

HIPC DEBT STRATEGY

The Newsletter of the HIPC Debt Strategy
and Analysis Capacity Building Programme



Debt Relief International

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HIPC II: PROGRESS ON COUNTRIES AND FINANCING

The Enhanced HIPC Initiative focussed above all in the last quarter of 1999 on mobilising the financing to ensure that the Initiative could proceed, and on beginning to define the content and mechanisms of Poverty Reduction Strategy Papers (PRSPs) and the Poverty Reduction and Growth Facility (PRGF), which are to replace PFPs and ESAF respectively (see pages 4-5). As a result, it was mid-December before any country papers were presented to the Bretton Woods Boards, and January before Bolivia and Uganda reached their "second decision points" and Mauritania reached its first decision point. Country papers are expected to come through more rapidly in the first half of 2000 – including Burkina Faso, Honduras, Malawi, Mali, Mozambique, Guinea-Bissau, Nicaragua, Senegal, Tanzania and Yemen.

There has been a lot of progress in mobilising financing and defining relief levels during the phase between the decision and completion points for HIPC II:

- the IMF has mobilised the SDR3.9 billion needed to finance its contribution, through SDR1.5 billion of bilateral pledges to its ESAF-HIPC Trust Fund, SDR1.8 billion from the profits on off-market transactions in gold, and SDR0.6 billion from foregoing ESAF administrative expenses and transferring other interest earnings. It will be prepared to provide up to 20% of its relief in each of the years between decision and completion.
- the World Bank will fund its relief from IDA resources, immediately refunded by the HIPC Trust Fund (itself funded by the IBRD net income and donor contributions). The World Bank will provide the maximum frontloaded interim assistance through debt service relief of not less than 50% of the service due – but only up to a ceiling of one-third of the total relief committed by the Bank.
- other multilateral development banks have

agreed in a framework for contributions, though firm decisions on contribution methods are still awaited (notably by the Inter-American Development Bank).

- the Paris Club has agreed on how to cancel 90% or more of HIPC countries' debt under the Cologne Terms (see page 12), and the Canadian, French, UK and US governments have gone even further, announcing 100% bilateral debt cancellation (on aid and non-aid debt) for all HIPCs.

First HIPC Ministerial Meeting urges faster progress

The first ever meeting of HIPC Finance Ministers was organised by DRI and the Danish Ministry of Foreign Affairs in Copenhagen on 8 December 1999, and attended by representatives of 16 HIPCs. Ministers discussed the progress of the Enhanced HIPC Initiative and their needs for future capacity building. Their conclusions were presented to international and regional capacity-building organisations by four HIPC Ministers at the Fifth Steering Committee Meeting of the HIPC DSACBP on December 9. The main conclusions were:

1 Implementing HIPC

1.1 Timing of relief

- no country's debt relief should be delayed by defining the Enhanced Initiative and Poverty Reduction Strategy Papers (PRSPs), or by mobilising funding;
- countries starting PRGF programmes cannot wait 3 years for a decision point, during which poverty reduction is underfinanced by lack of HIPC relief;
- retrospective relief, for those countries which have already passed decision or completion points under HIPC, is not coming fast enough. These countries have a strong case for simultaneous "first completion points", "second decision points" and "second completion points", except in cases of major problems with PRGF programmes;
- the dates used to calculate retrospective

relief should be the original HIPC decision points, to avoid penalising the best performers by calculating their relief based on later dates.

1.2 Eligibility criteria

- debt service/revenue ratios are the key measure of HIPC debt burdens, and HIPC should take account of domestic and private sector debt burdens (without relieving them directly);
- criteria and programmes need to protect (using realistic macroeconomic projections, and contingency mechanisms and financing) against unstable exports or budget revenue, to avoid post-completion point shocks making debt unsustainable, as has happened in several HIPCs

1.3 Poverty Reduction Strategies (PRSPs)

- the primary use of the savings from debt relief should be for spending on poverty reduction;
- most countries already have Poverty Reduction Strategies endorsed by donors, so the international community should not reinvent the wheel by insisting on new PRSPs;
- PRSPs may need to be broadened and deepened in several ways:
 - ✓ extending spending beyond social sectors to include all anti-poverty elements of government spending (e.g. rural development, microcredit, and welfare programmes);
 - ✓ analysing the distributional effects of all macroeconomic policies; and
 - ✓ improving income distribution, employment and empowerment of the poor.
- PRSPs should be flexible and adapted to country circumstances, in the nature of participation and consultation, and in their content (e.g. funding recovery from disasters or civil strife);
- PRSPs should ideally be designed or broadened by participatory consultation from the bottom up, before donors or the Bretton Woods Institutions become

- extensively involved;
- insofar as the international community is involved in designing PRSPs, countries should draw on the widest range of inputs (e.g. UN agencies and independent analysts as well as the BWIs);
- the level and timing of relief and new flows need to be predictable, to support medium-term budgets and poverty reduction which can fulfil the expectations of civil society and donors;
- all countries need considerable frontloading of relief for poverty reduction, to live up to public expectations of rapid debt relief, and to reduce uncertainty;
- governments must sensitise civil society to have realistic expectations of relief and new flows.

1.4 Conditionality

- ministers were concerned (and short of information) about PRGF programmes;
- conditionality should spring from a domestically-built PRS, which meets minimum standards for endorsement by the international community, rather than being donor-driven;
- ESAFs have contained too many conditions: so PRGF must have a very limited number of benchmarks, eliminating some ESAF conditions which are less related to poverty reduction;
- conditions should focus on aspects which are within government control (process of participation, spending levels and intermediate indicators);
- compliance needs to be flexibly assessed. For example:
 - ✓ debt relief should be provided even if a HIPC breaches one PRGF condition (especially if that is not directly related to reducing poverty);
 - ✓ social-spending targets should be guidelines, and relief should continue even if they are missed due to external or domestic shocks (shortfalls in budget revenue or aid).

1.5 Financing debt relief

- the international community must mobilise contributions from different creditor groups: HIPCs have very limited power to influence their creditors;
- some HIPCs face major shortfalls of relief from non-Paris Club bilateral creditors;
- regional multilaterals need to use own resources rather than diverting aid flows;
- all the bilateral debt of OECD countries needs to be treated in the Paris Club: there should be no categories of debt (monetary, postal, hospital, parastatal) excluded;
- all creditor governments should rapidly cancel ODA debt, additional to HIPC relief;

- the Paris Club should treat post-cut-off date debt where necessary;
- Multilateral Debt Funds will need to continue, and aid grants to rise, to fund accelerated poverty reduction before (and unless relief is frontloaded after) decision points;
- worries about financing for the HIPC Trust Fund should not delay relief, as there is certainly enough funding to provide relief for immediately eligible countries.

1.6 New borrowing/financing

- Debt relief must be fully additional, and total relief, grant and loan commitments must be sufficient for all low-income countries to reach the International Development Targets;
- Some donors (e.g. Japan/Arab funds) are threatening to end new flows if a country gets relief under HIPC. The international community should oppose this strongly;
- Aid disbursements continue to fall well short of commitments. PRGF programmes need to contain realistic projections, and measures to improve donor co-ordination and recipient absorptive capacity;
- HIPCs need to borrow on highly concessional terms (with grant elements well above 35%) or preferably to mobilise grants - but donors therefore need to provide more concessional funds for all low-income countries that are committed to poverty reduction.

2 Capacity Building Priorities

Many countries need to reinforce and update **institutional and legal structures**, but can do so by exchanging information among themselves on successful frameworks rather than by adopting any standardised solution. The key is to strengthen staff levels and training, clarify mandates between and within units and co-ordination structures, and ensure that these are implemented. HIPCs also need to establish permanent national teams to update, deepen and implement their national debt strategies.

Most countries need continued assistance in upgrading **debt recording and payment** systems, which need to be linked to all analytical softwares, extended to cover private sector and domestic debt and grants, and installed in networks among different government agencies.

All countries need dramatic improvement of their **debt negotiations** ability with Paris Club, non-Paris Club and multilateral creditors, as well as their capacity to manage domestic debt. Such assistance should be tailored to each country's needs using live data and documentation.

Almost all HIPCs have clear legislation and regulations which define **new financing policy**, but most still need to enforce these to make sure other agencies (especially parastatals) do not borrow non-concessional loans, and that central units have prior approval. They also need to be more proactive in negotiating new financing which is high quality (untied, oriented to poverty reduction and fast disbursing) as well as concessional, and to compile and exchange information on creditor and donor disbursement procedures to make them more proactive in mobilising disbursements.

Most HIPCs have weaknesses in **macroeconomic analysis and forecasting**, and a strong need for capacity building. Many need to improve data collection – particularly on imports, private capital flows, and aid flows; to develop their own country-specific models; and to avoid duplication among agencies by establishing technical working groups to co-ordinate forecasts and analysis.

Most countries need reinforcement of their capacity to design **poverty reduction strategies**, especially on designing precisely costed action plans for poverty reduction spending beyond health and education, analysing the effects of macroeconomic policies on poverty reduction, income distribution and employment, participatory/consultative design processes, and more frequent monitoring of the qualitative and quantitative poverty indicators.

As **capacity-building priorities**, HIPCs therefore recommend that training on basic debt management (recording, payment, disbursements) should be continuous, on-the-job and conducted by HIPC officials themselves, rather than using external assistance. Institutional reinforcement and training on debt sustainability analysis should be decentralised rapidly to regional institutions and inter-HIPC assistance. The key role of external assistance should be in subject-specific workshops, covering in detail debt negotiations, domestic debt, proactive new financing policy, macroeconomic forecasting and poverty reduction policies.

3 HIPC Ministerial Network created

The final decision of the Ministerial Meeting was that a permanent network of HIPC Finance Ministers should be created with support from the CBP, in order to monitor progress with the Enhanced HIPC Initiative and related capacity-building on a semi-annual basis. The next meeting of this network will take place in the second quarter of 1999, under the presidency of Gabriela Nuñez de Reyes, Minister of Finance of Honduras.

In the last four months, there have been so many developments in the HIPC Initiative that we have expanded this newsletter to 12 pages in order to cover them fully. First, the IMF and World Bank Annual Meetings in Washington in September 1999 endorsed the G7 Cologne Summit recommendations on an Enhanced HIPC Initiative (reported in our last edition). Prominent features of the Enhanced Initiative (also widely known as HIPC II) include a much closer link to poverty reduction and the new Paris Club Cologne Terms.

THE HIPC INITIATIVE AND POVERTY REDUCTION

When the HIPC Initiative was formally approved, in October 1996, no document supporting the original Initiative detailed an explicit link between the potential proceeds of debt relief and its use in poverty reduction programmes. It was only in the process of preparing the first two cases presented to the BWIs Boards – Uganda and Bolivia – that a link was made to ensure the use of debt relief and potential debt service savings for poverty reduction purposes. At the time Uganda and Bolivia had made decisions on their priorities in reducing poverty, preliminary strategies were in place and being implemented with donors' support. Therefore, it was not difficult for those countries to negotiate with BWIs at the time of their decision point (1997) the content of a social sector objectives matrix that was used for establishing benchmarks to be achieved by countries, together with the rest of the ESAF conditions, to reach the completion point. This became standard practice for all countries under HIPC I, and most countries reached their social targets or at least targets did not delayed or impeded completion points to be reached.

Independent evaluations of the contribution of HIPC I to poverty reduction through social sector conditionalities are mixed. Criticisms of its initial approach have evolved around the following points:

- objectives for spending allocation have been very variable among countries in terms of social targets;
- coverage was too narrow. In many countries it focused only on education and health and left out other poverty relevant spending, i.e. infrastructure and income generation activities;
- most HIPC programmes saw poverty reduction as separate from the macroeconomic reforms. No analysis was made of the potential implications for income distribution or employment of structural reforms,

such as privatisation or deregulation of prices in public services;

- in general, targets set were not always tailored to the amount of debt relief nor to the timing of the relief;
- while in a few cases (notably Bolivia and Uganda) the conditions were designed domestically in the framework of their poverty reduction programmes, some sources appear to see the HIPC social conditions in other countries as more imposed conditionality with little consultation, questioning therefore the ownership of the programmes by HIPCs;
- there were several examples of donor funds being earmarked to specific poverty reduction projects, which sharply reduced countries' ability to be flexible with their own resources when needed;
- insufficient resources were made available to countries to fulfil the social conditionalities, notably between the decision and completion points.

In the process of the HIPC Review, a consensus developed that Poverty Reduction is a long-term process that will go well beyond the HIPC Initiative timeframe. In that, it is closely related to allocating sufficient resources for social sector spending priorities, but to have a real chance to succeed, it will require a more comprehensive approach. This should identify the causes of poverty, appropriate policies, and multi-sectoral programmes to overcome them, a medium-term expenditure framework, enhanced administrative capacities, and above all long-term political commitment by policymakers. An additional necessary condition is the increased participation of all actors of the civil society in the process of designing and implementing the poverty reduction strategy, and in identifying appropriate monitoring mechanisms to achieve the objectives agreed.

Many of these elements are now the basis of the new framework to implement

the Enhanced HIPC Initiative, launched formally in October 1999. A number of key documents have been produced since by the BWIs to: i) explain the rationale for changes and present a systematic compendium of knowledge on poverty reduction; and ii) to provide guidelines to staff and countries to start implementing the revised framework. Most of these documents can be found in the IMF or IDA's websites. Among them the most important are:

- Heavily Indebted Poor Countries (HIPC) Initiative – Strengthening the link between Debt Relief and Poverty Reduction, IMF/IDA, 26 August 1999.
- Building Poverty Reduction Strategies in Developing Countries. The World Bank, 20 September 1999.
- Review of the IMF's Approach to Social Issues and Policies. IMF, 27 August 1999.
- Poverty Reduction Strategy Papers – Status and Next Steps. Revised. IBRD, 22 November 1999.
- Poverty Reduction Strategy Papers – Operational Issues. IMF/IDA, 10 December 1999.
- The Poverty Reduction and Growth Facility – Operational Issues. IMF, 13 December 1999.
- Poverty Reduction Strategy Papers – Internal Guidance Note. The World Bank, 23 December 1999.

The Enhanced HIPC Framework

recognises that poverty is multidimensional and not limited to the provision of social services. In that, the well being of the poor is determined by both income and other elements such as access to public services, increase of security and inclusion (participation). It also recognises that the challenge is to move away from the separate design of social policies, macroeconomic targets and sectoral-based interventions, to an integrated approach consistent with making progress toward poverty reduction and international human development targets. There is also recognition that debt relief is a key

element in promoting poverty reduction, if it is reinforced by: i) policies in HIPCs designed to promote equitable growth, sustainable development and poverty reduction; ii) increased aid flows – preferably grants to support those policies; iii) restrictions on commercial export credit lending to HIPCs; and iv) unrestricted access to industrial country markets for export products. Finally, it is acknowledged that, the Bank and the Fund will have to adapt their current way of operating – the manner in which they collaborate with each other as well as with governments, civil society, donors, and creditors.

Under the Enhanced HIPC Initiative countries are requested to prepare a Poverty Reduction Strategy (PRS) as a pre-condition to reach a decision point. Such a strategy would need to derive from a consensus building process that includes the different actors of the country's civil society. Successful implementation of the agreed strategy and achievement of specified social benchmarks would be a condition to deliver the debt relief at the completion point. While poverty reduction strategies will vary from country to country, as poverty has different roots and expressions, a number of general criteria have been agreed as necessary elements to be analysed in a PRS, to receive BWI's endorsement, including:

- the nature and determinants of poverty;
- choosing public actions with the highest poverty impact;
- reducing income poverty by increasing market opportunities to the poor;
- improving capabilities and delivery of essential services;
- increasing empowerment and participation;
- increasing security and reducing vulnerability;
- setting and monitoring outcome indicators.

The BWIs recognise that this framework is not new, and a number of countries including Uganda, Mozambique, Bolivia and South Asia have already moved in this direction. Nevertheless, to expect that all HIPCs will have a PRS agreed through a participatory process by their decision point might not be realistic and could delay the arrival of debt relief. The BWIs Boards have therefore decided that countries can still reach decision points with an Interim PRS, which would be finalised later. Countries would reach their

completion points by fulfilling of a number of macroeconomic and structural conditions, and implementing a finalised PRS for at least one year. Countries retain the main responsibility in design and consensus building to prepare their own participatory PRS, and the role of IFIs and donors will be limited to advising on best practices and identifying priority areas for donor resources.

Progress since the approval of HIPC II

has been slow but steady. In the last quarter of 1999, apart from the BWI papers already cited, a number of meetings have been organised to assemble ideas on how best to implement of the new framework (notably, an international seminar on Poverty Reduction and Debt Relief organised in the Hague by EURODAD and the Foreign Affairs Ministry of the Netherlands; a meeting organised by DFID, the Ministry of Foreign Affairs of Denmark and DRI in Copenhagen for representatives of selected HIPCs and the BWIs to discuss Enhanced HIPC and Poverty Issues; and a recent Seminar on Poverty Reduction and the Link to Debt Relief organised by UNDP in New York).

In early 2000, three countries have reached decision points under the Enhanced HIPC Initiative (Uganda, Bolivia, and Mauritania). For the first two, the Boards agreed a "second decision point" on the basis of the newly prepared PRSPs. For Uganda, the BWIs Boards endorsed its efforts to implement its poverty reduction plan, with sufficient participation from civil society and requested only a few minor enhancements to reach a "second completion point" by March 2000. In Bolivia's case, the government requested a delay in the "second completion point" until the PRSP was fully discussed in a national dialogue with civil society, to be completed by mid-2000. Mauritania has also reached a decision point, with a list of areas in which the government intends to concentrate its poverty reduction efforts, presented as an Interim PRSP. The Mauritania government will prepare a full strategy in consultation with civil society during 2000, and present it to the BWIs Boards by December 2000 for endorsement.

While experience in implementing the Enhanced HIPC is still relatively limited, it is clear that to reach a decision point, countries will have to undertake extremely complex and lengthy discussion processes, both internally

(with civil societies) and externally (with the BWIs, regional banks and donors) to build consensus on priorities, best policies and instruments to reduce poverty, and the selection of appropriate indicators and targets to measure government efforts. Many governments will need sharply enhanced technical capacities to negotiate all these aspects successfully. It will be crucial to be as comprehensive as possible in the areas tackled in the PRS, and as ambitious as possible in setting the levels of targets while making sure that they are realistic enough to reach a completion point rapidly and avoiding for the later to float indefinitely.

Countries need to discuss fully with the IMF its views and analysis on how to promote the sustainable and equitable growth necessary for poverty reduction. The new Poverty Reduction and Growth Facility (PRGF) is expected to provide such a framework, but so far countries have seen little change in the core macro and structural policies, or discussion of their impact on equity, apart from some flexibility on spending the proceeds of debt relief.

The successful implementation of the Enhanced HIPC Framework is a challenge for all stakeholders. In a process where HIPC countries have to be at the front seat to ensure that they set national priorities and translate them into clear strategies for poverty reduction, the international community and IFIs will need to provide technical and financial support to countries to understand better the roots of poverty in their countries (data and analysis), and in suggesting elements which comprise an appropriate PRSP, building on international experience.

The HIPC Capacity Building Programme (CBP) implemented by DRI will continue to provide such support to countries in designing and implementing their PRSPs, in the context of its regional and national debt analysis and strategy workshops. Moreover, the donors of the HIPC CBP agreed at its last Steering Committee in Copenhagen, to organise an international seminar in June 2000, on Poverty Reduction and Debt Relief, allowing HIPC officials and technical experts to exchange their knowledge, as a further contribution to the debate on how to best reduce poverty and reach the International Development Targets in all HIPC countries.

THE SUSTAINABILITY OF DOMESTIC DEBT

The HIPC Initiative has recognised that debt sustainability must be considered in fiscal terms, using ratios of PV or service of external debt compared to budget revenue. But external debt is only part of fiscal debt sustainability. Domestic debt and servicing costs are becoming central to analysing the fiscal burden of debt, as HIPC governments take advantage of growing domestic capital markets to broaden the basis for domestic budget financing and issue new domestic debt instruments.

Domestic debt has three main advantages over external debt for most HIPC – it is fast disbursing, conditionality-free and free of exchange rate risk if issued in local currency. On the other hand, for most HIPC, which are relatively new to domestic debt issuance, it has three large drawbacks: it is mostly short-term (in the form of Treasury Bills with maturity of between 91 and 365 days), comes on market terms with high and often volatile real interest rates, and is extremely hard to restructure. As a result, HIPC governments need to be highly cautious in relying more heavily on domestic debt for budgetary financing, and to conduct analysis of the sustainability of such policies before embarking on them.

What is domestic debt?

To assess fiscal sustainability, countries need to include all liabilities which government and public enterprises have, or may have, to repay from revenue. These include Treasury bills, notes and bonds; Central Bank bills; government bonds and stocks; loans and advances to government; promissory notes; government overdrafts with central or commercial banks; payment arrears; debts transferred to government during privatisations; bonds to recapitalise parastatals or financial institutions; and contingent liabilities such as pensions.

1. Domestic debt sustainability ratios

As the government is the main issuer of domestic debt (and guarantor for contingent liabilities), it has to pay the service, so the key denominator for analysing the ability to repay is budget revenue. Therefore the key sustainability ratios are:

Liquidity burden:

- Domestic debt service to domestic budget revenue
- Domestic debt interest to domestic budget revenue

Present value:

- Present value of domestic debt to domestic budget revenue
- Present value of domestic debt to GDP

Debt overhang:

- Disbursed outstanding domestic debt to GDP.

There are no internationally acknowledged benchmarks for sustainability of domestic debt in developing countries. There are three reasons for this:

- a) in most developing countries, liberalised financial markets are relatively recent, reducing the time series of data available for analysis;
- b) only a few governments have defaulted on or restructured domestic debts. Though many have incurred arrears, these have not been monitored initially, delaying the dates and inflating the ratios at which debt appears to become unsustainable;
- c) the interest rates and maturity structure of domestic debt are highly varied across countries, reflecting national economic conditions, making agreement on discount rates and cross-country comparisons of present value problematic.

There are also two key issues of definition in calculating these ratios:

a) What is the present value of domestic debt?

Identifying the interest rate to use as the discount rate (theoretically the alternative cost of borrowing) is difficult because many developing country governments have no realistic alternative source of domestic financing, and commercial banks and other financial institutions often base their lending rates on the short-term Treasury bill rate. If so, countries need to examine all rates and assess their cost of marginal borrowing.

b) What constitutes debt service payments?

Debt service is interest and principal, including T-bill principal payments being rolled over. There are five reasons for

including principal payments:

- some domestic debt takes the form of longer-term bonds and stocks;
- countries need to fully account for rollover and liquidity risk;
- governments may be unable to pay all rollovers and have to pay off principal;
- governments may want to reduce their short-term debt by paying principal;
- to maintain comparability with external debt.

Taking into account all these issues, analysis of 23 low-income countries (18 HIPC) indicates that ratios of domestic debt service (including principal payments) which exceeded 50% of budget revenue have led to the incurrence of arrears and (in the absence of fiscal adjustment) to eventual default or rescheduling, and may therefore be considered unsustainable.

But it is not enough to analyse static ratios. Countries need to look at how ratios move over time – through debt dynamics such as the relationship between the change in present value or the effective interest rate and the change in budget revenue.

It is also essential to identify potential interest rate risk, by analysing interest rate policy and expected trends in real and nominal rates, identifying through correlation or econometric testing which factors have influenced real rates, and taking account of shocks to interest rate policy such as exchange rate volatility. Countries should project multiple alternative scenarios for interest rates to test the impact on sustainability.

2. Beyond ratios: policy and institutional issues

While ratios are important in assessing sustainability, other key factors in assessing the desirability of a particular policy on new issuance or restructuring domestic debt are the interaction with government policy, and level of financial sector development.

a) Government policies

Governments usually have one of three reasons for issuing or restructuring domestic debt: budget deficit financing, implementing monetary policy and developing the financial sector. Each may provide reasons for departing from debt sustainability:

- *If government is borrowing to finance*

budget deficits, the sustainable level of debt needs to take account of temporary budget shocks and predictable economic and political cycles that may affect revenue or spending trends.

- *If government is borrowing to implement monetary policy* (tighter policy increases issues while looser money reduces issues), the amount of debt may need to vary depending on monetary conditions, and there may need to be a trade-off, whereby higher initial debt issuance will reduce inflation and interest costs over time.
- *If government is trying to develop the financial sector*, there may be a case for issuing more debt to boost financial saving habits – but if governments are not careful this can turn into saver dependence on high-interest government debt.

b) Financial and private sector development

The development and health of the financial and private sectors are major influences on the sustainability of domestic debt. The more sophisticated the financial sector, the easier it is for government to issue a wide variety of new instruments, or to restructure its portfolio. Key questions about the level of financial sector development include:

- *domestic savings and investment*: to what degree will debt relief promote private sector investment by removing

overhangs of debt to the private sector? Will the issue of new instruments promote domestic savings?

- *financial markets*: how will the operation improve the willingness or ability of financial institutions to provide other savings instruments or fund investment? What will be the effects on financial institutions currently holding debt?
- *banking sector*: is the sector competitive, or do banks collude to influence Treasury bill interest rates upwards? Are the commercial banks financially healthy, or do they have inadequate capital or high levels of non-performing loans, making them rely on income from high-interest Treasury bills to keep solvent?
- *private sector development*: will the operation encourage this, e.g. will reducing Treasury bills promote private sector equity investment as an alternative? Will the operation improve government credibility in the markets and economic stability? Or will it risk of “moral hazard” for government (i.e. of irresponsible future borrowing) or for creditors (e.g. increasing future interest rate demands) because they know they will be bailed out if things go badly wrong?
- *distributional effects*: what will be the distributional effects of the operation (insofar as they change flows to different sectors of society)?

These government policy and financial sector factors also raise major doubts about two key

theories on which many countries base policies for reducing debt burdens. First, they indicate that sharp falls in real interest rates are unrealistic, and it may be very time-consuming to reduce them below 10% or to produce an upward sloping yield curve. Second, there are many situations where financial markets perceive government policy as less credible, or where they prefer to hold (or government prefers to issue) short-term instruments, making it hard to lengthen maturities.

In spite of all the above constraints, there is a growing positive experience by countries of restructuring domestic debt by:

- changing maturities or switching to index-linked or exchange rate linked stock when rolling government debt over (though the last two carry considerable risks);
- separating government debt into fiscal and monetary policy instruments to improve credibility;
- buying back debt stock (though this can be highly risky);
- swapping domestic currency debt for foreign currency debt or equity; and
- mobilising donor funds to help pay down debt gradually or to clear arrears.

More information on all aspects of domestic debt management is available in the DRI paper, *Key Issues for Analysing Domestic Debt Sustainability*, by Alison Johnson.

CBP ACTIVITIES FROM OCTOBER 1999 TO JUNE 2000

The HIPC CBP has increased its work speed in order to meet the needs of the HIPC in enhancing debt management capacity and preparing to use HIPC relief in poverty reduction programmes. Between October an early February 2000, the CBP organised more than 2200 days of training and almost 300 days of missions.

- **Demand Assessment Missions** to Niger, Chad, Malawi and Republic of Congo, where a number of areas that will need more specific support were identified. All countries expressed their interest and commitment to strengthen

debt management and to prepare for implementing the Enhanced Framework as soon as possible and in the case Chad, Congo and Niger, to participate in the 3rd Francophone Regional Debt Strategy Workshop in 2000.

- **The 1st Lusophone Regional Debt Strategy Workshop** (preceded by data preparation missions) in Maputo, Mozambique attracted 45 participants from Angola, Guinea Bissau, Mozambique and São Tomé and Príncipe. All countries produced excellent reports on debt strategy and further identified areas where debt management and social expenditures programming have to be reinforced.
- **The First Francophone Debt**

Negotiations Regional Workshop took place in Ouagadougou, Burkina Faso, from 8-12 November 1999. Four countries simulated debt negotiations on bilateral, multilateral and commercial terms, and left the workshop with creditor-by-creditor debt renegotiation strategies and proposals for new borrowing guidelines (see page 9).

- **A Follow up Mission** in Burkina Faso from 12-18 November. The mission assisted the national staff in revising parts of their national debt strategy and to prepare for a BWIs mission to discuss decision and completion points under the Enhanced HIPC.

- **The 1st Anglophone**

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Macroeconomic Forecasting Workshop, jointly organised with MEFMI, in Dar es Salaam, Tanzania from 14-25 November (see page 9)

- The *Cameroon Debt Strategy Workshop* was held from 22-30 November in Yaoundé, and was attended by thirty-four participants from key government agencies, who were trained in debt sustainability analysis. They produced a preliminary Debt Strategy report, which included the necessary outline of a Poverty Reduction Strategy to be further discussed and reviewed in preparation for the country's eligibility for the Enhanced HIPC Initiative.

- The *Bolivia Debt Strategy Workshop* took place in La Paz, from 13-22 December 1999 and attracted thirty-five participants from the Finance Ministry, Central Bank and Sectoral Ministries in charge of Poverty Reduction Programmes. The national team produced a revised strategy report analysing the implications of the Enhanced HIPC for the country and presenting a list of issues to be raised while negotiating the retroactive debt relief.

- The *1st HIPC Ministerial Meeting* was organised in Copenhagen, Denmark on 8 December 1999 and was attended by senior representatives from 16 countries (see article on page 2).

- DRI also organised the *HIPC CBP*

5th Steering Committee Meeting in Copenhagen, Denmark in December 1999 in which, among other topics of interest, a detailed CBP work programme for January-June 2000 was approved.

- DRI started the new millennium with a *Seminar on Designing Debt Pro 2000*, the simulation tool used by the IMF and acquired by 20 HIPCs to perform DSAs. The seminar took place in London from 24-28 January and was attended by 35 regional and international experts who are working with DRI in implementing the CBP. It trained DRI's trainers and those of regional partner organisations in Debt Pro, and provided feedback to International Debt Management in the design of Debt Pro 2000.

- The *Mauritania Debt Strategy Workshop* took place in Nouakchott, from 30 January to 8 February 2000, and was attended by thirty senior participants from all relevant agencies. The capacity building exercise introduced participants to the details of debt sustainability analysis and discussed the implications of the recently approved decision point document. Participants have agreed that the enormous efforts requested from Mauritania to reach the completion point will require major enhancements in capacity and co-ordination in the coming years.

- We have continued to provide

comprehensive capacity building training in debt strategy through *longer consultants* in Honduras, Nicaragua, Guyana, Guinea-Bissau and São Tomé and Príncipe.

- Progress continued in *executing the transfer of the CBP to regional institutions*. The CBP is on the verge of signing a co-operation and transfer agreement with MEFMI for 2000-2001 for the Anglophone African region. We have reached an agreement with BEAC to implement the transfer to Francophone Africa, building on an agreement by BEAC, BCEAO, UEMOA and CEMAC to put BEAC in charge of ensuring such transfer. We continued to make progress in the Anglophone West African region in discussing with the ACBF and WAIFEM a possible transfer to the region. Finally, in Latin America 0.

CBP activities from October 1999 to June 2000.



TWO NEW EXCITING SUBJECT-SPECIFIC EVENTS

As part of the expanding and deepening of our work programme, the CBP has held two new exciting subject-specific events in Francophone and Anglophone Africa in the last three months: a Francophone Regional Negotiations Workshop, and an Anglophone Regional Macroeconomic Forecasting Workshop. This articles reports on the methodologies and results of both.

Francophone Regional Negotiations Workshop Ouagadougou, Burkina Faso, 8-12 November 1999



Francophone Regional Negotiations Workshop

The Francophone Regional Negotiations Workshop was held over 5 days in Ouagadougou, Burkina Faso, targeted at four countries which are advanced in their implementation of CBP recommendations (Burkina Faso, Guinea, Mali and Togo) as well as observers from Mauritania and Senegal. It aimed to deepen the knowledge of participants about the renegotiation of existing debt and the negotiation of new debt, by going beyond the broad scenarios designed in debt strategy workshops, to discuss and simulate the negotiations of all the details of debt reduction and new borrowing.

At all stages the participants were first fully trained in all the concepts and terms available from different creditors and lenders, and then simulated negotiations with all their creditors, using their own data and documents. They used the Debt-Pro computer system to calculate whether the

terms offered by creditors provided the necessary present value reduction on the debt and would allow them to reach overall sustainability. The workshop was the first anywhere in the world to use live country data and documents on a country's own negotiations as the basis for all discussions.

After a formal opening by the Minister of Finance of Burkina Faso, M. Tertius Zongo, the first day and a half focussed on the Paris Club. Participants were trained on Paris Club preparation and multilateral negotiations. They then prepared their own memoranda of poverty reduction policies, and debt relief requests, and attended simulated multilateral negotiations with the Paris Club, which included speeches by the debtor delegation and resource persons who played the roles of multilateral organisations and creditor countries. The debtor delegation then retired to its own room and the President of the Paris Club shuttled between debtor and creditors, negotiating an agreed minute. The

longest negotiations – 2 days – were with the Burkinabé delegation, which was extremely tough in demanding its full entitlement to relief under the HIPC Initiative. All countries then scrutinised their final versions of Paris Club agreed minutes and signed them with the "President of the Paris Club".

The workshop then proceeded to bilateral Paris Club negotiations, in which debtor countries had lengthy and tough negotiations with such creditors as France, Japan, Italy and Russia, particularly about some categories of debt previously excluded from Paris Club deliberations, and about the effects of ODA debt cancellation on new disbursements. They also noticed how CIRRs have been rising more rapidly than commercial interest rates, allowing export credit agencies to claim larger PV reductions under HIPC. They completed this session by defining strategies, choices of options, interest rates and payment dates for each

Paris Club creditor.

The next step was to negotiate comparable terms with non-OECD bilateral creditors. From complex negotiations with the Arab funds, Libya and Eastern European creditors, countries understood the complexities of ensuring that terms are genuinely comparable, and on this basis defined strategies for negotiation with each of their non-OECD bilateral creditors.

They then proceeded to negotiations on debt conversion. They evaluated three conversion proposals from different types of creditors and chose one on which they wished to negotiate, and thereafter defined the scope for debt conversion within their entire debt portfolio.

Finally on debt relief negotiations, they calculated the burden-sharing requirements of different creditors in the context of the HIPC Initiative, and negotiated frontloaded relief from multilateral creditors (IMF and World Bank) and donor contributions to multilateral debt funds, amalgamating these with other terms they achieved to ensure low, declining debt service ratios.

A penultimate session on new borrowing began with an introduction describing the institutional structures, procedures and calculations necessary to ensure that new loans match agreed grant elements and are "value for money", and hilarious attempts by new lenders to circumvent these. Countries then evaluated proposals from three creditors and decided on how to make their new borrowing strategy more concessional and their procedures more secure.

The final session allowed all countries to present future negotiating strategies with all creditors and to receive comments and criticisms from their fellow debt managers. The most fascinating aspect of the workshop was the exchange of information among debtors in the corridors and coffee breaks - which they used to reopen negotiations with their creditors. It underlined for us at DRI the need to promote the regular exchange of information among debtors, as the only reliable basis for a negotiating strategy to achieve the full relief they deserve in the Initiative.

Anglophone Macroeconomic Forecasting Workshop

The second new type of event was co-organised with the Macroeconomic and Financial Management Institute of Eastern and Southern Africa (MEFMI), in Dar es Salaam from 15-24 November. It aimed to exchange international and regional best

practice on macroeconomic forecasting and to ensure that MEFMI and Anglophone Africa continue to build their capacity in this area. 32 participants from 12 countries attended it (Botswana, Ethiopia, Ghana, Kenya, Lesotho, Malawi, Namibia, Swaziland, Tanzania, Uganda, Zambia and Zimbabwe).

The workshop was opened by the Swedish Ambassador to Tanzania, Sten Rylander, the Director of MEFMI's Macroeconomic Programme, Ephraim Kaunga, and the Director of DRI, Matthew Martin, who gave a keynote presentation on best practices in macroeconomic forecasting. Ben Tarimo (World Bank office in Dar es Salaam), Njuguna Ndung'u (Nairobi University), Stephen Karingi (Kenya Institute for Public Policy Research and Analysis, KIPPRA) and Ita Mannothonko (USAID-Gaborone) gave presentations on how to judge the relevance of the international models used by the Bretton Woods Institutions to regional needs.

They were followed by presentations on international best practice from Anders Palmer, recently head of forecasting in the Swedish government, who discussed Swedish and OECD best practice, Daniel Garces of the Bank of Mexico, who presented Mexican practice, and Karen St Jean-Kufuor of the Economist Intelligence Unit on best practice in forecasting commodity prices and production. Participants reviewed these forecasting methods, those of other OECD economies and those related to global economic indicators such as OECD growth, interest and exchange rates, to ensure their countries had access to the best information on global economic trends.

The workshop then built on a process of country-specific case studies commissioned by MEFMI, to document the forecasting and modelling methods used by its member states. Seven presented their findings at the workshop, and received comments and questions to reinforce the studies.

Participants then split into technical working groups to discuss best practices in forecasting individual line items of four sectors: balance of payments, financial/monetary, fiscal and real. They examined data quality, judgmental and model-based forecasting methods, and reached the following principal conclusions:

- almost all countries in the region are using basic financial programming models to monitor their IMF programmes, but these require further adaptation to country needs;

- a few countries are using RMSM-based models, but their accounting frameworks also require adaptation to country needs;
- most countries have CGE-style or macro-econometric models installed but, due to their complexity or irrelevance to the behavioural patterns of liberalised economies, many are in need of redesign. A good exception is the Tanzania MACMOD;
- the most essential element for reinforcement in the region is judgement-based forecasting based on detailed econometric and other tests. Whatever models countries use will only be as good as their underlying assumptions based on such judgements;
- most countries in the region need to improve their access to alternative sources of forecasts on global economic trends, commodity prices, interest rates and exchange rates;
- BoP forecasting improvements need to focus on commodity-specific export forecasting methods, disaggregated import forecasts by commodity group, line-by-line forecasts of services, improving data flows on private and official transfers (especially aid grants) and private capital flows through surveys, and improve exchange rate forecasting;
- financial/monetary forecasts need to make more complex assumptions about money demand and velocity, sources of money, and private sector credit, to forecast commercial bank foreign reserves, model the financial sector (savings, investment, interest rates) including the informal sector, and widen the factors included in inflation forecasts;
- fiscal forecasts needed to move to medium-term budget frameworks, with very detailed and more realistic line-by-line forecasts of revenue and expenditure based on proven elasticities and buoyancies, and modelling of the effects of different methods of external and domestic financing;
- real sector forecasters need to have more reliable baseline data, take more account of different institutional factors in economic sub-sectors, and include the informal sector, in order to build reliable supply side functions for individual sectors; and build better aggregate demand forecasts by modelling private sector consumption and investment;
- a final major priority for the region is to "endogenise poverty reduction" into its forecasting methods, in order to predict the effects of macro policies on poverty.

Further details of the conclusions and the papers are available from DRI or MEFMI.

SOURCES OF INFORMATION ON GLOBAL ECONOMIC FORECASTS

DRI Newsletter Issue 3 discussed the importance of international economic forecasts to debt sustainability analysis. Since then, DRI has located the best international sources of forecasts.

Global Economic Projections

The most comprehensive are IMF *World Economic Outlook* (published May and October), OECD *Economic Outlook* (June and December), and World Bank *Global Economic Prospects* (annual). WEO, GEP and a summary of OECD *Outlook* are free to download (www.imf.org, www.worldbank.org, www.oecd.org) or can be purchased from IMF Publications Services (t: +1 202 – 623 7430), World Bank Books (t: +1 202 – 476 2192); and OECD Publications (f: +33 1 – 45 24 13 91). The Overseas Development Institute periodically prepares excellent syntheses of all key forecasts – the next in mid-2000 (t: +44 20 – 393 1600).

Other international organisations producing forecasts include UNCTAD (*Trade and Development Report* from www.unctad.org), UN New York (*UN Economic and Social Survey*, UNIDO *Industrial Development Global Report*, and UN Link *World Economic Outlook* at www.chass.utoronto.ca/link); the World Trade Organisation (monthly *Focus Newsletter* free at www.wto.org); and BIS (www.bis.org). Regional analysis is produced by African Development Bank Group (*African Development Report* summary from www.afdb.org, t: +225 – 20 20 44 44), Asian Development Bank (*Asian Development Outlook*), and the Inter American Development Bank (www.iadb.org, t: +1 202 – 623 1000). It is also worth investigating governmental sources. In the UK for example, the National Institute for Economic and Social Research produces a "World Model", and HM Treasury a "New Treasury Model". Forecasting is also conducted by major private sector organisations, including banks, fund managers and commodity houses.

Commodity Prices

The most comprehensive and easily accessible projections come from the Economist Intelligence Unit's World Commodity Forecasts (quarterly), and the World Bank's Global Commodity Markets (quarterly, with monthly updates). Both cover beverages (coffee, tea, cocoa), oilseeds (coconut oil, palm oil, soybean oil, soybeans), grains (maize, rice, wheat), sugar, cotton, rubber and metals (aluminium, copper). In addition, the World Bank covers energy (coal, natural gas, petroleum), fertilisers (nitrogen, phosphates, potash), fats and oils, bananas, shrimp, tropical timber, metals and minerals (gold, iron ore and steel); and the EIU crude oil, grains (barley, sorghum), oilseeds (palm kernel oil, rapeseed oil, soybean meal, sunflowerseed oil), wool, and metals (lead, nickel, tin, zinc). The World Bank Commodities Team is led by Donald Mitchell (enquiries to gcm@worldbank.org). The EIU Commodities Editor is Karen St. Jean-Kufuor (t: +44 20 – 7830 1000, website: www.eiu.com).

The International Trade Centre in Geneva prepares short-term market reports (1 month - 1 year) for selected commodities. UNCTAD also analyses commodity markets (contact Mehmet Arda, Chief, Diversification and Natural Resources, UNCTAD, Palais des Nations, 1211 Geneva 10, Switzerland; f: +41 22 - 907 05 09). The IMF WEO team (above) also prepares confidential projections, as do the regional development banks. There are also many different analysts of markets in individual commodities, which we will discuss in future issues.

HISPANOPHONE REGIONAL EXPERTS

In the last two issues of our newsletter, we have presented information about regional experts that collaborate with DRI in the implementation of the CBP. We have started with the Francophone experts and followed with the Anglophone experts. We are now presenting some Hispanophone experts.

In Latin America the CBP has been collaborating with the Centro de Estudios Monetarios Latino Americanos (CEMLA) and the Fondo Latino Americano de Reservas (FLAR). As in previous articles this list is not comprehensive and we intend to continue intensifying our collaboration with more Hispanophone experts from HIPC countries.

Gonzalo Afcha de la Parra: Macroeconomist, debt analysis and strategy, former Secretary of Finance of Bolivia, independent consultant.

Juan Carlos Vilanova: economist, debt data and strategy analysis, independent consultant.

Jaime Oswaldo Coronado: macroeconomist, domestic debt analysis and strategy, former Under-secretary of the Treasury of Bolivia, independent consultant.

Javier Comboni Salinas: macroeconomist, debt analysis and strategy, former Principal Economic Policy Advisor to the Central Bank of Bolivia, independent consultant.

Carlos Sequeira: debt analysis and strategy, Deputy Manager for External Resources at the Central Bank of Nicaragua.

Carlos Alvarado Soza: debt data and strategy analysis, Central Bank of Nicaragua.

Edwin Rivera: macroeconomist, in charge of the financial programming training at CEMLA.

DRI's NEW CONTACT NUMBERS:

From the 22 April 2000, London dialling code will be 020, followed by an eight-digit local number. Our contact numbers will therefore be:

- telephone: +44 20 – 7935 7002;
- fax: +44 20 – 7935 8009.

Please DO NOT use the new code BEFORE 22 April 2000.

TECHNICAL QUESTIONS

1. How will the Cologne Terms be implemented?

The vast majority of creditors choose option A (Debt Reduction), cancelling 90% of the debt and maintaining grace and maturity of 6 and 23 years respectively, with market interest rates. Five creditors – Austria, Belgium, Italy, Japan and Spain – have indicated that they cannot cancel debt stock. Therefore they have been given two other rather convoluted options:

- where countries require 90% cancellation or more, a “very long term bullet option” where, instead of being cancelled, the 90% of the debt will be rescheduled with 0.0001% interest, with 1 payment after between 60 and 350 years of grace (the grace period falls if the Appropriate Market Rate considered is higher), and the remaining 10% will be paid over 6+23 years at market interest rates. This will remove some of the complexity of calculating PV reductions under the old option B but will complicate matters for country payments, requiring two per semester at different interest rates. The tiny amounts due at 0.0001% interest might even be less than the related payment processing costs!
- where countries require less than 90% reduction, a Debt Service Reduction Option (Option B) with a repayment period of 125 years including a grace period of 65 years and the necessary AMR reduction of interest rates.

2. Under HIPC II, what data are used to calculate eligibility and debt relief?

Under HIPC I, eligibility and debt relief was calculated on the basis of projected debt and macroeconomic data at the Completion Point. This has been changed under HIPC II and calculations of eligibility and the amount of debt relief to be received are based on actual data at the Decision Point that gets around the difficulties and uncertainties of using projected data. The actual data to be used now are the latest calendar year (or fiscal year) available at the Decision Point. So for a country with a Decision Point in 2000, the calculations will be based on end-1999 data.

3. How is the PV amount of HIPC debt relief at the Decision Point calculated?

The amount of debt relief a country receives under the HIPC Initiative is to be sufficient to reduce the country's PV/exports ratio at the Decision Point to 150% or its PV/budget revenue at the Decision Point to 250%. The actual ratios and present value of debt figures used to calculate debt relief are those computed after “Testing for HIPC”, that is after the 67% Naples Terms have been applied. An example using PV/exports criteria: ▶

In this example, debt relief of \$1600m in present value terms is required to achieve debt sustainability, thereby reducing the country's PV/exports ratio from 250% to 150%. If a country is eligible for debt relief

on the basis of the fiscal criteria, then this calculation is done on the same basis using the ratio of PV of debt to budget revenue.

4. What is a floating completion point?

Under HIPC II, the timing of a country's Completion Point and debt relief is no longer fixed at 3 years after the Decision Point. Instead it will be dependent on the country's implementation of agreed and pre-defined conditionalities, provided of course the country remains on track with its Fund programme. In theory, this means a country that succeeds in implementing policy conditions quickly will have its Completion Point brought forward. The difficulty and uncertainty is in the detail of the policy conditions and how these will be negotiated between the country and Bretton Woods Institutions. It is therefore essential that countries negotiate conditions which they can realistically fulfil within three years - and preferably sooner - so as to receive their debt relief as soon as possible.

Actual PV/exports ratio at the Decision Point:	250%
HIPC II threshold to be achieved:	150%
Reduction of PV/exports ratio required:	$250\% - 150\% = 100\%$
expressed as %:	$(100/250) * 100 = 40\%$
Actual PV of debt at Decision Point:	\$4000 m
Debt relief required in PV terms:	$\$4000m * 40\% = \$1600m.$