

STRATEGIES FOR FINANCING DEVELOPMENT

The Newsletter of the HIPC CBP and the FPC CBP



PÔLE-DETTE



Issue 17, 3rd Quarter 2003

HIPC Debt Analysis & Strategy

Dubai: HIPCs Press for Action on HIPC, PRSPs and MDGs	2
IDA Grants	3
Post-HIPC Sustainability of Debt: Experiences from Burkina Faso and Mali	4
Bolivia: First Latin American New Financing Workshop	5
Implementing Poverty Reduction in MEFMI HIPCs	6
Fiscal Management and Debt Accumulation	7
HIPC Initiative and PRSP Progress: September 2003	8
CBP Activities from June to December 2003	10
Technical Questions	12

Foreign Private Capital Flows

Foreign Private Capital CBP Update	13
Zambia Results Reveal Large PSED	14
Analysing Foreign Private Capital for Policymakers	15
Foreign Private Capital: Frequently Asked Questions	16

DUBAI: HIPC_s PRESS FOR ACTION

The 9th Meeting of HIPC Finance Ministers took place in Dubai at the BWI Annual Meetings on 20th September, under the joint presidency of Donald Kaberuka of Rwanda and Javier Comboni of Bolivia. Ministers also represented HIPC_s at a seminar on Debt Sustainability in Low-Income Countries during which they submitted formal comments to the BWIs on this issue, and held discussions with BWI senior management. They issued the following press release in a press conference attended by 30 journalists:



Hon. Javier Comboni, Finance Minister of Bolivia

1. HIPC Initiative

Too many creditors are still not participating in the HIPC Initiative. However, the international community are neither presenting a clear analysis of the effects of this non-participation nor helping HIPC_s sufficiently to ensure that creditors do participate.

- Every HIPC Board paper should specify exactly the impact of creditor non-participation on the country's debt sustainability.
- The international community should immediately establish a technical assistance facility to help countries avoid and defend lawsuits, and a trust fund to clear all debts among low-income heavily indebted countries, and widen the use of the IDA commercial debt reduction facility.

The current BWI review of debt sustainability in low-income countries suggests that domestic and private sector external debt should be analysed as well as public sector external debt. Ministers urge that all future PRGF documents should analyse these debts, and donors should give increased support to monitoring, analysing and reducing them.

The review also indicates that debt sustainability should be analysed case-by-case depending on a country's needs to finance the MDGs. Yet Ministers are increasingly finding themselves forced to reduce MDG spending, to avoid surpassing HIPC debt sustainability thresholds. They urge that the debt service to budget revenue ratio should be the key criterion used to judge sustainability after HIPC completion

point and that, if this is below 10%, PV ratios should be treated as secondary provided they are kept within reasonable bounds.

Recent BWI Board discussions have agreed to continue to examine whether 100% debt cancellations granted by some OECD governments should be additional to HIPC, providing an extra US\$1.2 billion of relief. Ministers urge the international community to support this extra funding.

HIPC_s are entitled to 'topping up' of their relief at completion point if they have suffered external shocks that have changed their circumstances. HIPC Ministers are clear that these shocks should include international interest rate and exchange rate changes, because they increase the PV of debt overhang and reduce future growth and investment. Ministers reject any attempt to exclude such shocks from reasons for topping up.

2. External Shocks

There has been an active discussion recently on how to deal with external shocks to low-income countries' growth. But many of these 'shocks' are predictable and recurrent, and Ministers urge that all foreseeable shocks should be included in the baseline forecasts for PRGF. Suggested solutions to shocks have included commodity hedging facilities and for lending in domestic currencies. Ministers believe these do not provide adequate solutions to most shocks they face. The most comprehensive response would be to provide immediately-disbursing contingency finance as floating tranches in donor budget support grants and IMF/World Bank loans and grants.

3. Poverty Reduction Strategies

There has been little movement to make macroeconomic frameworks in IMF programmes more flexible. They remain insufficiently growth-oriented, focussing excessively on reducing inflation below 5%. Poverty spending has not been allowed to rise in line with the long-term grants available to fund budget deficits. Several countries have had to reduce growth targets and anti-poverty spending, thereby abandoning the MDGs even when adequate financing is available. Ministers urge immediate action to ensure all macroeconomic frameworks target the MDGs, and to provide independent resources to HIPC_s to conduct Poverty and Social Impact Analysis of macroeconomic frameworks.

Ministers note also that many PRSPs have placed insufficient emphasis on gender issues, and especially on the girls' education MDG for 2005.

A recent IMF paper has suggested that the Fund should reduce its lending and move towards surveillance mechanisms for economically stable low-income countries. Ministers endorse this and urge the IMF Board to define clear operational guidelines for this to occur in all such countries as soon as possible. Reducing lending levels should also allow the Fund to increase the concessionality of its lending to low-income countries in the direction of IDA terms, reducing their debt burden.

4. Financing the MDGs

A recent World Bank paper suggests some African countries cannot absorb all the additional financing needed to reach the MDGs. Ministers reject this because many

ON HIPC, PRSPs AND MDGs

countries have dramatically increased absorptive capacity in a short period. They urge the international community to focus all its efforts on increasing absorptive capacity by studying and disseminating best practices in low-income countries.

Three years after adopting the MDGs, most countries and the international institutions still have no clear idea of their costs. Ministers urge that every PRGF Board paper should cost these goals and press donors to mobilise the finance needed to attain them. They also regret the lack of research and practical tools which they can use to analyse, project and cost their progress to the MDGs and urge rapid acceleration of work in this area.

Ministers endorse the UK proposal for an International Financing Facility. While insisting that the money it provides should be additional, in grant form and of high quality (i.e. as budget support), they urge other G8 countries to overcome their reservations and fund the IFF as soon as possible.

One of the key MDGs is reforming donor procedures to provide high-quality money. Ministers are establishing their own systems to evaluate the quality of donor aid. They request that the DAC and the IFIs conduct an urgent frank review of whether individual donors are living up to recent pledges of aid quantity and quality increases. This review should be presented at next year's Spring Meetings.



Hon. Donald Kaberuka, Finance and Economic Planning Minister of Rwanda

IDA GRANTS

Under IDA13 more grant resources will be available for the poorest and debt vulnerable countries over the next three years. As part of the 13th replenishment of IDA resources, the use of IDA grants has been increased and will account for between 18% to 21% of all IDA resources, with the poorest and most debt vulnerable countries having the greatest access to the additional grants. The allocation of grant funds will be based on the priorities set out in a country's Poverty Reduction and Strategy Paper (PSRP) and Country Assistance Strategy (CAS), agreed with the World Bank.

While IDA grants are to account for 18% to 21% of overall IDA financing over the next 3 years, the poorest and debt vulnerable countries will be able to obtain up to 40% of their IDA allocation in grants, with the remaining 60% being loans. The eligibility criteria for additional IDA grants are as follows:

- for debt vulnerable poor countries, up to 40% IDA grants: for countries that have an annual average per capita income of less than or equal to US\$360 and an expected long-term PV of debt to exports ratio of

150% or more, after all possible debt relief. In some special cases, where a country has a high export concentration (three products account for over 60% of exports), then the debt vulnerability is defined as having a PV of debt to exports ratio in excess of 120%;

- for poor IDA-only countries, up to 23% IDA grants: for countries with a per capita income of US\$360 or less which are not classified as debt vulnerable;
- for post-conflict countries, up to 40% IDA grants: for post-conflict countries needing to establish basic governance functions and rebuild infrastructure.

In addition, 100% IDA grant financing is available to fund HIV/AIDS programmes and reconstruction programmes arising from natural disasters such as major floods, earthquakes or a severe drought. This money is project-specific and is in addition to the 23% or 40% allocation above.

The table on page 12 shows the maximum possible IDA grants available to HIPCs for the three years to June 2005, based on countries' total allocation of IDA resources under IDA13, and the share of grants received from IDA in 2002-03. Not all HIPCs are listed in the table as

some, such as Bolivia and Guinea, have per capita income of more US\$360 and therefore are not eligible for grants under IDA13. Other countries such as Liberia, Myanmar, Somalia and Sudan do not currently have programmes with the IMF and World Bank.

It also shows that some countries, notably Benin, Lao and Madagascar, received all their IDA commitments as loans in 2002-03. For others, such as Central African Republic, Gambia, Guinea-Bissau, Mali, Mauritania, São Tomé and Príncipe and Togo, there were no IDA commitments in 2002-03. The average share of IDA grants for the 19 HIPCs with IDA commitments in 2002-03 was 30%.

Although IDA has committed to provide additional grants to the poorest and debt vulnerable countries over the three years to mid-2005, it is not clear how the allocation will be done on a year-by-year basis and whether there are sufficient resources available to enable countries to receive their full grant entitlement each year. The outcome may depend on the activism of HIPCs in negotiating access to their entitlement.

To be continued on page 12

POST-HIPC SUSTAINABILITY OF DEBT: EXPERIENCES FROM BURKINA FASO AND MALI

DRI and Pôle-Dette organised two national seminars on sustainable debt relief strategy for Burkina Faso (31 March to 12 April 2003) and Mali (4 to 16 August 2003) with a view to assessing the sustainability of their debt and public finances beyond the completion point of the HIPC Initiative and up to 2015. A number of lessons emerged from these workshops that could be of use to other countries in the Franc Zone.

I – BURKINA FASO'S AND MALI'S DEBT AND PUBLIC FINANCES SUSTAINABILITY: COMPARATIVE ANALYSIS OF PROSPECTS

Burkina Faso was the first country in the Franc Zone to reach the completion point of the HIPC Initiative, on 11 April 2002. In this context, the country should benefit from a debt reduction of USD575 million in VAN. Mali, which reached its completion point in March 2003, should benefit from a reduction of USD539 million of its external debt. Although Burkina Faso and Mali are both Sahelian primary production countries with many common features, their respective track records under the HIPC Initiative reveal several differences:

1. External debt sustainability

Burkina Faso and Mali were declared eligible for the HIPC Initiative on the basis of the ratio external debt present value/exports of goods and services (PV/XGS). Despite the debt reduction obtained through the HIPC Initiative, Burkina Faso's external debt could remain unsustainable with a sustainability ratio that would only fall below 150% several years after the completion point. However, the level of this indicator would decrease gradually and continuously up to the 2015 timeframe. As for Mali, its external debt would immediately become sustainable on the completion point of the HIPC Initiative. However, the sustainability ratio of the external debt would rise above 150% once more from 2009 and would deteriorate continuously until the 2015 timeframe.

There are three main reasons for the differences observed in the performances of Burkina Faso and Mali:

- **structure of the external debt portfolio:** the debt relief granted to Burkina Faso comes mainly from multilateral donors through a debt service reduction payable over a long period. In such cases, external debt sustainability indicators will only improve gradually in the medium- and long-term. On the other hand, when HIPC assistance originates on a larger scale from bilateral creditors, as in Mali's case, debt reduction impacts more rapidly on debt sustainability;

- **orientations of new external financing policy:** the financial strategy envisaged by the Burkinabè Authorities is based on grants accounting for 6.4% of the GDP on average between 2003 and 2015. In Mali, grants would represent on average 2.5% of the GDP between 2003 and 2015, based on current trends. These differences in orientation largely explain why external debt sustainability indicators would fall steadily in Burkina Faso while deteriorating gradually in Mali from 2009;

- **degree of diversification in the economy and scale of external shocks:** in Burkina Faso exports are focused on agricultural products and cotton (67.6% of total exports in 2001-2002) whereas in Mali, agricultural products (including cotton) accounted overall for 20.1% of total exports compared to 65.9% for gold sales. Burkina Faso, which depends to a greater extent on agricultural products than Mali, is more exposed than the latter to the effects of drought, which would increase its external sustainability compared to Mali.

2. Viability of public finances

Burkina Faso's debt service would decrease from almost 15.5% of budget revenue in 2002 to approximately 6.7% in 2005 and would continue to fall gradually to around 4.2% in the 2015 timeframe. As for Mali, this indicator would fall from 14.9% in 2002 to 11.2% in 2005 and 7.2% in 2015, i.e. almost double the indicator level recorded by Burkina Faso.

3. Implementation of poverty reduction programmes

Based on current orientations and economic prospects for the structural adjustment programmes currently being implemented,

Burkina Faso and Mali would not reach the international development targets in the 2015 timeframe. This situation is due to the inadequacy of the financing intended to reduce poverty (both HIPC debt relief and other financing provided outside the Initiative), but also because the policies currently envisaged by the two governments do not fully take into account the requirements for poverty reduction.

II – MAIN LESSONS FROM BURKINA FASO'S AND MALI'S EXPERIENCES

The experiences of Burkina Faso and Mali in the HIPC Initiative highlight a number of lessons that may prove useful to all the other countries in the Franc Zone, regardless of their current position in respect of the Initiative.

One of the main lessons is that debt relief for poor countries, provided by the international community, cannot on its own guarantee medium- and long-term debt sustainability. The support of the international community should be backed up by the efforts of HIPCs themselves to maintain a stable macro-economic environment that favours productive investment, diversification of their production with a view to limiting the effects of unfavourable external shocks, rationalisation of financial strategies in order to mobilise highly concessional terms with few risks, successful implementation of poverty reduction programmes and adoption of the best international public debt management practices.

However it remains the responsibility of the international community to ensure that HIPC resources are complementary to other forms of support it may provide with a view to achieve fully the international development targets in the 2015 timeframe. Financial backers should also support the HIPC in their efforts to ensure that their debt ceases to be unsustainable by guaranteeing them financing with a very large concessionary element in future, opening their national markets to products from poor countries in order to support their exports, coordinating their actions better or harmonising their procedures to help improve the capacity of the HIPC to absorb external aid.

BOLIVIA: FIRST LATIN AMERICAN NEW FINANCING WORKSHOP



This workshop took place in La Paz, Bolivia, between 1 and 11 September 2003, and was attended by 35 officials from the Ministry of Finance, Central Bank of Bolivia, Economic Policy Analysis Unit, and other government agencies involved in financial matters and poverty reduction. It was the first opportunity in the region to examine the subject of new financing on a par with the other areas usually dealt with in debt sustainability workshops.

The workshops' main objective was to provide comprehensive training to Bolivian government officials in the analysis of new financing and post-HIPC debt strategy, thus enabling the reinforcement of a permanent government team to regularly update debt and new financing strategy in future, with little external help. This will allow the Government of Bolivia to monitor debt relief results and especially future loan and grant flows, and make judgements as to the desirability of different concessional or non-concessional flows. It came at a crucial time for the Government of Bolivia, which was preparing a Consultative Group meeting on October 6 at which these issues must be analysed, and was the result of an urgent request from the Government.

PARTICIPANT EVALUATION

As usual in events organized by the CBP, evaluation forms are handed out and filled in by the participants, to obtain their opinions regarding the event. All participants indicated that the workshop would be useful in their working lives, and 82% considered it very useful. They particularly valued the contributions of the facilitators and the coordinated work and exchange of information between the different participating units. As a result, they strongly recommended that they should have greater and permanent contact with the workshop facilitators after the workshop by email in order to maintain and sharpen their skills; and that the national team already established to review and update the Bolivia debt and new financing strategy should be strengthened and widened. Finally, the participants said that preparing more information prior to the workshop would save

time at the workshop, providing added opportunity for analysis.

WORKSHOP RESULTS

Overall, the workshop's general and specific objectives were achieved. It also allowed the Government to review the macroeconomic framework in the PRGF projections negotiated with the IMF, the costs of its Poverty Reduction Strategy, and the arguments to obtain more concessional and higher quality finance at the Consultative Group.

Intense work by the officials led to numerous results and conclusions, among them that:

- Contrary to its intentions, the HIPC Initiative had not provided additionality as regards external financing flows. This was because donors reacted to Bolivia's intended debt sustainability under HIPC by withdrawing grants, especially programme support which had been used to pay multilateral debt service through a Multilateral Debt Fund. Overall, they found a considerable reduction in grants and in the grant/loan ratio over the past few years.
- Due to the reduction in grants and other factors, there was a sharp increase in non-concessional domestic and external financing, leading to clearly unsustainable external and total debt and a worsening fiscal position.
- The Central Government is the entity that must honor virtually the entire public external debt service. At the same time, the Enhanced HIPC Initiative obliges it to save an amount equivalent to the HIPC debt relief in order to transfer it to the fight against poverty. As a result, the Central Government (and the whole fiscal position) is in an extremely weak financial situation with very limited financing options.
- This means that there is a severe danger that Bolivia will not achieve its Millennium Development Goals or its other national poverty reduction and development targets. Indeed, if current trends and financing problems continue, the MDGs will not be achieved until 15 or 20 years beyond the 2015 deadline.
- The macroeconomic scenarios examined show that in order to gain sufficient fiscal space to implement poverty reduction actions, the country needs a major adjustment of all aspects of the budget (revenue, expenditure and financing) in the

medium and long term. However, it has first to overcome huge short-term imbalances and difficulties in the Bolivian economy, pending the arrival of new gas export projects.

- Reviewing the loan portfolio, recent disbursement patterns, and new financing prospects, the workshop determined that it will be possible to finance sustainability higher fiscal deficits than those currently forecast, in the years of the new PRGF.
- The financing requirements of the Bolivian Poverty Reduction Strategy, the Central Government, and other priority programs will demand an effort to increase financing by an average US\$180 million a year (above 2% of GDP) through 2015.
- However, the high domestic debt leaves little margin for domestic financing.
- As a result, an improved macroeconomic and fiscal situation, debt sustainability, and the financing of the MDGs all depend on the capacity to obtain greater concessional external financing in the short and medium term.
- Together with the recent sharp fall in GDP per capita in dollar terms, this means Bolivia must delay its graduation from the concessional to the non-concessional lending windows of the IMF, World Bank and Inter-American Development Bank, and maximise its use of bilateral donor grants.
- In addition, micro-conditionality of various financing programs, added to the weak institutional capacity of the country, are often delaying project execution. So Bolivia needs to increase the quality of its financing, encouraging budget support and the removal of micro-conditionality, as well as increasing absorptive capacity.
- Bolivia must implement a public debt strategy that allows it to generate sufficient resources to finance its development programs, without compromising debt sustainability. Only the efficient use of the most concessional and highest quality aid will lead Bolivia down a path in which all of its solvency indicators, and especially its liquidity indicators, enjoy substantial and sustained improvement.

The Government is showing high commitment to the workshop results, which were presented to the CG in October before being discussed for adoption as the national debt strategy.



IMPLEMENTING POVERTY REDUCTION IN MEFMI HIPCs

Four of the ten MEFMI member states have benefited from HIPC debt relief (Uganda and Tanzania have passed completion point while Malawi and Zambia are receiving interim relief). All have seen reducing high poverty levels as a key policy issue: in the 1990s, about 70% of the population in Zambia lived below the poverty line, 60% in Malawi, 56% in Uganda and 51% in Tanzania. They have, however, adopted different policy approaches to poverty reduction. Uganda, the first country in the MEFMI region to reach Completion Point, had developed a Poverty Eradication Action Plan (PEAP) long before HIPC came into effect. On the other hand, Tanzania, Malawi and Zambia developed their poverty strategies during the HIPC Initiative, which conditions debt relief on channelling the resources freed from debt service to social sector spending, to enhance the implementation of the poverty reduction strategy.

Macroeconomic Performance

All four countries recognize the importance of economic stability to poverty reduction, through low non-volatile inflation, low interest rates and high economic growth. All their national poverty reduction strategies aim at high growth paths of 6-8% and inflation at or below 5%. However, their economies have been affected by various shocks including droughts in Zambia and Malawi, volatile commodity export prices, and sudden withdrawal of donor aid. As a result, Tanzania and Uganda have reached their growth and inflation targets in most years, but Malawi and Zambia continue to experience low economic growth rates and double-digit inflation.

Poverty Reduction Spending Efforts

As the graph shows, all MEFMI HIPCs have made efforts to increase government expenditures on poverty reduction, with results higher than HIPC average.

Priority Sectors for Poverty Reduction

All countries have identified common priority sectors for reducing poverty: basic education, preventive and primary health care, water and sanitation, rural feeder roads, infrastructure and agriculture. They have also identified common cross cutting themes that need to be mainstreamed in the sectors during the implementation process; namely HIV/AIDS,

gender and environment. Malawi has chosen agriculture, water and sanitation, education, health, rural roads, commerce and industry, gender, police, labour and social safety nets as the priority sectors for budget spending.

Uganda has concentrated on five main areas - rural roads, water and sanitation, agriculture, education, and health. Tanzania is implementing the strategy mainly through agriculture, water and sanitation, education, health, judiciary, rural roads and HIV/AIDS. Zambia has identified education, health, water and sanitation, agriculture, roads and energy as top priority with social safety nets, disaster relief and rural industrial development as secondary.

The table below shows differing patterns in terms of allocating poverty reduction expenditure across sectors:

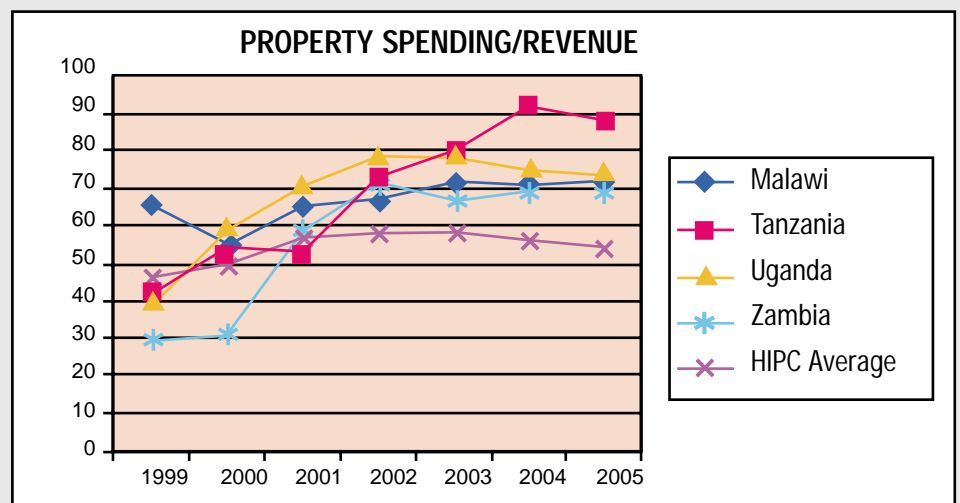
Some MEFMI HIPCs show policy convergence in their sectoral allocation of resources. Both Tanzania and Uganda see increased access to education (without compromising its quality) as fundamental to poverty reduction, and are allocating their poverty reduction spending accordingly. On the other hand, Malawi introduced universal primary education in the

mid-1990's, but allocation of resources does not reflect the immense challenges of the sector in high pupil/teacher ratios and overcrowding of students in classrooms.

Conclusions

It is still early to judge the success of poverty reduction strategies among MEFMI HIPCs. Poverty reduction is a long-term phenomenon that requires a change of mindset by most players. In addition, a longer period of time is needed to assemble data and analysis to measure the impact of poverty reduction programs, and to assess the linkages between poverty reduction, economic stability, wealth distribution and economic growth. These are vital tasks and, if countries are to manage this analysis themselves, their governments need much more support in human and financial resources to build their own capacity to shed more light on policy direction and implementation. However, it is clear that, when a stable economy and pro-poor growth policies are combined with well-targeted anti-poverty spending, there can be a noticeable fall in the poverty headcount, which in Uganda is now only 34%, well on the way to attaining the Millennium Development Goals.

Sector/Country	Malawi	Tanzania	Uganda
Education	30%	>50%	>50%
Health/Basic Health	40%	18%	18%
Water and Sanitation	9%	2%	9%
Rural Roads	5%	13%	7%
Agriculture	6%	3%	8%



FISCAL MANAGEMENT & DEBT ACCUMULATION



In all economies fiscal policies are important instruments for managing inflation, employment and growth. In the 1950s and 1960s, when many developing countries became independent of their colonial masters, the government sector was seen as playing a key role in the development process and therefore government spending was accelerated wherever possible. More recently, some developed and developing countries have attempted to reduce the role of government with lower taxes and spending levels. However, the key issue for HIPCs is the relationship between fiscal management, accumulation of external and domestic debt, and the attainment of the Millennium Development Goals. This article discusses those linkages

Lessons of Basic Economic Theory

According to basic economic theory, fiscal policy may create debt in three ways:

1. a budget deficit may require external or domestic borrowing to finance it. In turn the domestic borrowing may be from the Central Bank or other sources such as Treasury Bonds or Bills;
2. extra spending may produce higher import needs, requiring external borrowing to finance the resulting current account deficit;
3. the inflationary implications of, in particular, borrowing from the Central Bank, may depreciate the currency or increase local spending (or domestic borrowing) costs, thereby forcing more borrowing to cover these costs.
4. extra spending may create extra demand in the economy and be inflationary with the same resulting needs for higher borrowing.

It is certainly true that in past years in the WAIFEM region, as shown by a recent review of fiscal management and economic performance in WAIFEM's member countries by the Central Bank of Nigeria, the major causes of macroeconomic instability and low growth in national output have been the unsustainable level of fiscal deficits, and the poor management of the financing to fund these deficits, resulting in heavy debt service obligations.

From this one might infer that, the lower the budget deficit and the lower government spending, the lower a country's debt is likely to

be. However, the picture is more complex than this for most HIPCs and for countries aiming to meet the Millennium Development Goals, for the following reasons:

1. HIPCs and countries aiming to meet the MDGs often need to increase their budget expenditure on poverty reduction substantially. There is strong evidence from many countries that it is only the deficit and not government spending in itself that is inflationary. This is particularly true if expenditures are well-targeted so that they remove bottlenecks to production and increase supply. Given that in most low-income countries, supply shortages are a key factor in inflation, removing such bottlenecks can make government spending counter-inflationary. This is particularly true in a post-conflict economy, or an economy hit by a weather-related shock, where supply is the main problem.
2. In addition, the link between higher government spending and imports may be dramatically reduced by focusing a higher proportion of government spending on poverty reduction, much of which is likely to be executed using local raw materials (especially if donors untie their aid).
3. There is equally strong evidence that, provided the budget deficit is kept within reasonable bounds, it is inflationary only if financed in particular ways. An acceptable deficit is therefore what a country can finance sustainably, using:
 - multi-year donor grants;
 - concessional external borrowing with a very high grant element that does not lead debt to become unsustainable again; or
 - domestic borrowing that does not exceed sustainable levels or crowd out private sector borrowing.
4. It is also vital, in the context of countries receiving external debt relief and large amounts of grants, how the budget deficit is measured. In presenting the budget data, the spending will usually be recorded above the line, as will the grants, while the relief on debt will be presented below the line as a financing item. It is therefore vital that, if grants and debt relief are believed by the country to be likely to continue over the longer-term, the budget deficit be measured including grants and including the financing of the additional expenditures funded by

HIPC relief. This will provide a truer picture of the deficit including sustainable financing.

5. As very few countries are still borrowing from their Central Banks and therefore printing money and causing inflation (the countries of the WAIFEM region are legally limiting central bank lending to government to 10% of government revenue in the previous tax year), the risks of this type of unsustainable financing of budget deficits are much lower.
6. Finally, there now seems to be a general consensus from the literature (notably according to studies by the Fund and Bank) that the growth-maximising level of inflation is between 5% and 10%, and that excessive efforts to reduce inflation below this level can hit growth and poverty reduction. This means that countries with low inflation (single digit around 5%) should be less worried about inflation and more concerned to promote growth and poverty reduction.

The Way Forward

Countries in the WAIFEM region have been taking account of these lessons, as well as ensuring that their objectives are realistic, in the design of their regional convergence criteria under the West African Monetary Zone (WAMZ). As a result, they are targeting 5% inflation and a budget deficit of 4% of GDP by 2005, compared to 3% inflation and 0% deficit in the EU. They also realize the need to:

- reappraise the role of Government, reducing its role in direct production and focusing more on poverty reduction, infrastructure provision and creating the necessary environment for private sector investment;
- reform public expenditure; to ensure greater transparency, efficiency and pro-poor growth focus in the design and implementation of expenditures;
- Improve tax administration reform to plug the many loopholes and tax-free allowances that create major leakages in tax yields, in order to ensure growing reliance on budget revenue to fund expenditures.
- Focus on mobilizing grants and highly concessional loans to finance their expenditures, and on keeping both external and domestic debt burdens sustainable.

Meeting these objectives will require strong efforts by the governments if they are to achieve fiscal and debt sustainability and meet the Millennium Development Goals.

HIPC INITIATIVE AND PRSP PROGRESS: SEPTEMBER 2003

Country	HIPC II Dates		PRSP Dates		HIPC Initiative
	Decision	Completion	Interim	Final	Creditor Participation
Angola	no current timetable		3Q2003	...	NA
Benin	7/00	3/03	7/00	3/03	99%
Bolivia	2/00	6/01	2/00	6/01	95%
Burkina Faso	7/00	4/02	NA	7/00	88%
Burundi	2Q2004	...	3Q2003	...	NA
Cameroon	10/00	2Q2004	10/00	7/03	98%
Central African Rep.	1/01	...	NA
Chad	5/01	2Q2004	7/00	7/03	93%
Comoros	2004	...	1Q2004	...	NA
Congo, Dem. Rep. of	7/03	3Q2006	6/02	3Q2005	NA
Congo, Rep. of	2004	...	4Q2003	...	NA
Côte d'Ivoire	2004	...	3/02	...	NA
Ethiopia	11/01	1Q2004	3/01	9/02	91%
Gambia	12/00	2Q2004	12/00	7/02	81%
Ghana	2/02	2Q2004	8/00	4/03	89%
Guinea	12/00	4Q2004	12/00	7/02	85%
Guinea Bissau	12/00	2Q2005	12/00	4Q2003	81%
Guyana	11/00	4Q2004	11/00	9/02	91%
Honduras	7/00	2Q2004	7/00	10/01	93%
Kenya	DSA done in 2002		8/00	2004	NA
Lao PDR	no current timetable		4/01	4Q2003	NA
Liberia	no current timetable		no PRSP process		NA
Madagascar	12/00	3Q2004	12/00	4Q2003	91%
Malawi	12/00	3Q2004	12/00	8/02	97%
Mali	9/00	3/03	9/00	3/03	94%
Mauritania	2/00	6/02	NA	1/01	80%
Mozambique	4/00	9/01	4/00	9/01	88%
Myanmar	no current timetable		no PRSP process		NA
Nicaragua	12/00	1Q2004	12/00	9/01	86%
Niger	12/00	4Q2003	12/00	2/02	81%
Rwanda	12/00	2004	12/00	8/02	95%
São Tomé & Príncipe	12/00	4Q2004	4/00	4Q2003	85%
Senegal	6/00	4Q2003	6/00	12/02	79%
Sierra Leone	3/02	2Q2005	9/01	2Q2004	84%
Somalia	no current timetable		no PRSP process		NA
Sudan	no current timetable		2004	...	NA
Tanzania	4/00	11/01	3/00	12/00	90%
Togo	NA
Uganda	2/00	5/00	NA	5/00	96%
Vietnam	DSA done in 2002		4/01	6/02	NA
Yemen	6/00	...	2/01	8/02	NA
Zambia	12/00	2Q2004	7/00	5/02	97%

Sources:
IMF & World Bank

Dates for HIPC decision and completion points and PRSPs are those of final BWI Board approval. Most governments have published PRSPs several months before BWI approval.

Key Debt Relief and New Financing Issues	Key Macroeconomic and Poverty Reduction Issues
HIPC CBP DSA shows ratios under HIPC thresholds	Staff-monitored programme, oil export price rises
Most creditors provide relief, unsustainable due to new borrowing	PRSP finally approved, completion point reached after delay
Debt unsustainable after new borrowing/export shock	PRSP progress report finalised and strategy reviewed; new standby agreed in 2003 and PRGF expected for 4Q2003.
First to get additional relief at CP, large new borrowing allowed	PRGF/PRSP on track, cotton price shock but higher gold prices
Donor funds to clear multilateral arrears	PRGF to be agreed before end-2003
79% buyback from IDA on commercial debt, 2 lawsuits	PRSP approved in July 2003
Coup postpones HIPC timetable, multilateral arrears accumulating	Re-engagement with BWI and donors under discussion
10 non-Paris Club creditors not providing relief, delay to CP	PRSP approved by the BWIs in July 2003
High debt burden, plans own DSA soon. HIPC timetable uncertain.	New SMP possible in 2004, followed by PRGF for 2004
DP agreed in July 2003, Cologne terms applied	PRGF approved by the IMF Board in June 2002, on track
Oil-guaranteed commercial loans, DP requires track record	SMP satisfactory, PRGF negotiations on-going. PRSP being redrafted
DP delayed because of civil conflict	Civil conflict delays PRGF and full PRSP
Will be unsustainable at CP, need to provide topping-up. No relief from some non-PC & commercial creditors	Good PRGF record but drought/coffee shock.
China, Kuwait, Taiwan (19% of total relief) yet to agree to relief	Slow progress on structural reforms and PRSP further delays CP to 2004
Participation of some commercial creditors remains an issue.	New PRGF signed in May 2003.
Bulgaria, Iraq, Romania, Saudi, Thailand no relief	Reversion from PRGF to SMP delays CP. PRSP progress report due soon
IMF and Paris Club have suspended relief	SMP to be negotiated after delayed elections, delays in full PRSP
Only Lyons terms from PC; commercial lawsuit dropped; CP postponed	PRGF being reviewed; public administration reforms delayed
Could be sustainable at CP, however with great delay	PRSP 1st progress report and new PRGF possible by end-2003
May request relief, but DSA shows ratios under HIPC thresholds	PRSP to be finalised soon. Coffee price shock and tourism collapse
Debt stock yet to be finalised and agreed.	Completed 2 reviews of PRGF but 3rd delayed to late 2003
Debt stock estimated \$3bn (550% of GDP), 90% in arrears	IMF SMP abandoned in 2001, no current negotiations due to sanctions
No relief from non-Paris Club creditors, except China and Libya	Delays to HIPC CP conditions and PRGF reviews due to earlier instability
IMF relief awaits revival of PRGF, 2-year delay to CP	Delays in PRGF, donor suspension of budget support and drought shock
Difficulties with non-PC, commercial creditors	PRGF/PRSP on track. CP reached after delay. Drought and Côte d'Ivoire shocks
No relief from some non-Paris Club creditors (Algeria, Koweit, FKDEA)	New PRGF approved in July, PRSP approved by Government to be reviewed by BWIs
Non-Paris Club problems/lawsuit keep debt unsustainable	On-track with PRGF and PRSP
No WB lending since 1987. Probably unsustainable	No IMF programme since 1981-82
CP delayed for one year, lawsuits and 9 non-PC creditors refuse relief	New PRGF approved in Dec 2002
Taiwan wins lawsuit, 7 non-PC creditors not signing	PRSP progress report being finalised, some delays with PRGF reviews. Cotton shock
Will be unsustainable at Completion Point. Problems with non-PC	PRSP progress report completed, Off-track with IMF, completion point postponed
Paris Club interim relief only Naples, non-PC problems, CP delay	New PRGF to be reassessed following unsuccessful July coup.
7 non-PC creditors and 2 multilaterals problematic, CP delayed	New PRGF agreed in April 2003
Morocco to cancel debt. Commercial lawsuits	PRGF on track, PRSP now expected mid-2004
Accumulating large arrears to creditors	No current IMF programme due to lack of recognised government
Debt of \$21bn, possible donor Support Group to clear arrears.	Peace talks leads to start of I-PRSP preparation, completed review of SMP
Problems with non-Paris Club and commercial creditors	Low-amount PRGF and second PRSP review in May 2003
No current prospect of debt relief	No resumption of engagement after June 2003 elections
Debt unsustainable. Non Paris Club/commercial creditor lawsuits	Coffee export shock. New PRGF in September 2002. PRSP to be revised in 2003/04
Board report on HIPC eligibility due shortly	PRGF on track
Ratios under HIPC thresholds so Paris Club Naples stock treatment	PRGF on track
5 non-Paris Club refusing relief. India to cancel all ODA debt.	PRSP progress report due soon, delays with PRGF. Drought shock

CBP ACTIVITIES FROM JUNE TO DECEMBER 2003

Demand Assessment Missions

Sudan

In response to requests from the Sudanese Government, donors approved a demand assessment mission to Sudan. Further activities will depend on progress in negotiating a Peace Treaty in Sudan.

The mission carried out an assessment of how debt management takes place in Sudan and made the appropriate recommendations to government and it took place in the context of Sudan eventually benefiting from HIPC relief. The report showed a great deal of capacity already in the country, especially in macroeconomic and debt management areas. The authorities are eager to join the HIPC CBP programme and have participated as observers at the National Debt Strategy Workshop held in Ethiopia.

National Debt Strategy Workshops

Angola Debt Strategy workshop. It was organised by MEFMI and DRI, from 18-28 August in Luanda. It was facilitated by resource persons from Bolivia, São Tomé & Príncipe, DRI and MEFMI, and attended by more than 30 participants. The key strategy findings were:

- Angola should receive Paris Club Naples Terms, but not HIPC relief, because its debt sustainability indicators will be below HIPC thresholds after Naples Terms;
- however, it remains highly dependent on petroleum for exports and budget revenue, and therefore vulnerable to any major fall in oil prices;
- without an IMF programme and Paris Club debt relief, Angola's debt service will remain well above HIPC thresholds, reducing funds available for poverty reduction spending;
- revenue/GDP is high by HIPC standards and more could be spent on poverty reduction.

In terms of future capacity-building needs, participants recommended establishing a national team for debt strategy formulation, working under the Debt Management Committee, which would prepare for a second workshop and a Cabinet-level sensitisation seminar in 2004.

Bolivia: National Workshop on Debt and New Financing Strategy. This workshop took place in La Paz from 1 to 11 September. It was the first event in the CEMLA region to examine the subject of new financing on a par other debt sustainability issues, and its results were presented to the Bolivia Consultative Group (see article on page 5).

Ethiopia National Debt Strategy and New Financing Workshop.

This workshop, held in Addis Ababa, from 25 August – 5 September 2003, aimed to assist the Government to update Ethiopia's debt and new financing strategy analysis at HIPC completion point in preparation for the tripartite DSA. The workshop analysis confirmed that Ethiopia's debt will be unsustainable, after full HIPC relief and additional bilateral cancellations, at Completion Point, and so there is a need for topping-up. Ethiopian officials also analysed the arguments needed to support the case for topping-up of relief at completion point. In addition, the workshop also focused on new financing strategy analysis, including the implications of switching to 40% IDA grants under IDA 13.

There were 32 participants from the Ministry of Finance and Economic Development, National Bank of Ethiopia and the key line Ministries. The Resource People included MEFMI and WAIFEM regional experts.

Mali Post-HIPC Debt Strategy Workshop.

This workshop, was jointly organized by Pôle-Dette and DRI, in Bamako from 4 to 16 August 2003, to assess the post-HIPC sustainability of Mali's total public debt beyond the completion point of the HIPC Initiative, which was reached in March 2003. Three important lessons emerged from this workshop attended by 38 Malian officials, including 3 national facilitators, namely:

- Mali's external debt should be sustainable at completion point. However, the scale of future financing requirements and the current new financing policy could compromise this sustainability a few years down the line;
- a reorientation of the external new financing policy, favouring greater mobilisation of grants and highly concessional loans, could enable Mali to implement its PRSP without compromising the sustainability of its external debt again;
- Mali should continue to manage its domestic debt prudently.

Mozambique National Debt Strategy and New Financing Workshop.

It was jointly organized by the Commonwealth Secretariat, DRI, and MEFMI, from July 21st to the 31st. It trained government officials in designing a post-HIPC debt strategy that would secure enough financing for the Plan for Total Poverty Reduction (Plano de Acção para Redução da Pobreza Absoluta: PARPA) and at the same time keep the debt indicators sustainable ratios

in the long term. Participants included officials from the Ministry of Finance, Central Bank, and line ministries. This was the first national event in Mozambique and was very successful in combining external and domestic debt, new financing, with the macroeconomic and poverty reduction scenarios. During the workshop, participants measured and ranked the different donors and creditors and designed three different new financing scenarios. The results showed that the type of financing used, especially a higher proportion of grants and program (rather than project) aid, will be crucial to debt sustainability in Mozambique. It also highlighted the effect of creditor non-participation, which is keeping Mozambique's debt unsustainable after completion point.

Regional Events

Regional Workshop on Domestic Debt Strategy.

This event took place in Mexico City from 23 June to 2 July, with 30 participants. The delegations included Bolivia, Honduras and Nicaragua (HIPCs) and – as observers – Ecuador, Guatemala and Haiti (Non-HIPCs). In addition to strengthening the countries' capacity for total (external and domestic) and domestic debt analysis, the methodology – introduced for the first time in the region – provided a basis for governments to design and implement policies for future financing and restructuring of new domestic debt which will ensure long-term debt sustainability, fiscal financing, monetary policy coherence and financial sector development (see article in Newsletter 14).

The results of the workshop showed that domestic debt has become a serious problem in Bolivia, Nicaragua and some observer countries, and is getting worse, though it is less significant in Honduras. Restructuring and new issuance policies are complicated by the high level of dollarisation of the economies. Due to the lack of time and access to detailed information (which were expected at a regional event introducing a new methodology is introduced), the delegations also planned the steps needed to finalise more precise domestic debt strategies.

Second Regional New Financing Francophone Workshop.

Jointly organised by Pôle-Dette and DRI, from 7 to 12 July 2003 in Yaoundé (Cameroon), this workshop followed on from a first one



Comoran Observers at 2nd New Financing Francophone Regional Workshop

held in Dakar in March 2003. Although the workshop was principally addressed to post-conflict countries, some of which had not yet been declared eligible for the HIPC Initiative, the objectives remained the same, namely to assist participating countries in formulating consistent strategies for new external financing outside the context of the HIPC Initiative.

Among the lessons learned from this workshop, attended by sixty people, we wish to highlight participants' wish to see their countries adopt the methodology developed by the HIPC CBP in order to optimise mobilisation of external aid and secure adequate financing for their poverty reduction programmes without jeopardising the sustainability of their debt once again.

Country-specific Technical Assistance

Training Mission to Comoros. There has been substantial progress since the demand assessment mission conducted to Comoros last March. The National Debt Directorate was officially created on 14 June 2003, new staff recruited and additional computers purchased. A DRI mission visited Kigali from 18 to 23 August to train staff on basic debt management concepts, present the necessary steps for debt data recording and identify additional training needs for each participant. The mission urged the Comoran Authorities to set up a reliable computerised debt database, quickly deciding on the right computerised tool for their country. Considering that most of the staff were recently recruited, there are important training needs in most aspects of debt management.

DSA Mission to Congo. DRI and Pôle-Dette jointly organised a mission to update Congo's debt sustainability analysis, in Brazzaville, from 13 to 24 August 2003. The main objective of this mission was to re-assess the country's eligibility for the HIPC Initiative based on the latest data.

The Congo is a post-conflict country, which has not yet reached the HIPC Initiative

decision point could be reached during 2004.

The simulations carried out during the mission confirmed that the Congo is still potentially eligible for the HIPC Initiative.

Mission to Guinea-Bissau. DRI and Pôle-Dette organised a mission in Bissau from 28 July to 2 August 2003. The main objectives of this mission, initiated in response to a request by the Bissau-Guinean authorities, were to assist the country's debt managers to improve the reliability of their database with a view to improving the soundness of their DSAs, and enable them to establish a simple procedure for reconciling and recording the external debt in order to alleviate the consequences of the disabling of the software normally used by the Debt Department. The third objective of the mission was to train debt managers in a number of operations mainly relating to the production of reports and data on the debt for the purposes of DSA.

Distance Learning

The distance-learning programme was launched on 4 August, when 20 officials from the four pilot countries, Bolivia, Cameroon, Ghana and Uganda, started work on their study Modules. Many of the students chose to start with the Debt Portfolio Review Module and they will then go on the study the other external debt strategy Modules on multilateral debt relief and the HIPC Initiative, Paris Club and Non-Paris Club debt restructuring. Some students selected to study the Debt Database Module, which teaches how to prepare your debt data for debt strategy analysis. In addition, a number of students have selected to do the new financing pathway and they will go on to learn about designing new financing strategies after having finished their Debt Portfolio Review Module.

Under the programme, students submit their written work, on the basis of the study timetable, to a nominated Mentor, who is a recognised expert. The role of the mentor is

crucial in providing feedback to students on their work. Overall the programme is running smoothly, although there have been some delays in the initial assignment submissions, mainly because of the timing of IMF missions which have meant the students have not had sufficient time available to follow their studies.

Information Products Missions

As part of the Phase III development and transfer to partners of information products, there needs to be full sharing of technical and administrative procedures for the production and distribution of information production among the co-operating partners. In order to ensure all partner stakeholders involved in newsletters publications and websites developments are consulted and to overcome language constraints, DRI is scheduling a series of 2-3 day missions to partners' headquarters. The missions to BCEAO/BEAC Pôle-Dette and CEMLA took place in early July to coincide with other CBP events held at BCEAO/BEAC Pôle-Dette and CEMLA headquarters. The mission to MEFMI took place on 27-29 October.

CBP Partners' Finance Attachments

The Finance Officer from Pôle-Dette, Hilarion Ewolo Mani, and from MEFMI, Anthony Undi went on attachment to DRI in London from 22 to 26 September. The purpose of this attachment was to accelerate the transfer of financial reporting to donors as well as full training in CBP financial procedures.

Future activities

The CBP work programme for the next quarter is summarised below:

- National Debt Strategy Workshops in Benin, Cameroon, Guyana, Nicaragua, and Rwanda;
- Institutional Management Missions to Comoros, DR Congo, Guyana, Honduras Malawi, Mauritania and Tanzania (follow up mission and sensitisation seminar);
- Regional Events: CEMLA Training for Trainers Regional Workshop;
- Distance Learning: start of Module 2;
- Update of website;
- Attachments: from the CEMLA region to IDM;
- Information Product Missions to WAIFEM;
- Publication on HIPC Capacity Building Needs and Modelling Poverty Reduction;
- Continuing support by Debt Advisors to Rwanda and Guinea. Starting up of intensive assistance to Burundi (DFID);
- 13th meeting of the HIPC CBP Steering and Advisory Committees in La Paz.

IDA13 Grant Commitments

Category	% grants	HIPC country	Total commitments FY 2003-05 (SDR m)	Potential IDA grants* FY 2003-05 (SDR m)	Grants as % total IDA commitments*** 2002-03
Debt vulnerable (expected long-term PV/XGS > 150% after debt relief) and poorest IDA countries (per capita GNP < \$360)	up to 40%	Burkina Faso	257	103	30%
		Ethiopia	1022	409	54%
		Gambia	30	12	-
		Malawi	202	81	35%
		Mali	228	91	-
		Niger	197	79	100%
		Rwanda	206	82	26%
		São Tomé & Príncipe	8	3	-
		Uganda	728	291	18%
		Zambia	200	80	56%
Poorest IDA countries (per capita GNP < \$360)	up to 23%	Benin	145	33	0%
		Central African Rep	15	3	-
		Chad	152	35	17%
		Ghana	560	129	34%
		Kenya	250	58	45%
		Lao PDR	70	16	0%
		Madagascar	373	86	0%
		Mauritania	85	20	-
		Mozambique	358	82	40%
		Tanzania	850	196	13%
		Togo	24	6	-
Post-conflict countries	up to 40%	Burundi	124	50	31%
		Congo, DR	350 (est)	140	10%
		Congo, Republic	31	12	32%
		Guinea-Bissau	10**	10**	-
		Sierra Leone	31**	31**	38%

* excludes grants for HIV/AIDS programmes (up to 100% of project) and for natural disaster reconstruction (100% of project)

** one year post-conflict allocation and therefore 100% is grants.

*** represents countries with no IDA commitments in 2002-03

Source: based on World Bank data and information

TECHNICAL QUESTIONS

Why might a country have unsustainable PV ratios at its completion point?

The amount of HIPC debt relief a country is to receive, determined at the time of its decision point, is supposed to be sufficient to reduce its PV/exports (or PV/budget revenue) ratio to a sustainable level of 150% (or 250%) at its completion point. This debt relief is calculated on the basis of the debt stock, CIRR and exchange rates and exports (or budget revenue) prevailing at the time of its decision point debt strategy analysis (DSA). However when the time comes to do the completion point DSA, the expected debt relief may not be sufficient to achieve debt sustainability for the following reasons:

- new debt – new loans contracted since the decision point as well as new disbursements on existing loans will increase the burden of debt, in both nominal and present value terms. If a country has borrowed more than was projected at its decision point, then this can give rise to

higher than projected PV of debt at completion point:

- decline in international interest rates, including CIRRs. As a decline in CIRR discount rates results in a higher PV of debt, and CIRRs have fallen significantly since 2000, the PV of debt for countries which reached their decision point in 2000 and 2001 will be considerably higher than had been projected at that time. However should CIRRs increase in future, then this will lead to lower PV of debt. The table below shows how the key rates have moved in recent years;
- weakening of the US dollar. The lower US dollar exchange rate, particularly in relation to the SDR and Euro, means the PV of debt denominated in these currencies will be higher when converted into US dollars (the currency used for debt strategy analysis). On the other hand, a strong US dollar in future will mean a lower PV of debt calculation;
- lower than expected exports or budget revenue.

If a country's export earnings (or budget revenue) are less than those projected at the time of its decision point, then its PV/exports (or PV/budget revenue) ratio at the completion point will be higher;

- local currency depreciation vis-à-vis US dollar: If the local currency depreciates against the US dollars, then this can result in a lower budget revenue denominator when converted to US dollars terms, and hence a higher PV/budget revenue ratio. An appreciation of the local currency will have the opposite effect.
- When it comes time to do the tripartite completion point DSA, HIPCs need to be aware of all these factors and able to calculate their impact on their sustainability ratios. This is particularly true if the completion point ratios look like being unsustainable and the country needs to negotiate the 'topping up' of debt relief to achieve a PV/exports ratio of 150% (or PV/budget revenue ratio of 250%).

Currency	Discount (CIRR) rates six-monthly average rate (%)			Exchange rates (currency / US dollars)		
	End-1999	End-2000	June 2003	End-1999	End-2000	June 2003
Euro	5.47	6.25	4.85	*	1.07	0.87
UK Pound	6.70	6.73	5.30	0.62	0.67	0.60
USD	7.04	7.19	4.52	1.00	1.00	1.00
Yen	1.98	2.03	1.49	102.2	111.2	119.8
SDR	5.59	6.09	4.25	0.73	0.77	0.71

FOREIGN PRIVATE CAPITAL CBP UPDATE

Missions in the third quarter have assisted Malawi, Tanzania, Uganda and Zambia to prepare closing dissemination events during the next 3 months. Six other countries are applying to join Phase II; and DFI, regional partner organisations and donors are finalising the overall programme.

COUNTRY SUPPORT CONTINUES

Uganda held the first Phase II closing conference in September, followed by meetings to chart the way forward, assisted by DFI/MEFMI. Preliminary results show their stock of foreign liabilities increasing by 10% to US\$1.2bn in 2001, or 21% of GDP. FDI was 90% of the total, with a third of investments coming from tax havens such as Bermuda, possibly suggesting some round tripping by resident investors. African countries (particularly Kenya) made up another fifth. FDI was equity financed and of long-term maturity, and went mainly into manufacturing (especially agro-industries) and finance. Private sector external debt was relatively low at US\$0.3bn or 6% of GDP – with long-term maturity. However, the NTF urged the private sector to improve its reporting of short-term debt, which was thought to be significantly underestimated.

Investment perceptions were bullish as over 85% indicated intent to expand turnover and profits over the medium term. Constraining factors identified, however, were high interest rates; corruption; bureaucracy; electricity costs and the negative impact of HIV/AIDS on labour. During the closing, discussions on policy and advocacy centred on diversifying the economy beyond manufacturing; on orienting the economy more towards export production; and on improving macro-conditions to increase access to credit. The team is planning to incorporate these and other comments in the final report that will be widely disseminated.

Zambia hosted a DFI/MEFMI mission in June, which assisted the NTF to achieve very high accuracy in its database. Phase I dissemination will take place in October, but

preliminary results are presented on page 14.

Malawi has achieved an excellent 83% response rate, due to a committed NTF and a supportive private sector. This covered 95% of total foreign investment. A DFI/MEFMI mission in September focused on editing, software training and data processing, sharing regional experiences and developing NTF data management skills. Simultaneous IMF GDDS and ROSC missions were highly complimentary about the programme. The Phase II closing workshop is planned for November.

Tanzania, helped by a DFI mission in August that devised new techniques to improve data quality, is finalising its database in preparation for their first Phase II closing dissemination workshops on the Mainland and Zanzibar in December. A DFI/MEFMI mission in the fourth quarter, to train in analytical techniques and report writing, may precede the closing events.

PHASE II PREPARATION AND LIAISON

The Gambia, Ghana, Kenya and Lesotho are finalising proposals and budgets for Phase II participation and arranging meetings with donors. **Trinidad & Tobago's** Phase II proposal is expected shortly. Meanwhile, DFI and Bank of Tanzania met the IMF Africa Technical Assistance Centre to enhance coordination in the region, and DFI held meetings with the World Bank FIAS and Commonwealth Secretariat in London.

Core funding arrangement for the programme is expected to be finalised by the end of September, allowing the programme to focus more on decentralisation, training of trainers and expansion to new languages and regions, notably Latin America and Francophone Africa.

COUNTRY CAPACITY EVALUATION

Participating country teams provided comments on the methodology, and are completing their first evaluations. ROs and DFI will report findings to the FPC CBP

Meeting in November.

METHODOLOGY AND INFORMATION PRODUCTS

DFI and its partners are designing new methodologies in investor register & sampling, improving data quality, analysis & report writing, software & database management, policy and sustainability analysis. It will report completed analysis in the fourth quarter on the technical pages of the website. DFI will complete the first drafts of two publications in the fourth quarter, and update its website.

FUTURE WORK PROGRAMME

In the next three months:

- The Phase II framework and documentation will be finalised and circulated;
- Zambia will finish Phase I while Uganda, Malawi and Tanzania will complete their first annual Phase II exercise;
- Depending on funding, Kenya will start Phase II activities;
- The above and other methodology (on non-survey methods and FPC management & institutional best practises) will be further developed;
- A draft software and database management manual will be produced;
- Coordination meetings with the IMF and World Bank will be held in November, and the first FPC CBP Meeting will take place in La Paz.

ZAMBIA RESULTS REVEAL LARGE PSED

Zambia has been experiencing a long-term decline in copper production and exports, with negative effects on the economy and the poor. Since the early-1990s Government introduced many economic reforms, including abandoning exchange controls, restructuring the financial sector, privatisation and price liberalisation. After initially responding positively, economic growth and development lagged. By 2001 Zambia was ranked 143 of 161 nations on the Human Development Index.

Recognising the need for informed external sector policy decisions, Zambia approached DFI and MEFMI in April 2001 to assist the authorities to build sustainable FPC monitoring capacity. Working with the Central Bank, Statistics Office and Zambia Investment Centre, DFI and MEFMI conducted national training in December 2001 and the National Task Force launched the FPC survey in June 2002. The closing dissemination event is now scheduled for October 2003. This article presents the preliminary overall results of the survey.

Overall Results

The results revealed much previously unknown information on Zambia's external sector, and the NTF is currently linking these findings to the analysis in the *Economic Diversification Initiative*.

Despite weakening global demand and lower primary commodity prices, Zambia's economy grew by 5% in real terms in 2001 reflecting increased metal production and distribution and manufacturing. The FPC results indicate that the country's private sector *foreign liabilities* are vital for development financing, with high stocks (US\$1.4bn) and flows (US\$0.2bn), 38% and 5% of GDP respectively. Three-quarters consist of FDI, which was predominantly debt-financed with long-term maturity (see Table 1)

Mining privatisation and vibrant sectors such as food & beverages, distribution and real estate attracted new FDI. Despite these new investments, a sharp shift towards debt financing occurred in 2001, reflecting investor plans to expand production over the medium term, the high inter-company financing in 2001 that provided existing investors with added flexibility to increase capacity. However, from a macro and micro economic viewpoint, this FDI debt component may be volatile, as it has no terms and can be recalled at any time by parent companies.

The main *source countries* of FDI (UK, Netherlands and South Africa) represent 70% of the total. African countries (mostly South Africa and Zimbabwe) accounted for only 13%. This is



Gandeon Moyo, Bank of Zambia, and DFI's Research Assistant, Cleo Rose Innes

much lower than the 25% average of other African Phase I countries, but a high proportion of UK investment is from companies registered elsewhere but which take their decisions in the region. FDI went mostly into the finance (26%), mining (17%), manufacturing (13%) and agriculture (12%) sectors, and into Lusaka (50% of total) and Copperbelt (45%) areas. Good news for the *Diversification Initiative* is that manufacturing attracted the most investors (31%), particularly in chemicals, food & beverages, and that many manufacturing sub-sectors were very profitable, implying there is scope to expand investment.

The stock of *private sector external debt* (PSED) was very large at 25% of GDP, with net flows at 4% of GDP. However, PSED was relatively low-cost with an implied interest rate of 3.8%, making equity the most expensive source, with profits of 6% and dividends and retained earnings of 11%. Most of the debt was between related companies and long-term. By

sector, mining had the highest debt/adjusted equity ratio at 88%, but most of this was in long-term debt. Though no sector appears to be immediately vulnerable to debt default, continuous monitoring is needed in this area.

Zambia's *foreign assets* were small, with a stock of US\$6m as FDI. However, the total loan

stock at US\$93m was some 2.4% of GDP, mostly short-term with a low rate of return of 2%. It thus appears that investors may benefit from more financial instruments to hedge risk, diversify portfolios abroad and maximise their returns.

Preliminary Analytical/Policy Implications:

- Though large and apparently sustainable, sharp changes in the way FDI is financed imply the NTF should research further into the causes of debt / equity and the rates of return demanded by various classes of investors / creditors;
- The geographical pattern of source country – and thus where the ultimate investment decisions are made – should be presented by immediate and original source country of investment. The proportion of African-sourced investment is then likely to rise sharply;
- The Zambia Investment Centre should expand marketing the country to neighbouring countries – only 5 African countries are currently investing in Zambia in a significant way;
- The NTF should research how to attract more local and foreign investors into the manufacturing sub-sectors, and into the under-invested Southern Region;
- The NTF should research PSED further by sector and over time, to identify and advise on overall and sectoral vulnerabilities and sustainability.

Table 1: Zambia's Private Sector External Liabilities & Assets, 2000 - 2001 (in US\$ m)

TOTAL FOREIGN LIABILITIES	End-2000	Net Transactions	End-2001	Income	Implied Costs / Returns
	1,074.3	175.9	1,383.9	-80.1	6.5%
<i>of which: long-term</i>	967.2	167.9	1,263.3	-79.2	7.1%
Direct Investment	850.7	150.7	1,084.8	-71.5	7.4%
Equity Capital at Market Values	457.6	50.5	467.3	-51.3	11.1%
Intercompany Borrowing	393.1	100.2	617.5	-20.3	4.0%
Portfolio Investment	6.1	5.4	11.8	0.0	0.0%
Other Investment	218.6	25.2	293.6	-8.6	3.3%
Loans	188.5	23.6	262.8	-7.9	3.5%
Trade Credits	30.2	1.5	30.8	-0.7	2.1%
TOTAL FOREIGN ASSETS	76.6	18.7	99.4	1.8	2.0%
<i>of which: short-term</i>	56.4	17.4	77.3	1.7	2.6%
As a % of GDP					
Total Foreign Liabilities	29.5%	4.8%	38.0%	-2.2%	N/A
TOTAL FDI	23.4%	4.1%	29.8%	-2.0%	N/A
Total PSED	16.8%	3.6%	25.2%	-0.8%	N/A
Total Foreign Assets	2.1%	0.5%	2.7%	-0.0%	N/A

Source: Zambia FPC 2000/1 Survey.

ANALYSING FOREIGN PRIVATE CAPITAL FOR POLICYMAKERS

One key objective of the Foreign Private Capital Capacity Building Programme (FPC CBP) is to provide policymakers with analysis, which can ensure the stability and sustainability of private capital, and contribute to balanced economic growth. This article describes some of the techniques the programme uses.

Policy Environment

The member states of the FPC CBP are characterised by:

- A (largely mistaken) belief that FPC is small and that they are dependent on foreign aid flows for development.
- Assumptions that foreign direct investment in equity form will make a major future contribution to their development.
- Lack of information about source countries or target regions / sectors of investment.
- Very limited analysis of the effects of macro policy and external (e.g. commodity) shocks on investment or the effects of investment on macroeconomic stability.
- Inadequate analysis of private sector perceptions of which factors influence investment decisions, and of their intentions to increase or reduce investment.
- Lack of knowledge of how to analyse the sustainability of foreign private capital.
- Little information on corporate non-financial behaviour and contributions to sustainable development and poverty reduction.
- Insufficient analysis of private sector foreign asset-holding behaviour
- Failure to integrate analysis of private and public sector finance to assess national development financing prospects and develop a national public-private strategy.

Analytical Needs of Policymakers

The FPC CBP responds by providing analysis of the following types:

- **FPC Scale** – analysing scale in relation to other economic variables. Phase I of the FPC programme found total foreign liability stocks to average 25% of GDP. One key element of this was improving data to reflect market values of investments (which increased data by 40-80%). This indicated to participating governments that FPC was much larger than believed and merited more analytical attention.
- **Investment Composition by Instrument** – equity, intercompany flows and debt. Over three-quarters of liabilities are in FDI, mostly equity. However, most countries have large private sector debt, with stocks of 13-25% of GDP. Debt-to-equity ratios vary considerably, from 57/43 in Zambia to 21/79

in Uganda. Much debt is owed to related companies, but most countries have significant non-related debt. This has signalled to policymakers that FPC requires constant monitoring.

- **Direction of Flows** – by sector, region and source country. Source country results have identified new countries for investment promotion agencies to target – especially inter-African investment. Sector flows are generally not in line with country PRSP or development strategy priorities, but show prospects for diversification well beyond natural resources. Regional results show a need to target poorer regions with public infrastructure.
- **Macroeconomic Analysis** – understanding how private sector consumption and investment influences macroeconomic savings and investment gaps, how domestic financing availability impacts on foreign financing, and how external sector liberalisation, exchange rate, monetary and fiscal investment incentives affect FPC. Several countries have re-examined external sector liberalisation and fiscal incentives after finding that they have marginal impact on FPC.
- **Investment Promotion Analysis** – investor perceptions questions examine private sector views on the investment climate to address their concerns. They help investment agencies to analyse how investors view key factors that influence investment, and make medium term investment forecasts. Governments can then refine a range of promotion policies and encourage investors to increase flows.
- **Sustainability Analysis** – assessing cost and prospects. This includes the maturity profile, the returns investors demand on equity and debt, and future investment intentions. Around 80% of FPC is long-term, but short-term intercompany debt is potentially volatile. Rates of return demanded on equity (10%) are generally higher than on debt (5%). While positive for future investment prospects, this raises risks for sustainability of flows. In addition, most countries have at least one sector with excessive debt exposure in terms of gearing, cost and profitability. Most countries' investors intend to increase investment, which should allow continued positive net inflows. However, countries have realised that FPC need to be better analysed, to help companies to obtain more favourable terms.
- **Analysis of Corporate Non-Financial Behaviour** – assessing behaviour on labour,

health, environment and other issues which affect poverty, to analyse how FPC can contribute to poverty reduction, and feed into national Poverty Reduction Strategies. Phase II results are showing few companies with clear policies and vast scope for action to encourage private sector-led poverty reduction.

- **Foreign Asset Management** – analysis of assets informs macro-economists and policymakers about returns on national overseas investments. Phase 1 findings show low stocks, flows and rates of return, indicating that investors might benefit from more training, financial instruments and extended maturities to increase returns, hedge risk and diversify portfolios abroad.
- **National Development Financing Strategy** – integrating all of the above analysis into a national development financing strategy (also analysing public sector debt and domestic financing) to ensure sustainable development and poverty reduction. Countries have realised that FPC is not a panacea for future development finance.

Next Steps

Country results have already provided policymakers with vital new information, via private-public sector dialogue in FPC dissemination fora. These results have fed into national private sector development, investment and poverty reduction strategies.

However, they also raise further analytical needs, including:

- More attention to FPC scale by uprating book to market values.
- Analysis of the causes of company decisions among financing instruments, to adjust taxation and other incentives to influence the mix of debt and equity.
- What influences the source country, sector and region of investment.
- The factors influencing the rates of return demanded by companies, the maturity of financing and the future investment intentions.
- How the availability and cost of domestic finance influences FPC decisions.
- How to improve the financing terms and sustainability of FPC.
- Best practices encouraging companies to promote corporate social responsibility.
- Development and implementation of national development financing strategies.

Phase II of the FPC Programme is addressing these policy issues.

FOREIGN PRIVATE CAPITAL: FREQUENTLY ASKED QUESTIONS

WHY AND WHEN TO OFFICE-ESTIMATE MARKET VALUES OF EQUITY CAPITAL?

Why Office-Estimate?

In Newsletter 16, we defined *Market Value* (MV) of equity stock, and justified the importance of this concept for policymakers and compilers. We also indicated practical difficulties in its estimation, and how countries have sought to address this. Some OECD countries do not up-rate data supplied by companies from book value to market value, as the task is onerous and there are doubts about the accuracy of the results. In addition, similar to country experiences under the FPC CBP, OECD respondents tend to favour Net Asset Values (NAVs) for book values. In many OECD countries, these are likely to be regularly revalued according to accounting standards and therefore the basis of valuation is likely to approximate market value.

In FPC CBP countries, while respondents in recent surveys have mostly used NAV, latest international accounting standards do not apply widely, so NAV is not revalued regularly, and liabilities data from large, long-established companies are often deceptively low. Given their economic importance, this distorts the overall picture. In addition, many respondents use non-NAV estimates of market value, including proxies other than stock exchange values because so few companies are listed.

Nevertheless, to reduce fieldwork costs, mitigate survey fatigue, and overcome lack of company financial statements, it is essential to office-estimate MV. *Though challenging, this produces data much closer to 'true' equity value, and of greater value to users.*

When to Office Estimate?

If BV data for equity are available, the key factor is the proxy used to estimate MV (making it important to ask respondents to specify this). Company MV estimates should not be adjusted if based on director's estimates, a recent company transaction, stock market estimates for listed companies, or valuation by analogy - or if companies provide the same MV as BV within 1 year of their start-up. However, it does make sense to make office estimates for companies using NAV, stock market estimates for unlisted companies, and where companies have been operating for more than one year but still report MV = BV.

Given that companies do not always specify the proxy used, compilers need look very carefully at the data supplied by the respondent to decide whether to office-estimate.

1. MV omitted

Many respondents omit MV. If the following other data are contained in their response, in financial statements, or based on other local knowledge, then MV should have been provided, justifying office-estimation: BV held by non-residents; dividends paid to non-residents; retained earnings attributable to FDI; shareholder and intercompany debt; equity transactions during the period.

2. MV equal to BV

Many respondents supply MV identical to BV, but BV is only acceptable as the least preferred proxy of MV. Often, this is because respondents did not understand the concept or have time to estimate, or unqualified staff completed the return. However, the response may be legitimate, and the editor needs to consider other information before deciding to office-estimate.

Generally, MV = BV is acceptable for companies starting operations up to a year before the reference period begins (though some new companies supply MV > BV, which may reflect profitability and positive growth forecasts). BV = MV is not usually accepted for companies starting operations more than 1 year before the reference period begins, or those making large profits or losses.

3. MV significantly > BV

MV tends to exceed BV and country MV/BV ratios are usually between 1 and 3. However, some companies, sectors and countries show much larger ratios. It is considered not necessary to office-estimate when a high MV:BV ratio reflects:

- Expected / actual profitability or key sector characteristics (for example mining companies may include the value of un-mined resources or high ratios for tourism may reflect untapped sector potential. This may be crosschecked for consistency against other data such as profitability, perceptions and expectations about investment climate, as well as against financial statements and other local knowledge;
- Long-established companies for which BV is deceptively low (due to exchange rate and inflation effects, no new equity, and no revaluation) rather than MV too high;

- BV may also be deceptively low if the respondent has incorrectly supplied only the equity part, excluding other elements of shareholder funds such as retained earnings. This is often easy to spot, as equity tends to be quite low and presented as a rounded number, while shareholder funds are larger and more precise.

Countries have sometimes found it necessary to down-rate MV where they feel this has been overstated, based on the above consistency checks. Sometimes for example, it is clear that a respondent has derived its MV by adding its debt exposure to BV.

4. MV < BV

Occasionally, companies supply MV less than BV. This is acceptable if the company has been experiencing difficulties, but office-estimation is encouraged where a company is highly profitable, or sector prospects are favourable. In deciding whether to accept the data, own knowledge and the media can be used for high profile companies, while investor perception data and comparison with companies in the same sector or the overall economy are helpful for less well-known companies. Rarely, companies supply MV < 0. Usually, the minus is misplaced, but occasionally high profile companies experiencing chronic problems have been sold for a token value, reflecting debt and restructuring costs. Under such circumstances, MV is assumed to be zero.

Conclusions

As with National Accounts, BoP/IIP compilation is about combining 'hard data' with well-founded estimates, especially if your country is committed to meet international BoP/IIP standards but lacks international accounting standards. Office-estimation is intended to bring data closer to 'true' value of equity, but not 100% accurate. It needs to be used on a case-by-case basis, prioritising companies by size, region and sector. Compilers need to draw extensively on their local knowledge of a particular company, sector and the wider economy, on company financial statements, and on reviewing survey forms for their internal consistency, using data on profitability, debt and investor perception. Newsletter 18 will go into more detail on how to office-estimate MV.