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PRSP and HIPC Completion Point: Unravelling Zambian experience

The Heavily Indebted Poor Countries (HIPC) Initiative was launched to create a framework for debt relief to the world's poorest and highly indebted countries, with the objective of enhancing economic growth and reducing poverty. It also attempts to bring the debt burden of the poor countries within manageable limits. After assessing the progress made in meeting the criteria for debt relief, the International Monetary Fund (IMF) and the World Bank (WB) formally decide on a country's eligibility and the international community commits itself to reducing debt to sustainable levels.

The three stated objectives of HIPC are: achieving long-term debt sustainability, promoting poverty reduction and growth. The main challenge for the HIPCs is not to curtail social spending at the time of tight fiscal squeeze but to focus on poverty reduction programmes without increasing external debt. Against this background, this policy brief argues that the current debate on debt sustainability vis-à-vis poverty reduction should be seen in a much broader context than what is currently the case, so that the needs and requirements of poor countries are better appreciated and addressed.

The Reality of HIPC

The HIPC Initiative was launched in 1996 by the IMF and the WB to create a framework for all creditors, including multilateral creditors. It aimed to provide debt relief to the world's poorest and most heavily indebted countries, and thereby reduce the constraint on economic growth and poverty reduction imposed by the debt build-up in these countries. HIPC attempts to ensure that no poor country faces a debt burden it cannot manage. It was modified in 1999 to provide three key enhancements as given below:

1. Deeper and broader relief

External debt thresholds were lowered from the original framework. As a result, more countries became eligible for debt relief and some countries for greater relief.

2. Faster relief

A number of creditors began to provide interim debt relief immediately at the 'decision point.' Also, the new framework permits countries to reach the 'completion point'[1] faster.

3. Debt relief and poverty reduction

Freed resources are to be used to support poverty reduction strategies developed by national governments through a broad consultative process.

As of June 2004, 27 countries,[2] two-thirds of the HIPCs, had reached their decision points, 23 of them in Africa. They are receiving debt relief from all sources that will provide US$31bn (net present value terms)[3] in debt service relief over time and an average net present value (NPV) stock-of-debt reduction of nearly two-thirds. Of the 27, thirteen countries, namely, Benin, Bolivia, Burkina Faso, Ethiopia, Guyana, Mauritania, Mali, Mozambique, Nicaragua, Niger, Senegal, Tanzania and Uganda have now reached their completion points.

Basis for the HIPC Status

Through this expanded, enhanced HIPC (e-HIPC), a more comprehensive approach to debt relief, including, for the first time, multilateral debt, has emerged. A country qualifies for inclusion under the Initiative when it faces an unsustainable[4] debt burden that is beyond traditionally available debt-relief mechanisms.

Once a country has qualified for debt relief under the HIPC, the first step is to carry out a debt sustainability analysis (DSA) to determine the debt relief needs. If a country's external debt ratio after traditional debt relief mechanisms is above the 150 percent threshold for the value of debt to exports (or, in special cases, the value of debt to fiscal revenues), it qualifies for assistance under the Initiative. Once a country has made sufficient progress in meeting the criteria for debt relief, the Executive Boards of the IMF and WB formally decide (the decision point*)* on a country's eligibility, and the international community commits itself to reducing debt to the sustainability threshold.

When a country reaches its decision point, it may immediately begin receiving interim relief on its debt service falling due. In order to receive the full and irrevocable reduction in debt available under the HIPC Initiative, however, the country must establish a further track record of good performance under IMF and WB supported programmes. Once a country has met these criteria, it can reach its completion point, at which time lenders are expected to provide the full relief committed at the decision point.

HIPC Initiative Challenged

In developing the external debt management policy *vis-a-vis* the merits of the HIPC Initiative and what it can meaningfully be expected to realise for an indebted country like Zambia, it is important to be mindful of the limitations of this approach. Serious reviews are currently going on both within the WB and outside, regarding the areas where the HIPC Initiative requires strengthening.

Further, the appropriateness to many poor countries for the HIPC debt sustainability criteria have been challenged. It has been argued that the criterion for calculating the amount of debt relief required to reach sustainability is not suitable for achieving the HIPC Initiative's stated objectives[5], let alone the attainment of Millennium Development Goals (MDGs)

Long Term Volatility

Firstly, countries which rely heavily on a limited range of primary commodities whose prices are set by international markets have remained extremely vulnerable to the long-term volatility. The WB, for example, estimates that exports in value terms have a standard deviation from the long-run trend of about 15 percent in such countries. The choice by the HIPC Initiative to use three years backward-looking average export earnings as the main indicator for determining future debt sustainability is, therefore, seen not likely to provide accurate medium to long-term predictions.

The problem is compounded by somewhat 'rule of thumb' 150 percent debt-to-export ratio that was arrived at mainly from the experience in Latin America where the socio-economic characteristics are significantly different from those in many African HIPC countries.

Debt Burden for HIPCs

Secondly, to link debt sustainability primarily to export earnings assumes that export receipts are the primary constraints to debt sustainability. And yet, for many HIPCs, debt burdens are more pronounced at the budget level while export earnings, though important, are quite often very significant in total government revenue. It is increasingly being recognised that, in a good number of HIPCs, the country's debt sustainability is fundamentally a function of several other variables beyond export revenue and includes such variables as the debt service schedule for a given debt stock. It addresses the magnitude of domestic debt (and its servicing) as well as the anticipated flow of grants or highly concessional loans.

Independent analysis has shown, for example, that domestic debt is a huge burden for many HIPCs. Central Bank overdrafts and government arrears to suppliers and employees have often swelled some poor countries' fiscal liquidity burdens to levels that make the exclusion of domestic debt in DSA questionable.

Thirdly, and perhaps more importantly, the overly narrow definition of what constitutes sustainability has ignored the reality that a country can have a 'sustainable debt' while the majority of its citizens are wallowing in poverty, hunger and disease, hence, ignoring important developmental goals and challenges. Although poverty reduction considerations were taken on board when HIPC was enhanced, DSA is yet to include countries' poverty levels in the assessment of debt sustainability. Similarly, some of the biggest threats to growth and welfare in many HIPCs, such as the HIV/AIDS pandemic are still 'non-issues' in the assessments of future debt sustainability.

The realities above are not meant to question the value of the HIPC Initiative *per se*. Rather they bring to the surface the challenges that the Initiative is yet to contend with when addressing the issues associated with a complex phenomenon, such as poverty reduction.

The WB is among the institutions that have acknowledged some of these vexed realities. For example, the WB's Operation Evaluation Department (OED), in its 2003 report, noted that the HIPC Initiative, as it is currently designed, is unable to simultaneously meet its three stated objectives of achieving long-term debt sustainability, and promoting poverty reduction and growth.

The main challenge for the HIPCs is that, to remain within the 150 percent threshold, they may have to curtail social spending as a consequence of the needed tight fiscal squeeze. Further, if they focus on poverty reduction through less stringent fiscal policy and foreign borrowing, this could result in increased external debt stock in a way that could compromise the sustenance of the required HIPC threshold.

Debt Sustainability *vis-à-vis* Poverty Reduction

Against the above background, it is strongly recommended in the current debate regarding the former *vis-a-vis* poverty reduction should be seen in a much broader context than is currently the case so that the needs and requirements of poor countries like Zambia are better appreciated and addressed. Three principles should guide Zambia's efforts at this level.

First, is to meaningfully determine how much external debt in Zambia can realistically be sustained. DSA should take into account the overall picture of a country's financial constraints and its budgetary resources. This immediately calls for the inclusion of domestic revenues and liabilities.

Second, it is necessary to assess the resource needs (and gaps) for poverty-reducing interventions and establish the proportion of the government resources that should be spent on poverty-related interventions and how much can reasonably be spent on debt servicing. The MDGs internationally accepted targets should be used as the main benchmarks.

Third, in line with the Monterrey Consensus, external debt service should be seen as being a secondary concern and poverty related expenditures elevated to a priority level, thus, reversing the HIPC Initiative's prioritisation.

WB & IMF to Check Sparking Debt Crisis

Mindful of the challenges posed by the HIPC Initiative in its current logic and provisions, the WB and the IMF are working on a framework to prevent lending to low-income countries from sparking a new debt crisis. The new Debt Sustainability Framework (DSF), which has been discussed by the boards of the WB and the IMF, is a forward-looking approach that will involve conducting a more systematic analysis of borrowing countries' ability to repay debt before loans are approved. In determining how much money can be lent to a country, the new framework will take into account the following:

- quality of policies and institutions in a country;
- potential shocks which could make it difficult for them to repay loans; and
- level of debt and debt service.

Debt Sustainability Framework

In countries where policies are sound but where the existing level of debt indicates that new loans would jeopardise its debt sustainability, the framework calls for lending to be provided on more concessional terms or in the form of grants. Under the new DSF, governments in low-income countries will remain primarily responsible for maintaining their debt sustainability. This would include implementing good policies in support of economic growth, which can improve a country's prospects of repaying a loan. Low-income countries are also expected to take measures to increase their resilience against exogenous shocks by building reserves, using market instruments to hedge risks where possible and diversifying their production and export bases over the long term.

The DSF is separate from the HIPC Initiative in the sense that, whereas the latter is a debt reduction programme, the former is an approach aimed at helping countries with their new borrowing strategy to maintain long-term debt sustainability.

Eligibility for HIPC Landmarks

- To obtain assistance under the HIPC Initiative, a country must be eligible for concessional assistance from the IMF and the WB, face an unsustainable debt burden even after the full application of traditional debt-relief mechanism, and establish a track record of reform and sound policies through IMF and WB supported programmes.
- Time Frame for the Initiative is set up in two stages. In the first stage, the debtor country pursues a strong adjustment and reform programme, supported by the IMF and the WB, and in the second, it receives flow reschedulings on concessional terms from bilateral creditors.
- The Decision point is reached after the country has established a three-year policy track record. At this point, the international community, including the IMF and the WB, makes a commitment to provide sufficient debt relief to reduce the debt burden of an eligible country to sustainable levels at the *completion point.*

- The Completion point is reached after a further period of strong policy performance with a focus on continuing structural reforms and social policy actions. The required performance period is being implemented flexibly and shortened, on a case-by-case basis, for countries with sustained records of implementing economic and social reforms.

Determining a Country's Debt Sustainability

- A Debt Sustainability Analysis will be prepared by the staff of the WB and the IMF, together with officials of the debtor country, to determine whether a country is facing an unsustainable debt situation after the full application of the traditional debt relief mechanisms.
- Under the new framework, sustainable debt-to-export levels are defined at a fixed ratio of 150 percent (on a net present value basis).
- For very open economies where the exclusive reliance on external indicators may not adequately reflect the fiscal burden of external debt, an NPV debt-to-export target below 150 percent can be recommended if the country concerned meets two criteria at the decision point: an export-to-GDP ratio of at least 30 percent and a minimum threshold of fiscal revenue in relation to gross domestic product (GDP) of 15 percent. For countries meeting these thresholds, the NPV debt-to-export target will be set at a level which achieves a 250 percent of the NPV debt-to-revenue ratio at the decision point. Côte d'Ivoire and Guyana qualified under this criteria under the initial framework.

Source: http://www.worldbank.org/hipc/about/hipcbr/hipcbr.htm

Donors and Borrowers' Policy Implication

The proposed DSF is based on two broad pillars:

- indicative country-specific external debt-burden thresholds that depend on the quality of the country's policies and institutions; and
- an analysis and careful interpretation of actual and projected debt-burden indicators under a baseline scenario and in the face of plausible shocks.

The proposed debt thresholds are based on empirical analyses, which demonstrate that there is a significant dispersion in the debt ratios that countries can sustain including countries with weaker institutions and policies are likely to experience debt distress at significantly lower debt ratios. The new framework maintains that projections of debt burden indicators are essential for a forward-looking analysis, and need to incorporate, among other things, judgments on the evolution of domestic public debt and private external debt over the projection period as well as the impact of normal volatility on a country's repayment capacity.

It is maintained by the WB and the IMF that these two pillars, in combination with other relevant country-specific considerations, can help in designing an appropriate external borrowing strategy under which the amount and terms of new financing would facilitate progress towards achieving the MDGs and generate a sustainable debt and debt-service outlook.

The proposed framework has important policy implications for donors, creditors, and borrowers. There are two broad areas where policy changes in donor and creditor assistance would be needed:

- First, the creditors would need to review current lending policies to ensure that they appropriately reflect countries' risk of debt distress. This would almost certainly require an increase in the concessionality of financing to low-income countries, including an increase in the volume of grants; and
- Second, since an appropriate mix of concessional loans and grants would provide only limited capacity to absorb large, unforeseen, exogenous shocks, the framework urges creditors to consider new or modified concessional lending instruments to deal with such eventualities.

In contrast to the policy dimension, a country's susceptibility to shocks – while also of major importance for debt sustainability – will not be captured in the country-specific threshold but rather through stress-tests, and by defining a prudent borrowing path that keeps debt ratios at sustainable levels even in the event of plausible shocks. In this regard, a careful case-by-case judgment will be required to incorporate other considerations that are deemed to have a significant bearing on the debt and debt-service ratios countries can sustain.

Zambia's Experience with HIPC Initiative

The WB Group's International Development Association (IDA) and the IMF agreed in December 2000 to support a comprehensive debt reduction package for Zambia under the enhanced HIPC Initiative. Total debt service relief from all creditors of Zambia was at the time worth more than US$3.8bn. This is equivalent to about US$2.5bn in net present value terms, or approximately 63 percent of the NPV of debt outstanding at end of 1999 after the full use of traditional debt relief mechanisms.

Zambia's Debt Relief

The e- HIPC Initiative is expected to help Zambia to advance its poverty reduction programmes and stimulate economic growth. Compared to projected debt service obligations without HIPC assistance, Zambia's annual payments will be reduced by about US$260mn over 2001-05 and roughly US$130mn over 2006-15. This corresponds to a reduction in debt service obligations of about 45 percent. Compared to its actual debt service payments in 2000, the year prior to HIPC assistance, Zambia will save an average of some US$30mn per year over the following fifteen years, with reductions beginning immediately and continuing over the coming three years.

The assistance committed in the 2000 decision by the IMF of US$602mn in NPV terms was expected to be delivered quickly over a five-year period, and to cover, on average, about 62 percent of debt-service obligations to the Fund. The debt relief provided by IDA of US$488mn was expected to be spread over a period of 20 years, covering about 84 percent of Zambia's debt-service obligations to IDA. IDA and the IMF started providing interim debt relief immediately at the decision point.

Reaching Completion Point

Zambia is expected to receive the bulk of the assistance under the enhanced HIPC Initiative when, at Completion Point, it satisfies a number of conditions that include the following:

- continued commitment of Zambia to the financial and economic programme supported by the IMF's Poverty Reduction and Growth Facility (PRGF) and IDA's structural adjustment loans;
- the adoption of a full Poverty Reduction Strategy Paper (PRSP) to be prepared through a participatory process, and satisfactory progress in implementing and monitoring the PRSP for at least one year based on an annual report;
- implementation of an agreed set of measures in the context of the Government's poverty reduction strategy, particularly in the areas of HIV/AIDS, education, health, expenditure management and control, privatisation and poverty reduction; and
- confirmation of the participation of other creditors in the debt relief operation.

Zambia's PRSP Status

A full PRSP was received in April 2002 and endorsed by the WB and the IMF Boards in May 2002. The first annual PRSP Progress Report, covering the period from January 2002 to June 2003, was discussed by the IMF and the WB Boards in June 2004. The Joint Staff Assessment (JSA) concluded that Zambia's Poverty Reduction Strategy continues to articulate a sound set of policies and programmes. However, despite satisfactory growth performance and some progress on reforms related to public expenditure management processes, satisfactory implementation of the PRSP still needs to be established.

An updated PRSP Progress Report, covering the period from July 2003 to June 2004, is needed to demonstrate satisfactory implementation of the PRSP. Poverty-reducing spending was lower than programmed, due to limited implementation capacity and fiscal slippages. Priority poverty-reducing programmes amounted to 1.8 percent of GDP in 2001 and about 2.4 percent of GDP in 2002 and 2003.

Zambia's Policy Performance

The PRGF arrangement, which was approved in May 1999, expired at the end of March 2003 without the completion of the final review. Agreement on a new three-year PRGF arrangement could not be reached because of delays in the privatisation of the Zambia National Commercial Bank (ZNCB) and also awarded to government employees in April 2003. Agreement was reached on a Staff Monitored Programme (SMP) in July 2003 to run from July to December 2003. Performance under the SMP was poor, owing mainly to weak expenditure management and the policy that necessitated the authorities' request for an extension of the SMP through June 2004. Satisfactory progress under the extended SMP led to the approval of a new PRGF programme in June 2004.

Critical Completion Point Triggers

One of the key outstanding completion point triggers is the successful implementation of the PRSP, as demonstrated by an annual progress report. It is necessary to conclude whether this trigger will have been met. HIPC completion point triggers in the areas of HIV/AIDS, health, and education have been met. The Government has also made considerable progress on the following completion point triggers:

- commercialisation of the Zambia Electricity Supply Company (ZESCO);
- increasing the discretionary budget share of education to 20.5 percent;
- the issuance of bidding documents for the privatisation of the ZNCB (still a controversial area though with possible suspension of the effort); and
- implementation of the Medium Term Expenditure Framework (MTEF).

However, progress has been relatively slow in the implementation of an Integrated Financial Management Information System (IFMIS).

Conclusion

Zambia reached the HIPC decision point in December 2000. The HIPC Completion Point, initially envisaged for the end of 2003, was reached by early 2005, since the Government successfully adhered to the conditions under the new PRGF arrangement and demonstrated satisfactory implementation of the remaining triggers.

At decision point, Zambia received financing assurances of HIPC assistance from creditors holding about 97 percent of its total debt. The WB, the IMF, the ADB, the European Commission (EC), and Paris Club creditors have provided interim relief. IMF interim relief expired at the end of December 2003. India has written off 50 percent of its claims (Government of India lines of credit) on Zambia. So far, Kuwait and Romania have sold their claims to commercial creditors. Bulgaria, China, Iraq, and Saudi Arabia have not signed agreements to provide HIPC relief to Zambia but could do so after the Completion Point.

The main challenge for HIPCs is that on the one hand, for them to remain within the 150 percent threshold, they may have to curtail social spending as a consequence of the needed tight fiscal squeeze. On the other hand, if they focus on poverty reduction through less stringent fiscal policy and through foreign borrowing, this could result in increased external debt stock in a way that could compromise the sustenance of the required HIPC threshold.

This dilemma is particularly evident in countries, such as Zambia where enhanced external resource inflows that are required to meet the high levels of poverty, at the casualty level of more than 70 percent of the population, could easily be curtailed to ensure that the debt sustainability threshold is not breached. The more recent reforms in HIPC Initiative, such as the 'topping-up' debt relief at completion point would not address such fundamental flaws in the Initiative.

The WB is among the institutions that has acknowledged some of these vexed realities. For example, the WB's OED in its 2003 report noted that the HIPC Initiative, as it is currently designed, is unable to simultaneously meet its three stated objectives of achieving long-term debt sustainability, and promoting poverty reduction and growth.

Against the above background, it is strongly recommended in the current debate regarding debt sustainability *vis-a-vis* poverty reduction that debt sustainability should be seen in a much broader context than what is currently the case so that the needs and requirements of poor countries like Zambia are better appreciated and addressed.

Endnotes

1 The completion point under the HIPC Initiative is when creditors commit irrevocably to and fully deliver debt relief.
The decision point, which precedes the completion point, is when debt relief is committed and begins on an interim andvoluntary basis.

2 Benin, Bolivia, Burkina Faso, Cameroon, Chad, Democratic Republic of Congo (DRC), Ethiopia, The Gambia, Ghana, Guinea, Guinea-Bissau, Guyana, Honduras, Madagascar, Malawi, Mauritania, Mali, Mozambique, Nicaragua, Niger, Rwanda, Sao Tome & Principe, Senegal, Sierra Leone, Tanzania, Uganda and Zambia.

3 A Net Present Value (NPV) of debt is the discounted sum of all future debt-service obligations (interest and principal)

on existing debt. It is a measure that takes into account the degree of concessionality. It is defined as the sum of all future debt-service obligations (interest and principal) on existing debt, discounted, under the HIPC Initiative, at the market interest rate. Whenever the interest rate on a loan is lower than the market rate, the resulting NPV of debt is smaller than its face value, with the difference reflecting the grant element.

4 In the current set-up of the HIPC initiative, sustainability is defined by an indicator that links the amount of debt on a net present value (NPV) basis to the value of the country's exports: when the ratio of the NPV of debt to exports is greater than 150 percent, this is defined as an 'unsustainable' debt level, and the HIPC Initiative aims to reduce the debt level to 150 percent by canceling debt stocks and/or through 'topping-up' debt relief at completion point for countries that have been proven to have suffered from external/exogenous shocks. Countries can also qualify for debt relief under the 'fiscal' criterion, which defines unsustainability as a debt-to-government revenue ratio of more than 250 percent.

5 The objectives of the HIPC Initiative are: to provide a permanent exit form debt rescheduling; to raise long-term growth by removing the debt overhang; and to contribute to poverty reduction freeing up resources for higher social spending.

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