief. Spending on poverty reduction will rise from less than two times that on debt-service payments to more than four times.

5. Implementation of the Initiative continues to face challenges. First, countries already past their decision points need to remain on track with their economic reform and poverty-reduction programmes to reach their floating completion points. Several countries in this group have encountered problems in the implementation of their macroeconomic programmes (Guinea, Guinea-Bissau, Guyana, Honduras, Malawi, Nicaragua, Niger, Rwanda, Senegal, and Sao Tome and Principe), although for some (Honduras, Niger and Rwanda) this problem has been temporary. Some other countries are finding that implementation of completion-point triggers in social and structural areas takes longer than anticipated. Several countries (Benin, Cameroon and Mali) have experienced delays in preparing full poverty-reduction strategy papers (PRSPs).

6. The challenge of achieving and maintaining external debt sustainability has become more difficult with the deterioration of the global economic environment. Virtually all HIPCs are heavily dependent on primary commodities for their export earnings and government revenue, and as a result they remain

vulnerable to declines in world commodity prices and other adverse exogenous developments. Developed countries' policies could be made more supportive of HIPCs' debt sustainability (and hence their poverty-reduction efforts). At the same time, HIPCs could implement policy reforms to diversify their export base, supported in this by appropriate external financing on highly concessional terms and conditions. The enhanced Debt Initiative provides for the possibility of additional debt relief at completion point in exceptional cases in which exogenous factors have caused fundamental negative changes in a country's economic circumstances. This has been the case for Burkina Faso, with additional debt relief approved in 2002.

7. The 12 countries not yet at decision point (eight of which are affected by conflict and/or have substantial arrears) need to be brought to their decision points as soon as conditions permit. The challenges are daunting as these countries strive to achieve peace and internal stability, pursue sound economic policies, and develop their economic management capacity. The PRSP process may be particularly difficult for several of them since they have large displaced populations and have problems undertaking broad-based participatory processes. The international community acknowledges the need for flexibility in this regard. With respect to arrears, the international financial institutions (IFIs) are called upon to deal with the issue proactively and creatively to ensure that decision points are not delayed much longer after achievement of the basic decision-point conditions. Against this background, arrears are now included in the debt stock outstanding at the cut-off date of eligible debt.

Total Costs and Financing of the Debt Initiative

8. As shown in Table 2, the total cost of the aggregate Initiative in 2001 NPV terms has increased and currently amounts to USD 37.2 billion (or USD 46 billion, including Liberia, Somalia and The Sudan).

Table 2: Updated Estimates of Total Debt Initiative Costs
(for 34 countries, in USD billion)

	September 2001 Costing Exercise 2000 NPV Terms	July 2002 Costing Exercise 2001 NPV Terms	Percentage of Total Costs
Bilateral and Commercial creditors	**17.1**	**19.2**	**51.8**
Multilateral creditors (AfDB, IDB, IFAD,IMF, World Bank, etc.)	**16.1**	**17.9**	**48.2**
Total costs (without Liberia, Somalia and The Sudan)	**33.2**	**37.2**	**100.0**
Total costs (with Liberia, Somalia and The Sudan)	*41.6*	*46.0*	*123.7*

Source: International Monetary Fund/World Bank staff estimates (September 2002).

9. IFIs are expected to mobilize *internal resources* within their financial capacity, but the balance between internal and external resources has not been defined and varies de facto from one institution to another. Participating IFIs have used a variety of financial approaches to internalize Debt Initiative costs, and institutions with a strong and diversified financial structure, in particular, have managed to do so. However, in many cases, additional external resources have been called upon as well. For instance, while the Inter-American Development Bank (IDB) will finance approximately 72.7% of its debt relief from its own resources, 27.3% will be financed from external resources through the HIPC Trust Fund under a multilateral arrangement. The African Development Bank (AfDB) will receive HIPC Trust Fund resources for about 84% of its Debt Initiative costs, while it will use USD 370 million (or approximately 16.1%) of its own resources to finance its debt relief.

10. The HIPC Trust Fund was established under the administration of the World Bank to mitigate the impact of debt relief on the resource base of participating IFIs and help multilateral creditors finance

their participation. Many countries have contributed significant amounts of resources to this fund. "The HIPC Trust Fund is an instrument of the donors to the trust fund. [It] provides funding to eligible creditors, based on the instructions of the donors." In principle, all IFIs facing constraints in participating in the Debt Initiative according to the base principles of additionality and financial integrity are eligible for access to the HIPC Trust Fund, if the donors to the fund so decide. Document REPL.VI/2/INF.4, "HIPC Debt Relief Trust Fund Support for Regional and Sub-Regional Multilateral Creditors", transmitted information from the World Bank on the structure and modus operandi of the HIPC Trust Fund.

11. The document also flagged the issue of the gap between the resources currently available and the resource requirements so far subscribed. In the technical meeting for the HIPC Trust Fund, held on 24 October 2002, donors reviewed the current estimates of the Trust Fund's requirements to support the debt relief of eligible creditors. The total costs for the 34 costed countries are now estimated at between USD 3.37 billion and 3.42 billion (including USD 100 million-150 million for topping up). Resources available in the HIPC Trust Fund (including pledges and investment income) for eligible creditors had reached USD 2.62 billion by September 2002. As a result, the fund faced a funding gap for the regional and subregional creditors of USD 750 million-800 million (this compares to the estimated financing gap set out in the October 2001 meeting of around USD 700 million). World Bank staff advised that additional donor pledges would be needed before the Democratic Republic of The Congo reached its decision point, currently scheduled for early 2003. Not included in these estimates are (i) the potential cost of the four non-costed countries (Laos, Liberia, Somalia and The Sudan); (ii) possible additional earmarked donor funding of IFAD through the HIPC Trust Fund; and (iii) allowance for costing uncertainties. The meeting concluded with tentative pledges of close to USD 850 million.

Policy Developments in 2002

12. In the course of 2002, the operational policy framework for the Debt Initiative has continued to evolve, and some developments may lead to further cost increases of the Initiative.

13. **Extension of the 'sunset' clause.** The establishment of a track record under programmes supported by the International Monetary Fund (IMF) and the International Development Association (IDA) has been one of the main requirements for eligible members to qualify for assistance under the Initiative. The 1996 Programme of Action stated that the Initiative would be open to all HIPCs that pursued or adopted programmes of adjustment and reform supported by the IMF and IDA in the ensuing two years, after which the Initiative would be reviewed and a decision made whether it should be continued. The inclusion of a 'sunset' clause was intended to prevent the Initiative from becoming a permanent facility; it was also meant to encourage HIPCs to adopt adjustment programmes that could be supported by the IMF and IDA. In the event, the World Bank and IMF executive boards reviewed the 'sunset' clause in 1998 and in 2000, and agreed to a two-year extension at both junctures. At end-2000, the Democratic Republic of The Congo started an adjustment programme with IMF and World Bank support. However, eight HIPCs have yet to do so: Angola, Burundi, The Comoros, The Congo, Liberia, Myanmar, Somalia and The Sudan. Except Angola, all these countries are expected to require Initiative debt relief based on a preliminary analysis of their debt situations. Consequently the 'sunset' clause has now been extended to end-2004 to allow these countries to establish a policy track record that would allow their consideration for debt relief under the Initiative.

14. **Arrears as part of the debt stock.** As a matter of Debt Initiative policy for post-conflict countries, the World Bank and the IMF are including arrears in the debt stock outstanding at the cut-off date of eligible debt. The first such case was Guinea-Bissau (2001), followed by Sierra Leone (approved in 2002) and the Democratic Republic of The Congo (approval expected soon).

15. **Topping up to the NPV of debt-to-exports ratio at the completion point that was projected at the decision point**. The enhanced Debt Initiative provides for the possibility of additional debt relief at completion point in exceptional cases in which exogenous factors have caused fundamental negative changes in a country's economic circumstances and therefore debt sustainability. One option considered was to top up relief to bring the NPV of debt-to-exports ratio only to the level (for the completion point) anticipated at the decision point, instead of the normal debt-to-exports target ratio of 150%. The costs for potential topping up under these assumptions, estimated at USD 0.2 billion-0.5 billion, are about half those under the current methodology. The debate at the time recognized the moral hazards associated with the completion-point topping up and the importance of not providing additional assistance to compensate for poor policy implementation. Nevertheless, it also recognized the large uncertainty associated with projections, which vary across countries and cannot be applied as topping up criteria without compromising equal treatment of deserving cases. In addition, topping up at the completion point cannot be automatically linked to any particular debt sustainability threshold because a high level of debt may sometimes be economically justifiable if it finances productive investment that will enhance long-term debt sustainability.

16. **Exclusion of additional relief provided by official bilateral creditors in the calculation of topping up.** Proposals from several bilateral creditors are also under consideration that additional bilateral relief (outside of the Debt Initiative policy framework) be excluded from the calculation of completion-point topping up. If topping up were calculated before additional bilateral relief, some 14-15 HIPCs, including half of the completion-point cases, would be likely to have debts at completion point in excess of the Initiative thresholds by an amount ranging from USD 2.0 billion to 2.4 billion. As higher Initiative relief would replace a part of additional bilateral relief, the net additional relief for HIPCs – assuming all of the excess debt were to lead to topping up – could amount to about USD 1.5 billion-1.8 billion (or USD 1.1 billion after accounting for current topping-up estimates). One consideration in assessing this option was that this additional relief would need to be provided mainly by multilateral creditors and non-Paris Club creditors. The provision of existing relief by the former is considered as not yet fully funded, and many of the latter are already reluctant to provide the debt relief currently required. Also, it is considered that such a cushion would not be equitable across countries because the amount of debt to be forgiven by these bilateral creditors over and beyond the Debt Initiative may not be evenly distributed across deserving cases. The World Bank and IMF executive boards have, however, stressed the importance of achieving the objectives of the Debt Initiative by providing a solid basis for HIPCs to maintain long-term debt sustainability once they exit from the Initiative process.

17. At the October 2002 technical meeting for the HIPC Trust Fund, further questions were raised concerning the costs of such topping up. It was noted that estimates of topping up were subject to much uncertainty and were also sensitive to small changes in critical variables such as exchange rates, interest rates and exports. Donors looked forward to receipt of a paper currently being prepared by the World Bank and IMF on the issue of topping up. A range of views on topping-up methodology were expressed. Some donors proposed that bilateral debt cancellation additional to that required under the Debt Initiative framework be excluded from the debt-sustainability calculations made by the IMF and World Bank at completion point. A few donors indicated that, if necessary, they would consider bilateral means to ensure this. Other donors stated that debt cancellation under the Initiative should be based only on a full debt-sustainability analysis, and in that context reaffirmed their support for the existing methodology, which includes all bilateral relief. Donors asked the World Bank and IMF executive boards to review the issue in the light of the new analysis to be provided in the forthcoming joint note from the two institutions. In this general context, some donors noted that they had already committed to cancel 100% of their bilateral debt and called on other donors to join them.

III. IFAD'S PARTICIPATION IN THE INITIATIVE

Current Estimate of IFAD's Total Debt Initiative Costs

18. The total NPV cost of IFAD's participation in the full Debt Initiative is currently estimated at 230 million Special Drawing Rights (SDR) (USD 308 million), which corresponds to an approximate nominal cost of SDR 351 million (USD 469 million). These costs are projected to peak in 2005 at a level of USD 39.5 million in nominal terms.

IFAD's Commitments So Far

19. IFAD has so far committed itself to providing debt relief to the 26 countries that have reached their enhanced Initiative decision point, for a total NPV amount of approximately SDR 168 million (USD 224 million). Assuming prompt fulfilment of completion-point conditions and a relatively front-loaded modality for debt relief, this would amount to about SDR 245 million in nominal terms (USD 327 million) spread over varying periods of time, depending on the country, ranging from two years to 27 (for Sao Tome and Principe) or even 35 (for Nicaragua).

Debt Relief Delivered by IFAD

20. As shown in Table 3, the debt relief delivered by IFAD up to 31 August 2002 amounts to approximately USD 20 million (USD 24.8 million, including the post-conflict cases where IFAD is providing interim relief). This has been financed with USD 7.0 million from The Netherlands' contribution, USD 4.8 million from Germany's contribution, USD 1.3 million from investment income in IFAD's own Debt Initiative Trust Fund, and USD 11.7 million (or 47%) from IFAD's own resources.

Table 3: Relief Provided and Sources of Funds
(in USD, as of 31 August 2002)

Relief Provided (Nominal)		Resources in IFAD's own Debt Initiative Trust Fund	
Bolivia	5 505 380	Netherlands	7 008 638
Burkina Faso	1 410 520	Germany	4 789 542
Guyana	914 155		
Mali	1 678 124		
Mozambique	3 060 913		
Tanzania	734 562		
Uganda	6 576 116	Investment income	1 312 242
Guinea Bissau[1]	*2 216 018*	IFAD's own resources	11 728 847
Sierra Leone[1]	*2 743 481*		
Total	24 839 269	Total	24 839 269

[1] Interim relief: Corresponds to arrears as of 30 September 2002, and net of the NPV-loss recovery included in the arrears settlement package, also part of the arrears.

IFAD's Resource Mobilization Efforts

21. As shown in Table 4 (and allowing for fluctuations in exchange rates – see note to the table), to support IFAD's resource requirements for the original Initiative and to safeguard the Fund's capacity to finance new loans, the Dutch Government pledged 26.62 million Netherlands Guilders (approximately USD 15.4 million at historic exchange rates) in complementary contributions within the framework of the Fourth Replenishment of IFAD's Resources. In addition, in 2001 the German Government earmarked 15 million Deutsche Mark (about USD 6.6 million) of its contributions to the HIPC Trust Fund for debt owed to IFAD, to be disbursed over a three-year period. Beyond the Dutch and German contributions, IFAD's participation in the Initiative is currently being financed from internal resources that would otherwise be available for commitment for additional loans and grants under the programme of work. A total of 120 million Belgian Francs (2.97 million euros) from the resources pledged by the Belgian Government to the HIPC Trust Fund have also been transferred to IFAD and will be allocated to the upcoming debt relief for the Democratic Republic of The Congo. Table 3 shows relief provided as at 31 August 2002 and the sources of disbursed funds.

22. IFAD has further received formal commitments of: (i) up to USD 3 million from the country-earmarked resources pledged by the Swiss Government to the HIPC Trust Fund; (ii) a complementary contribution for IFAD's Initiative requirements by the Italian Government of 3.72 million euros; and (iii) the equivalent of USD 17 million from the Swedish Government, through the HIPC Trust Fund (see Table 4).

Table 4: External Contributions to Help Finance IFAD's Debt Initiative Costs
(in USD, current exchange rates[1/])

Belgium	2 713 086
Germany	7 051 924
Italy	3 874 193
Netherlands	11 748 859
Sweden	17 000 000
Switzerland	3 000 000
Total	45 388 062

1/ It should be noted that these pledged resources are disbursed over time, in tranches, and therefore the USD value differs from the pledged amount due to fluctuations in exchange rates.

23. Notwithstanding these important external contributions, there is a concern that the high levels of debt relief due in the next ten years, particularly from 2003 to 2005, will affect IFAD's capacity to sustain its lending programme and compromise the integrity of its financial structure. Therefore, the issue of a balance between internal and external resources has become critical. The required balance has not been defined in general terms and depends on the financial position and capacity of the IFIs participating in the Initiative. In the light of the 27.3% of debt relief financed by IDB from HIPC Trust Fund resources and the 84% of AfDB, it is important to ensure a level of additionality of resources also for IFAD's participation in the Debt Initiative comparable to that provided to other IFIs. This might be through equitable access to the HIPC Trust Fund, commensurate with the access of other IFIs, and/or through access to direct funding for the Debt Initiative.

24. With the objective of defining the balance between internal and external resources for IFAD, document REPL.VI/3/INF.3, "Financing IFAD's Participation in the Debt Initiative for Heavily Indebted Poor Countries", recommended that the following considerations be taken into account:

- IFAD's resource base is limited, as highlighted in the financial scenarios discussed in the framework of the Consultation on the Sixth Replenishment.

- During the last two IFAD replenishments, 22% of total contributions have been made by the developing countries of Lists B and C. This compares with an average of 2.1% for the IDA, 4.6% for the African Development Fund and the Asian Development Fund, and 8.3% for the IDB Special Operations Fund. Thus a substantial share of IFAD's core resources consists of replenishment contributions from developing countries, which are, in effect, financing a significant proportion of debt relief under the Initiative. This raises an issue for some developing Member States that the contributions they have provided to IFAD for poverty reduction are being eroded.

- Close to 40% of IFAD's lending programme is committed to sub-Saharan Africa, which has the majority of HIPCs. Consequently, IFAD is heavily exposed to HIPCs and the cost implications of the Debt Initiative. The Fund's exposure is thus much more in line with that of AfDB than that of IDB.

- If a lack of additional external resources for IFAD's participation in the Debt Initiative were to lead to a reduced lending programme, Africa and the group of highly concessional borrowers (accounting for 70% of IFAD's lending) would be seriously affected.

25. Based on the above, management recommended that the balance for IFAD between internal and external resources be close to that of AfDB. Taking into account IFAD's institutional and lending programme characteristics, which are closer to those of AfDB, management recommended that IFAD seek external funding for about 66% of its total Debt Initiative costs. The Executive Board has not taken a decision on the issue. It is also recommended that the Fund pursue two avenues for mobilizing additional external resources:

- IFAD's Member States could directly provide IFAD with additional resources to help finance its participation in the Initiative, following the example of The Netherlands, and Italy's pledge;

- they could provide IFAD with access to the HIPC Trust Fund, following the example of the pledges from Belgium, Germany, Switzerland and Sweden, at the level recommended above. This would need to be done in the context of the forthcoming technical meetings for the HIPC Trust Fund and its replenishments.

26. A significant number of IFAD Member States pursued the issue (the second avenue) in the October technical meeting of the HIPC Trust Fund, also attended by IFAD as an observer. In the meeting, donors asked for clarification regarding: (i) the completion-point timing for the Democratic Republic of The Congo and Côte d'Ivoire; (ii) the status of discussions with The Sudan; and (iii) IFAD's funding requirements. They also asked the AfDB to provide them with a detailed year-by-year breakdown of its Debt Initiative costs. Some donors also emphasized the need for an orderly process of consideration of the inclusion of additional multilateral institutions for support from the HIPC Trust Fund and the amount of financial support that could be provided. Donors requested IFAD to submit detailed information on the financing consequences that the Debt Initiative has for the institution so that they can re-examine the case for IFAD's access to the HIPC Trust Fund. IFAD will naturally pursue this invitation.

IV. RECOMMENDATIONS

27. The Executive Board is invited to:

- take note of the status of implementation of the Debt Initiative for Heavily Indebted Poor Countries and of IFAD's participation in the Initiative;

- note the further policy developments in the Debt Initiative and the possible impact on the costs of the Initiative;

- endorse the submission of the substance of this progress report for 2002 to the forthcoming Governing Council for its information.