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Enabling the rural poor
to overcome poverty

IFAD's participation in the Debt Initiative for Heavily Indebted Poor Countries

Proposals for the Republic of the Congo and the Republic of Malawi, and 2006 progress report

Executive Board — Eighty-ninth Session
Rome, 12-14 December 2006

For: **Approval**

Note to Executive Board Directors

This document is submitted for approval by the Executive Board.

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Recommendation for approval

The Executive Board is invited to approve a new country case for debt relief under the Debt Initiative for Heavily Indebted Poor Countries (Republic of the Congo), a proposal for debt relief top-up (Republic of Malawi), and the submission of the substance of this paper to the thirtieth session of the Governing Council for information, in accordance with the recommendation contained in paragraph 28.

I. Introduction

1. The objective of this progress report for 2006 is to:
 - Seek the Executive Board's approval of a new country case (Republic of the Congo) for debt relief under the Debt Initiative for Heavily Indebted Poor Countries (HIPC);
 - Seek the approval of the Executive Board for debt relief top-up at completion point for the Republic of Malawi;
 - Inform the Executive Board of the status of implementation of the HIPC Debt Initiative and of IFAD's participation in the Initiative; and
 - Seek the Executive Board's approval for submitting the substance of this progress report to the forthcoming session of the Governing Council for its information.

II. New country case: Republic of the Congo

2. In March 2006, the executive boards of the International Monetary Fund (IMF) and the International Development Association agreed to support a comprehensive debt-reduction package for the Republic of the Congo under the enhanced HIPC Debt Initiative.
3. Following the elections held in 2002 and the relative stability that has ensued, the Congo has been in a position to meet the prerequisites for reaching the decision point under the enhanced HIPC Initiative. It has made satisfactory progress in building a track record of macroeconomic stability and structural policy implementation, prepared an interim poverty reduction strategy paper (PRSP), and made significant progress in normalizing relations with creditors.
4. Successive and intense rounds of civil war (1993, 1997 and 1998/99) had significant negative socio-economic consequences. It is estimated that 70 per cent of the population lives below the poverty line (defined as US\$1 per day) compared with about 30 per cent in 1993. The 2004 United Nations Development Programme human development index ranked the Congo 144th out of a total of 177 countries. The pervasiveness of poverty is further reflected in labour force statistics. Unemployment affects more than 50 per cent of the active population, with youth being particularly affected. Once classified as a lower-middle-income economy, the Congo experienced a continuous decline in per capita income from the mid-1980s to the late-1990s. Per capita real GDP in 2004 stood at about 70 per cent of its 1984 level.
5. Recent political developments are encouraging against the background of recurrent conflicts in the 1990s. Under the umbrella of peace, the Congo completed a four-year political transition period, held elections, and made significant progress in putting in place democratic institutions required by the Constitution. Peace and security have improved since a new government was appointed following a constitutional referendum and presidential, legislative and local elections, all held between January and June 2002.
6. Emerging from a conflict situation and starting from a very low base, the Congo has made significant progress in implementing macroeconomic, financial and structural reforms. Large challenges remain, however, including the need to further enhance transparency in the management of its natural resources, and to strengthen budget management, address widespread and primarily urban poverty, and continue to demobilize armed combatants.
7. In 2004, the Government prepared an interim PRSP, based on consultations with civil society and donors, and has since begun the preparation of a full PRSP. The participation process for a full PRSP will be broadened and deepened by including input from civil society early in the design process. To enable an

improved poverty diagnosis, a rapid poverty assessment was conducted in June 2005, and a household survey, which is under way, is expected to be completed by the end of 2006. With about 40 per cent of the active population employed in the agricultural sector, increasing agricultural productivity and improving market access are among the Government's priorities to increase food security and reduce poverty. The Government's strategy for rural development aims at increasing financing for the agricultural sector through the development of microfinance institutions; the rehabilitation and maintenance of rural roads and water access; improvement of the fiscal environment for agricultural development; and the provision of technical advice to producers. IFAD's current loan supports the rehabilitation of rural infrastructure (in particular, feeder roads) in order to improve the accessibility of farmers and fishers to markets, including assemblage, group sales and the search for markets. The loan also ensures farmers' access to improved inputs (seeds, plants) by supporting the multiplication and diffusion of improved seeds, cuttings and plants (cassava and yams in particular).

8. The Congo's public and publicly guaranteed external debt is estimated to be US\$9.2 billion in nominal terms, or US\$9.0 billion in net present value (NPV) terms as of end-December 2004, before considering the Paris Club debt treatment. This level of debt corresponds to an NPV of debt of 661 per cent of fiscal revenues and 252 per cent of exports as of end-2004.
9. Debt relief under the enhanced HIPC Initiative is expected to reduce the Congo's external debt by about a third (after accounting for the impact of traditional debt relief mechanisms). The delivery of traditional debt relief lowers the external debt-to-revenue ratio to about 370 per cent; reducing this ratio further to the HIPC target of 250 per cent implies a common reduction factor of 32.4 per cent for all creditors. This would be equivalent to enhanced HIPC debt relief in the amount of US\$1,679 million in end-2004 NPV terms.
10. Out of total enhanced HIPC relief, multilateral creditors would contribute US\$118 million in NPV terms, and Paris Club bilateral creditors US\$913 million. Commercial creditors would be expected to provide a further US\$590 million of relief in NPV terms, and other official bilateral creditors US\$58 million.
11. The level of outstanding debt at end-2004 for IFAD was based on projected payments of principal and interest on loans in the portfolio for the Congo. All the loans – which had been approved by IFAD's Executive Board in the 1980s and one in 1990 – were, at the cut-off of December 2004, close to full repayment. The debt analysis therefore provided to the World Bank indicated a level of debt of approximately US\$300,000 in December 2004 NPV terms. Since that point, IFAD has continued to receive repayments on those loans.
The Executive Board is requested to approve IFAD's contribution to debt relief for the Republic of the Congo in the amount of SDR 77,000 (equivalent to approximately US\$114,000) in end-2004 NPV terms.
12. As IFAD does not give debt relief during the interim period between decision point and completion point, loan repayments will continue. The debt relief to be made available after completion point will be applicable to any outstanding repayments not yet made on earlier loans and on service charges due on the remaining loan in the country's portfolio, the Rural Development Project in the Plateaux, Cuvette and Western Cuvette Departments.
13. The country authorities are committed to ensuring that HIPC assistance is used to increase poverty-related spending. Securing the effective use of debt relief for pro-poor growth and spending, and the capacity to monitor a shift towards pro-poor expenditure, are key elements of the HIPC Initiative. These objectives will require continued efforts to strengthen the programming, management and control of expenditures, and to improve service delivery in key sectors. The

Congo will reach its completion point under the enhanced HIPC Initiative when the following sector-specific triggers have been reached (in addition to the standard triggers): public finance management, natural resource (oil and forestry sector) management, telecommunications reform, and basic health and education reform.

III. Country case for top-up: Malawi

A. Background

14. In December 2000, Malawi reached its decision point under the enhanced HIPC Initiative and, in April 2001, IFAD's Executive Board approved debt relief for Malawi in the amount of SDR 8.3 million in end-1999 NPV terms (EB 2001/72/R.15). This was equivalent to a 44 per cent reduction of Malawi's debt outstanding with IFAD in December 1999. The approved NPV debt relief amounted to SDR 12.2 million in nominal debt service relief on a pay-as-you-go basis, spread over nine years.
15. In August 2006, Malawi reached its completion point. The Government has made satisfactory progress in implementing its PRSP for at least one year, and has maintained satisfactory macroeconomic policies. It has also met all the completion point targets in the area of economic governance and public expenditure management, safety nets and microfinance. Having met the completion point requirements, Malawi is now poised to accelerate its pace of growth and poverty reduction. The new strategy being prepared to succeed the Malawi Poverty Reduction Strategy (MPRS) will be implemented within the context of a stable macroeconomic environment, significantly improved public expenditure management system, and a conducive framework for improving health and education outcomes and for protecting the most vulnerable members of Malawian society.
16. The completion point analysis of Malawi's external debt shows a substantial worsening in debt burden indicators compared with the projections made at decision point. At decision point, the NPV of the debt-to-exports ratio at end-2005 was projected to amount to 169 per cent, assuming full delivery of the assistance committed under the HIPC Initiative at decision point. The completion point analysis shows the actual outturn to be 245 per cent of exports. After additional voluntary bilateral debt relief, this ratio has been pared back to 229 per cent of exports.
17. The substantial deterioration in Malawi's NPV of the debt-to-exports ratio since the decision point is primarily attributable to exogenous factors, which have led to a fundamental change in the country's economic circumstances. These exogenous factors include:
 - Lower-than-projected export receipts, which explains a third of the higher NPV of the debt-to-exports ratio. The price of the country's main export commodity, tobacco, fell by 13.6 per cent due to declining demand in international markets.
 - A lower discount rate, which explains about half of the unanticipated increase in the NPV of the debt-to-exports ratio. While international interest rates have declined since the decision point, the nominal debt service burden facing Malawi has remained broadly unchanged, as interest rates on external debt are mostly fixed.
 - Depreciation of the United States dollar against the euro and the special drawing right, although this was a relatively minor factor.
 - Unanticipated new borrowing, which led to only a small increase in Malawi's NPV of the debt-to-exports ratio of 3.8 per cent.

18. Finally, unanticipated increases in international oil prices since the decision point have also contributed to the deterioration in Malawi's debt servicing capacity.
19. In approving the completion point and recognizing the deterioration in the debt situation of Malawi during the interim period, the executive boards of the World Bank and IMF approved a top-up of the debt relief approved at decision point to bring the country's NPV of the debt-to-export ratio from 229 per cent to the 150 per cent threshold established under the enhanced HIPC Initiative framework.
20. **IFAD's Executive Board is requested to approve a top-up of the debt relief approved for the Republic of Malawi in an amount equivalent to SDR 5.8 million (equivalent to approximately US\$8.2 million) in December 2005 NPV terms.** The total amount of debt relief to be provided by IFAD would thus amount to SDR 14.1 million in NPV terms (SDR 8.3 million in end-1999 NPV terms and SDR 5.8 million in end-2005 NPV terms).

B. Progress in implementation

21. Twenty countries have now reached the completion point and nine are in the interim period between the decision and completion point (see table). Following the conclusion of the "sunset clause" analysis, the boards of the World Bank and IMF endorsed the inclusion of four new countries (Eritrea, Haiti, Kyrgyzstan and Nepal), which are now included as pre-decision point countries. The pace at which countries in the interim period reached their completion points has accelerated over the past two years as countries made progress in implementing their macroeconomic programmes and poverty reduction strategies. Since September 2004, Cameroon, Honduras, Madagascar, Rwanda and Zambia have all reached their completion points, with the IFAD Executive Board approving top-ups for Ethiopia, the Niger and Rwanda. In addition, Sao Tome and Principe and Sierra Leone could reach their completion points by the first half of 2007, and a decision point document could be ready for Kyrgyzstan in early 2007.

C. Total cost of the HIPC Debt Initiative to IFAD

22. The total NPV cost of the Fund's participation in the full HIPC Debt Initiative is currently estimated at SDR 282.9 million (equivalent to approximately US\$417.4 million), which corresponds to an approximate nominal cost of **SDR 438.5 million (approximately US\$647.6 million)**.¹ The current cost estimates are likely to increase due to countries' delays in reaching decision and completion points, worsening economic conditions leading to the need for completion point top-ups, and continuing low discount rates. Total debt relief payments are estimated to be US\$34.5 million for 2006 and to peak in 2007, when IFAD may potentially have a nominal requirement of approximately US\$54.2 million.

D. IFAD commitments to date

23. To date, IFAD has committed the required debt relief to all 28 HIPCs that have reached their decision point. IFAD's total commitments so far amount to SDR 206.1 million (approximately US\$304.2 million) in NPV terms, which amounts to **SDR 314.6 million (approximately US\$464.8 million)** of debt service relief in nominal terms.

E. Debt relief provided

24. IFAD has thus far provided US\$118.3 million in debt relief to the 20 completion point countries.

¹ September 2006 base estimates at exchange rates prevailing at 30 September 2006, excluding the proposed Malawi top-up.

IFAD Member States participating in the HIPC Debt Initiative, by stage

<i>Completion point countries (20)</i>	<i>Decision point countries (9)</i>	<i>Pre-decision point countries (11)</i>
Benin	Burundi	
Bolivia	Chad	Central African Republic
Burkina Faso	Republic of the Congo ^a	Comoros
Cameroon	Democratic Republic of the Congo	Côte d'Ivoire
Ethiopia	Gambia	Eritrea
Ghana	Guinea	Haiti
Guyana	Guinea Bissau	Kyrgyzstan
Honduras	Sao Tome and Principe	Liberia
Madagascar	Sierra Leone	Nepal
Malawi		Somalia
Mali		Sudan
Mauritania		Togo
Mozambique		
Nicaragua		
Niger		
Rwanda		
Senegal		
Uganda		
United Republic of Tanzania		
Zambia		

^a Subject to approval by the Executive Board at its December 2006 session.

F. Financing of IFAD's debt relief

25. IFAD is funding its participation in the HIPC Debt Initiative through its internal HIPC account, external contributions (paid either directly to IFAD or transferred through the World Bank-administered HIPC Trust Fund) and its own resources. External contributions (paid or pledged) amount to about US\$91.5 million (55 per cent of the total). IFAD's own-resource contributions amount to about US\$70.0 million (42 per cent) under three separate Executive Board-approved transfers in 1998, 1999 and 2002, the last one in the amount of US\$41.0 million. The balance has been covered by investment income from the IFAD HIPC Trust Fund balance.
26. As at end-September 2006, the balance in IFAD's HIPC Trust Fund is US\$14.0 million. With the estimated payments to be made in 2006, **the Executive Board is hereby informed that the President of IFAD transferred from IFAD's internal resources to the Trust Fund account amounts equivalent to US\$10.0 million in October 2006.** Should the balance of funds in the Trust Fund not be sufficient to meet future debt-relief payments as they fall due, the Board will be informed about further transfers from IFAD's internal resources.

IV. Update on IFAD's efforts to mobilize resources

27. In order to mitigate the impact of debt relief on IFAD resources available for commitment to new loans and grants, Management pursues two avenues for mobilizing more such additional external resources, encouraging IFAD's Member States to:
- (a) Directly provide IFAD with additional resources to help finance its participation in the HIPC Initiative; and/or

- (b) Provide IFAD with access to the World Bank-administered HIPC Trust Fund. This is the approach taken by several Member States and, as a next step, IFAD has been requested to present a technical paper detailing its HIPC exposure to the technical pledging session of the World Bank-administered HIPC Trust Fund on 19 November with a view to IFAD's obtaining formal access, for the first time, to the latter trust fund.

V. Recommendations

28. It is recommended that the Executive Board:

- (i) Approve the proposed contribution to the reduction of the Republic of the Congo's debt to IFAD as of 31 December 2004 (see paragraph 11), in the amount of SDR 77,000 in end-2004 NPV terms. This relief will be provided in accordance with the terms of the following resolution:
- "RESOLVED: that the Fund, upon declaration at completion point by the International Monetary Fund and the World Bank that the Republic of the Congo has satisfied the conditions for debt relief under the Debt Initiative for Heavily Indebted Poor Countries, shall reduce the value of the Republic of the Congo's debt to IFAD through the reduction by up to 100 per cent of its respective semi-annual debt-service obligations to IFAD (principal and service-charge/interest payments), as these fall due after the respective completion point, and up to the aggregate net present value (NPV) amount of SDR 77,000 in end-2004 NPV terms."
- (ii) Approve the proposed top-up of IFAD's contribution to the reduction of the debt of the Republic of Malawi to IFAD as of December 2005 (see paragraph 20), in the amount of SDR 5.8 million. This relief will be provided in accordance with the terms of the following resolution:
- "RESOLVED: that the Fund, upon the decision of the Executive Board, shall lower the value of the Republic of Malawi's debt to IFAD through the reduction by up to 100 per cent of its respective semi-annual debt-service obligations to IFAD (principal and service-charge/interest payments), as these fall due, and up to the revised aggregate net present value (NPV) amount of up to SDR 14.1 million (consisting of SDR 8.3 million in end-1999 NPV terms and SDR 5.8 million in end-2005 NPV terms)."
- (iii) Take note of the status of implementation of the HIPC Debt Initiative and IFAD participation therein, and approve the submission to the Governing Council – in the form of an information paper – of the relevant sections of this paper, appropriately revised to incorporate the above decisions of the Executive Board, as the 2006 progress report.

