

DEBT RELIEF AND POVERTY REDUCTION: DO WE NEED AN HIPC III?

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Introduction

In 1996, the international community introduced the Heavily Indebted Poor Countries Debt Relief Initiative (HIPC I in the rest of this paper). In 1999, it reinforced this initiative, transforming it into the Enhanced HIPC Initiative (HIPC II). This paper assesses the achievements of the first two HIPC Initiatives, and whether they have allowed debt relief to make a sufficient contribution to financing poverty reduction. Based on this analysis, it looks at the case for and possible design of an HIPC III.¹

However, it is vital to see debt relief in its wider context – the financing needs of developing countries to halve world poverty by 2015. This paper also compares the relative advantages of debt relief and other types of funding for poverty reduction. It argues that, though debt relief can only provide a small part of the amounts needed to attain the Millennium Development Goals (MDGs), it is the most desirable type of funding.²

Debt relief

Drawing heavily on recent declarations by HIPC Finance Ministers (HIPC Ministerial Forum 1999-2002), there are several key outstanding issues on debt relief in HIPC II.³

Debt relief is insufficient

The HIPC II Initiative has undoubtedly provided a large amount of debt relief. In terms of the “debt overhang”, it has promised to reduce the “present value”, or PV, of HIPCs’ debt by US\$25 billion (additional pledges of debt relief by creditor governments will provide another US\$5 billion) for the 26 countries which have already reached their decision points. When relief is delivered to all 34 countries which are currently believed to be eligible for the Initiative,⁴ the total amount of overhang relief will be US\$36 billion, plus US\$8 billion of additional bilateral pledges – or 47 per cent of the pre-HIPC PV. In terms of “liquidity” relief, HIPC will provide around US\$56 billion over 33 years (out of US\$124 billion of scheduled service) – or around 45 per cent. Additional bilateral pledges will add another US\$11 billion.⁵

However, these overall amounts leave two important questions unanswered: Is the relief enough to make HIPC debt sustainable? And is HIPC relief freeing funds to spend on poverty reduction?

Is the relief enough to make HIPC debt sustainable?

The overall amount of debt relief under the two Initiatives has been determined by eligibility criteria which (according to statements by the International Monetary Fund (IMF) and World Bank officials in various public forums) were based on some initial analysis (e.g., Underwood, 1989) substantially modified to suit political compromises among G-7 creditor nations, balancing the necessity to include strategic G-7 allies and the desire to keep costs down. This is above all true of the "Côte d'Ivoire" criterion (as it is commonly known in Washington) – the PV/budget revenue (PV/BR) threshold of 250 per cent. This was set at a level just low enough to include Côte d'Ivoire in HIPC (under pressure from France which was threatening to vote against the eligibility of other HIPCs), but was accompanied by empirically unjustified sub-criteria which exclude many other HIPCs.

Several studies (notably Cohen, 1998 Elbadawi, Ndulu and Ndung'u, 1997; Johnson, 2000; Martin, 1999a; and Vaugeois, 1999) have examined the levels of debt which have proven historically or econometrically unsustainable. They found that while the PV/export criterion of 150 per cent adopted in HIPC II is somewhere near the levels which were historically sustainable, export earnings are largely irrelevant to government debt payment capacity. This is particularly true when most export earnings are held in offshore accounts and used to repay growing amounts of private sector debt; or when export-earning projects are given long-term tax holidays, so that they contribute no tax revenue to government debt service payment capacity.

On the other hand, the PV/budget revenue criterion is far from a sustainable level. This point is made very effectively in Johnson (2000), who examines the fiscal sustainability of total (external plus domestic) debt and finds that the levels of thresholds used by HIPC for external debt are higher than those which have proven to be unsustainable for total debt. The analysis by Vaugeois (1999) and Martin (1999a) indicates that the PV/DBR (debt burden ratio) criterion should be reduced by more than one-third from its HIPC II level (to 155 per cent). It also finds that the broad target of 15-20 per cent for debt service/exports is far too high – this should be set at 12-13 per cent.

In addition, and in spite of the fact that all HIPCs regard this as the key indicator of debt burden if the aim is to free resources for poverty reduction spending by government, HIPC II continues to avoid sufficiently systematic attention to the debt service/budget revenue ratio. HIPC II aims only for a debt service/revenue ratio which is "low and declining". In practice this leaves a large leeway for subjective viewpoints about the desirability of poverty reduction spending and the need for further budget deficit reduction, and especially for tailoring the profile of relief to creditor preferences. Independent analysis has found that this ratio should be set near a 10 per cent level – one which bodies as diverse as Oxfam and the US

Congress have also endorsed – but many HIPCs have ratios above this level in the initial years of HIPC relief.

There are several other reasons to doubt whether HIPC debt relief is making HIPC debt sustainable, which can be split into those affecting the numerators of the ratios and those affecting the denominators.

On the side of denominators, HIPC analyses omit two types of burgeoning HIPC debt. Fortunately, HIPCs have been analyzing these debts for themselves, reaching the following conclusions:

- Domestic debt is a huge burden for most HIPC economies.⁶ Traditionally measured domestic debt of the government (treasury bills, bonds, stocks, etc.) is relatively small in many countries, partly because many HIPCs (notably those in the Franc Zone) are only just now beginning to use market-based instruments. However, when less traditional debt – central bank overdrafts, arrears to suppliers, and government employees etc. – is taken into account, the fiscal liquidity burden is higher than external debt for more than 20 HIPCs. The international community insists that this burden cannot be reduced using resources committed for HIPC. Yet, though there are many other ways to reduce this burden, it is currently being largely ignored or exacerbated, with Poverty Reduction and Growth Facility (PRGF) programs assuming almost immediate clearance of domestic arrears, or projecting that the domestic debt interest burden will fall due to sharp inflation falls. It is impossible to improve many HIPC countries' prospects for poverty reduction spending unless we analyze and resolve the domestic debt problem.

Another key burden emerging for low-income countries, especially those which have liberalized capital accounts and have been receiving large amounts of foreign investment (e.g., Bolivia, Guyana, Mozambique, Tanzania, Chad, Uganda) is the rapidly growing amount of private sector debt to finance foreign investment projects or export/import transactions. Private sector debt stocks of 50-100 per cent of export earnings are not uncommon in these countries. There is an urgent need to enhance monitoring and analysis of these debts in order to ensure that they will stay sustainable and not produce their own foreign exchange crises in recipient countries if private sector debtors fail to reimburse the debts or foreign exchange reserves become short for other reasons.⁷

Again on denominators, an old chestnut among criticisms of HIPC is becoming even more valid – the irrelevance of PV as a measure of what is known as the “debt overhang” (the stock burden which deters investors and has other pernicious effects):

- There have long been doubts about the degree to which any private market actors in HIPCs or overseas assess debt burdens using PV rather than the nominal “stock” of debt owed to the creditor. While creditors may wish to pretend that reductions of stock and service are equivalent by using PV calculations, the investor community and civil society in the debtor country react very differently to reductions in debt stock and service. The most prominent example of this was in Guyana, where civil society believed the

press releases about US\$636 million of PV debt relief under HIPC I, and burned down part of the Finance Ministry when the Minister tried to explain that this would be delivered only over 30 years through gradual service reduction. If HIPC is to continue to use PV rather than stock, creditors and investors need to be educated about its meaning and trained to track it – but it would be preferable for transparency to abandon it altogether.

- Many have also questioned the validity of PV discount rates which have little to do with the cost of financing loans for creditors and no link to the marginal or alternative borrowing cost for HIPCs. With the international rise in interest rates in 1999-2000, countries reaching decision points in 2000-01 lost hundreds of millions of dollars of debt relief without any objective justification. As interest rates have tumbled after September 11, countries – notably those with the worst adjustment track records – may gain hundreds of millions of dollars at decision point. It would be far more equitable among countries and over time to freeze discount rates for calculating PV at end-1998 levels – or to abandon PV for stock.

On the side of denominators, this paper has already discussed the irrelevance of exports as a measure of government payment capacity. But, in addition, the denominators used in HIPC are highly flawed because they are based on:

- A three-year average, or the recent year, of export earnings, and the most recent year of budget revenue, rather than any average which is more tailored to the measured volatility of export earnings or budget revenue.⁸
- A snapshot of debt sustainability projected only twice during a three to four-year period – at the decision and completion points, and not between the two or after the completion point (though there is currently much pressure to change this from some in the G-7 and HIPCs themselves).
- Projections of future prospects of the economy which take far too little account of so-called “external shocks” to aid flows, commodity prices, and climate which affect almost all HIPCs on a regular basis.⁹ The Bretton Woods Institutions (BWIs) often argue that such shocks cannot be foreseen – but shocks of similar magnitudes have happened many times in recent decades, a secular decline or stagnation in commodity prices is now beyond doubt, and climatic shocks are easily predictable because they occur with regular frequency. In this light, it is possible to refer to systematic over-optimism of projections in BWI program and HIPC documents and to believe that these shocks are really “non-shocks” These lead to underestimates of balance-of-payments “financing gaps”, future borrowing, and the debt burden.¹⁰
- Insufficient analysis of other actual and potential shocks to growth and budget revenue. The latest BWI paper¹¹ shows that Gross Domestic Product (GDP) growth has been on average 1 per cent below targets and way below the rates needed to halve poverty in almost all countries. It also mentions shortfalls of budget revenue (which have been a

persistent problem in HIPCs in the past) but does not take into account the effects of these shortfalls on poverty reduction expenditure programs.

- Largely ignoring another key “non-shock” – the potential impact of the HIV/AIDS pandemic on growth and debt sustainability. UNAIDS and the World Bank indicate growth could be reduced by 2.5 per cent a year in the worst-affected countries – and that this will sharply reduce budget revenue and exports through their effects on skilled labour forces. Yet only three HIPC analyses have taken this into account.

HIPC II has in theory been adapted to take account of shortfalls in economic performance compared to projections, by allowing relief to be “topped up” at the completion point if ratios have changed substantially. Recent BWI analysis clearly shows the effect that the recent downturn in global commodity prices has had on debt sustainability, rendering 14 of 24 countries unsustainable again, and eligible for topping up of their relief at the completion point. However, the implementation of this topping up in practice is way short of providing debt sustainability to HIPCs, because it aims only to reach “sustainability” at the precise moment of the completion point. The one country that qualified for topping up – Burkina Faso – will nevertheless have unsustainable debt ratios for the next 16 years due to new borrowing after completion point. Mauritania has not qualified for topping up though it will have unsustainable ratios for four years. HIPC II now seems to be completely ignoring long-term debt sustainability.

Yet there seem to be virtually no measures planned (beyond endorsing International Development Association (IDA) grants which is a very inefficient way to reduce the debt burden) to overcome these shocks beyond increases in interim relief or additional disbursements of aid.

Is HIPC relief freeing funds to spend on poverty reduction?

HIPC relief based on such faulty criteria and calculations clearly does not allow countries or the international community to declare HIPC debt sustainable. As a result, it is impossible to avoid returning to the key criterion if we are interested in maximizing poverty reduction: the degree to which debt service relief is currently freeing funding for government spending on poverty reduction.

The answer is that while large amounts of debt service relief are being provided, the impact on each country is not always significant, for several reasons:

- Some countries are not reducing their debt service payments. Compared to what they have actually been paying in recent years. BWI data indicates an average debt service reduction of 30 per cent during 2001-05 compared to actual service in 1998-99 (and about 45 per cent compared to scheduled service for 2002-05). However, five countries will be paying almost as much as before HIPC (Ethiopia, Guinea-Bissau, Honduras, Nicaragua, and Uganda), and four will actually be paying more (Mali, Niger, Sierra Leone, and Zambia). This is a key issue for two types of debtors:

- Those which had not been paying various (especially non-OECD government) creditors and had been leaving the debt in arrears (Ethiopia, Mali, Niger, Sierra Leone), or had received extremely concessional treatment from the Paris Club (moratoria on debt service for Guinea-Bissau, Honduras, Nicaragua, Zambia) and now have to pay service to these creditors.¹²
 - Those which had mobilized donors to pay a considerable amount of their debt service to multilateral institutions before HIPC, and therefore had a lower amount of debt service to pay out of their own budget revenues – but whose donor contributions fell sharply once debt sustainability was reached. Bolivia, Guinea-Bissau, Mozambique, Rwanda, Tanzania, and Uganda have suffered particularly from this phenomenon though, to some degree, donors have increased post-HIPC budget support to offset the cut in “debt relief aid”.
- The debt relief savings themselves may not actually be spent on poverty reduction – use of the savings is subject to negotiation with the BWIs and, in a few countries, they are being used to reduce budget deficits or domestic debt, or to resolve financial sector problems. These alternative uses while highly desirable in some cases – not least for their positive effects on private sector activity and counter-inflation strategies – have not generally been subject to transparent public debate.
 - The BWIs¹³ indicate that countries will be spending between 1.5 and three times as much on social sectors as on debt service in 2002-05, and that social spending as a percentage of GDP has risen by half during 1999-2002, though independent reports by NGOs and the US General Accounting Office indicate that debt relief on its own will increase social spending by only 20 per cent. This would seem to show that even if HIPC relief has not freed huge amounts for poverty reduction, spending has increased dramatically due to the combined effects of HIPC relief, new money, and the impact of the Poverty Reduction Strategy Paper (PRSP) process.
 - However, focusing on traditional social sectors – health and education – leaves us woefully short of measuring the increase in anti-poverty expenditures across the range of the Millennium Development Goal needs (such as water and sanitation, feeder roads, rural electrification, smallholder agriculture, microcredit, gender programs, population, and social welfare). What is clear from case study analysis of Bolivia, Nicaragua, and Uganda¹⁴ and the results of 15 national workshops held by Debt Relief International is that poverty reduction expenditure based on HIPC debt relief will be insufficient to allow HIPCs to reach the MDGs.¹⁵

Relief is not being provided as planned

A large number of creditors of HIPCs are not fulfilling the terms of HIPC agreements – either in the overall scale of debt reduction, or in frontloading relief in order to free the maximum funds for poverty reduction between decision and completion points.

Non-Paris Club creditor governments are not sharing the burden with the Paris Club. Governments such as Algeria, Brazil, Costa Rica, Egypt, Honduras, Hungary, Kuwait, Morocco, Pakistan, Saudi Arabia, and South Africa have been more generous than before. But at least 40 creditors, representing around 60 per cent of HIPC debt relief from this group of creditors (US\$1.8 billion) are falling short of HIPC terms or refusing to participate in HIPC II. There are six categories of this debt: around 30 per cent is owed to creditors which are non-members of the Bretton Woods Institutions or take little notice of their decisions because they are under international sanctions; 24 per cent is owed by Latin American HIPCs to middle-income Latin American countries; 22 per cent to middle-income Arab or North African countries; 13 per cent to Asian countries (largely China and India); 10 per cent to former Eastern European countries; and 2 per cent to other HIPCs.

Efforts to convince them to participate have so far relied largely on moral suasion. The BWIs have tried intensive discussions with Executive Directors and at the Spring and Annual Meetings, and publication of non-compliance in several Board papers. But the response from non-Club governments has been meagre. Indeed an increasing number have been either suing debtors for full recovery of debts (Iraq, Yugoslavia) or selling debts to third parties in secondary markets which in turn sue for full recovery.

It had been assumed until recently that commercial creditors were relatively insignificant for most HIPCs, since most such debt had been cleared by IDA-funded commercial debt buybacks. However, there is around US\$2 billion in PV terms outstanding from HIPCs to commercial creditors, and a worrying trend has emerged recently, whereby creditors are increasingly refusing to participate in commercial debt buybacks (Cameroon, Tanzania) or have sued debtors (usually successfully) for full recovery. Even if the total debt to such creditors is small, full settlement of amounts as large as US\$50 million in one year can devastate poverty reduction spending plans.

The Paris Club has made major steps forward under HIPC II, and is due to provide around US\$14 billion in PV relief under HIPC. It has agreed that, for the many HIPCs where the cumbersome Cologne terms will be insufficient, it will implement up to 100 per cent reduction of pre-cutoff date debt – and most Paris Club members have gone further to provide relief on post-cutoff date debt where necessary to attain sustainability thresholds. However, three problems remain:

- Some Paris Club governments are not fully sharing the burden, by excluding special (monetary, postal, and hospital) debts or debts owed by parastatals.
- A few creditors are charging excessive interest rates, fees or penalty interest in Paris Club bilateral agreements (thereby failing to provide agreed PV reduction).
- A considerable number of HIPCs (Bolivia, Ethiopia, Gambia, Guyana, Nicaragua, São Tomé, Uganda, and Zambia) have not received relief due under HIPC, because the amounts are small, the period between decision and completion point is short, there is

an administrative backlog in the Club, or there are delays in creditor discussions or PRGF agreements. The reasons for such delays are not always transparent but they cost HIPCs large amounts of liquidity.

The cancellations of 100 per cent of debt announced by various OECD governments are supposed to provide a further US\$5 billion of PV relief, and to bring down the PV/export ratios by an average extra 21 per cent (ranging from 1 per cent to 41 per cent for individual HIPCs). However, they are not being allowed to do so, due to shortage of funds to finance the overall HIPC relief: without much public discussion, this “safety margin” of 21 per cent has simply been abandoned. The cancellations are also not comparable in their coverage or timing – and in some cases are not cancellations at all. Only Australia, Canada, Italy, Norway, the UK, and the US are genuinely cancelling 100 per cent of all bilateral debt from the decision point. Other G-7 governments are excluding post-cutoff date debt, or ODA debt. Others are implementing cancellation in ways (via debt conversions – France – or via refinancing with grants which must be spent on new projects or new imports – Japan) which provide no additional budget savings for spending on poverty reduction.

Multilateral creditors have generally made the most progress in providing relief under HIPC, with all major creditors agreeing to participate and many agreeing to provide interim relief between decision and completion points. However,

- political, administrative, and other bureaucratic delays have deprived many HIPCs of the early months of interim relief or of full relief immediately at completion point, even for those creditors which have agreed in principle to participate.
- Many multilateral institutions (based on decisions by powerful Board members) are not making the maximum possible contributions to HIPC from their own resources. While they have gone further than before, there remain reserves (including gold), provisions, and reflows which could be used, notably by the IMF, World Bank, and Inter-American Development Bank (IADB), but also by other multilateral and sub-regional organizations, without damaging their financial credibility or future lending to HIPCs. Instead, bilateral donors have to divert grant funding to support this relief (see below).
- Multilateral institutions are continuing to maintain their “preferred creditor” status, where they provide relief proportionally with other creditors only after pre-HIPC relief by other creditors has been fully applied. However, nobody has ever made a sustainable argument for why this should happen now that the multilaterals have agreed they can provide relief without damaging their own funding – and some have argued that they could easily cancel all of the debt owed to them without any damage.¹⁶
- At least seven regional and sub-regional institutions (admittedly small creditors) have not yet approved any debt relief for HIPCs.

The overall extent of this non-participation is a critical factor in debt sustainability. HIPCs themselves estimate at 20 (six more than the BWIs) the true number of countries

which will be unsustainable at completion point. They also indicate that three of the first four countries to reach completion point (Mozambique, Tanzania, and Uganda) cannot reach sustainability if deadlock with various creditors continues.

Finally, HIPC is already leading for the IMF (and potentially for the Paris Club and World Bank) to stricter application of rules which delay or suspend interim debt relief rapidly when countries go off track with PRGF programs. IMF suspension is automatic, and has already delayed relief for Burkina Faso, Gambia, Guinea, Guinea-Bissau, Guyana, Honduras, Malawi, and Zambia. The Paris Club can in theory suspend automatically but is understood to have agreed not to apply this measure (as it has not done in the past) – though some creditors have written to debtors demanding payments on the basis that they are off track with the Fund. IDA has been more flexible and will suspend interim relief only if a country is off track for one year. Suspension of relief – combined with suspension of aid – is disastrous for any country, providing the most immediate type of “shock” to the economy, and should be much more assiduously avoided except in extreme circumstances.

Relief is not coming fast enough

HIPC Ministers have been becoming increasingly strident in their concern about the way in which relief is being provided over excessively long periods under HIPC. This includes two main elements: the very gradual provision of relief by some creditors, and the delay in over-all relief packages.

First, apart from the IMF, World Bank, and a few small multilaterals, few creditors are “frontloading” relief enough to allow rapid poverty reduction, particularly between decision and completion points. The Paris Club and other creditors which are rescheduling could easily provide moratoria on interest and post-cutoff date service (as the Paris Club has done often in the past) – to ensure maximum early liquidity relief, and a kick-start to poverty reduction. Yet many creditors are insisting on continuing with relief options which provide relief over 30-40 years. This problem has been largely ignored because, in order to simulate in BWI Board papers that countries reach a sustainable level of debt, the impact of debt relief on the present value of the debt is “assumed to be delivered unconditionally” or “brought back to the decision/completion point” – i.e., involves assuming that all relief occurs immediately. In other words, it is highly questionable whether countries actually reach sustainability at their decision or completion points.

Second and more importantly, HIPC Ministers are worried by the growing delay in reaching the decision and completion points at which HIPC relief respectively begins and is finalized. As of June 2002, 27 countries had begun to benefit from HIPC relief and six had reached completion point – but nearly all of this progress occurred in the second half of 2000 when 16 countries reached decision point. Since then only four countries have reached decision point and six completion point. Many have had decision and completion points delayed, and the momentum of 2000 is disappearing.

What is the cause of this delay? The popular perception – caused by the welcome vociferousness of HIPC country civil societies and international NGOs – has been that relief is being delayed by the design and execution of new participatory processes to design poverty reduction strategies – leading to much discussion of the “trade off” or “tension” between HIPC and PRSPs. However, recent discussions with and publications by Bretton Woods staff confirm what HIPC Ministers have been saying for two years – that it is traditional conditionality rather than PRSP processes which are causing the delay. This manifests itself in three ways:

- persistence of over-rigid fiscal and macroeconomic frameworks which reflect a continued obsession with anti-inflation policies even for those countries which are “post-stabilization”¹⁷
- insistence on executing “leftover” structural conditions from past Enhanced Structural Adjustment Facility ESAF/PRGFs (regardless of whether these impact directly on poverty reduction), and
- the proliferation of conditions through new poverty reduction performance criteria, especially for those countries which reached decision points before the fourth quarter of 2001 when the BWI staff began to reverse such proliferation.

The conditionality linked to HIPC II (together with that left over from HIPC I) is the principal reason why almost every HIPC has seen its completion point slip. At least five HIPCs have PRSPs ready but these cannot be presented to the BWI Boards because agreement cannot be reached on new PRGFs or reviews of current PRGFs. Even with these delays, extension of interim relief will continue to provide some funding for most PRSPs, however, some creditors are already beginning to suspend relief for HIPCs which fall onto staff-monitored Fund programs (see above), compounding their funding shortfalls. Other HIPCs look likely to run out of their interim relief because of delays in the completion point.

There has been some considerable recent progress in the right direction:

- recent PRGFs have streamlined conditionality, limiting conditions more to macro issues – but with some structural conditions moving to World Bank programs
- more flexible interpretation of the execution of conditions required to reach completion points
- an agreement in March 2002 that the period of execution of a full PRSP could be less than one year if this will cause major problems for funding
- very limited evidence of more flexibility on the macro framework for those countries which have inflation at levels at or below 5 per cent.

However, it is easy to exaggerate the scale of the change. A recent survey by the BWIs¹⁸ indicated that countries were finding considerably more flexibility in all these areas. However, ministers and senior officials from 34 HIPCs, in meetings in the first quarter of

2002, indicated that flexibility, even though growing slightly, was still woefully insufficient, and much more progress is needed now. If it does not materialize, we are in danger of returning to the pre-HIPC situation of constant problems implementing Fund programs – reflecting traditional factors of rigid and excessive conditionality and insufficient attention to the effects of non-shocks (see above) – and little delivery of debt relief.

Countries which are “post-conflict” or who are experiencing post-governance problems, which have excluded them from international support, have encountered particular delays.¹⁹ Though measures have been taken dramatically to accelerate the initial integration of such countries into HIPC, the fundamental problems remain of needing much stronger early interventions for conflict prevention and resolution (which HIPC and the BWIs are not best placed to handle) and for flexibility in the macro framework to allow more rapid post-war reconstruction and supply response (which is the responsibility of the BWIs) if these countries are to receive timely debt relief.

The financing of debt relief has not been additional

There is considerable worry that the funding of HIPC relief may not be additional – largely because multilateral institutions are not providing sufficient funding from within their own resources. As a result, large amounts of aid are being diverted from bilateral budgets to fund relief by multilateral institutions:

- Over US\$2.6 billion of OECD aid has been promised (of which US\$1.6 billion has been paid) to the HIPC Trust Fund or used for bilateral payments of multilateral debt in the HIPC framework.
- A further US\$700 million of donor funds will be required to meet extra costs of non-BWI relief, as well as more for International Bank for Reconstruction and Development (IBRD) relief and diversion of new IDA-14 funds from new lending.
- Additional contributions to the IMF PRGF-HIPC Trust are US\$1.5 billion in end-1999 PV terms.
- Donors have also been asked to fund IADB contributions separately.

The total amounts represent more than 50 per cent of bilateral donor aid flows to HIPCs in 1998: though their disbursements will be spread over several years, there is strong evidence of aid diversion to fund debt relief. In addition, OECD governments are now being asked to fund relief for HIPCs from non-OECD governments and sub-regional multilateral institutions. Even if debt relief is more desirable funding than aid, this advantage depends largely on the speed with which it is provided. It is obvious that diverting funds away from desperately needed and fast-disbursing program aid, to trust funds which provide debt relief over a long period, is not the fastest way to reduce poverty. Donors need to minimize diversion and maintain program aid levels to give recipients maximum choice in how to fund poverty reduction (see the following section entitled “The Wider Picture.”)

This lack of overall additionality is of course different from additionality at a recipient country level. Here recent BWI analysis²⁰ indicates that most HIPCs have experienced an increase in net flows in 2001 due to a resumption of Fund and Bank assistance, and a (probably related) increase in loans and grants from other sources – the total additionality is estimated at US\$1.2 billion. However, this message is qualified by the falls in assistance to Guinea, Guinea-Bissau, and São Tomé, partly as a result of the suspension of their BWI programs. It remains to be seen whether the overall increase in flows to HIPCs will continue, as it may well be linked to the acceleration of decision points and related PRGF programs at the end of 2000: much will depend on whether the emerging delays in HIPC progress can be overcome. And, of course, unless large increases in aid materialize following the Monterrey Summit, these increases themselves represent a diversion from non-HIPCs.

Relief is not being designed to maximize worldwide poverty reduction

Under HIPC I, targets set for poverty reduction varied, with an apparent strong linkage to the available amount of debt relief and aid. Among eligible HIPCs, the most indebted countries targeted the fastest poverty reduction, and ineligible HIPCs or non-HIPC poor countries risked losing funds if aid had to be diverted to eligible countries to supplement inadequate debt relief. HIPC II has reduced the scale of this distortion, because almost all HIPCs are eligible for some relief, and can therefore make more progress to the Millennium Development Goals. But it is clear that poverty reduction targets have still often been based on available debt relief and aid, with insufficient efforts to mobilize additional aid, especially beyond those HIPCs which are “favourites” of like-minded donor countries who have scope to increase aid.

As a result, it is obvious that

- many HIPCs (notably those in Francophone Africa) are not even aiming to reach the MDGs by 2015, and
- additional resources for poverty reduction have been allocated largely to those IDA-only countries which are most indebted – rather than on the basis of current poverty indicators or government commitment to poverty reduction.

In addition, it is not clear that the current list of HIPCs is comprehensive. Since 1996, Comoros, Gambia, and Malawi have been added to the list. Initial analysis of the ex-CIS countries²¹ indicates that at least two (Kyrgyzstan and Moldova) might be eligible for HIPC-style treatment. These changes alone are sufficient to justify regular tripartite examination of the debt sustainability of all PRGF-eligible countries by the countries themselves, in cooperation with the BWIs.

More importantly, all IDA-only countries should be examined to see whether they might benefit from substantial (non-HIPC) debt reduction by the Paris Club and other bilateral and commercial creditors (as Yugoslavia has received). Early candidates for examination on the basis of low income and high debt burdens would include Bangladesh, Cambodia, Haiti,

Indonesia, Nigeria, Pakistan, Turkmenistan, and Zimbabwe. On their reintegration into the international community, Afghanistan and Cuba would also deserve analysis. If debt relief is an essential and qualitatively superior component of financing for poverty reduction, other middle-income countries with high poverty levels should also be investigated with a view to providing limited concessional debt relief through the Paris Club to fund poverty reduction.

Across all developing countries, the most reliable available estimates²² indicate that we are about US\$50 billion short of the funding necessary for attaining the MDGs – compared to total current annual HIPC relief of only US\$1.5 billion. HIPC is a drop in the ocean in funding the MDGs.

The wider picture: Financing poverty reduction sustainability

It is all very well to say that more could be done to increase debt relief, but some still question the desirability of debt relief compared to other flows. This section attempts to compare the quality of debt relief with other types of foreign and domestic sources of financing for poverty reduction, to assess its relative priority.²³ It bases this comparison on seven factors:

- the current scale of the financing and potential for increases/additionality
- the stability/predictability of the financing and its reaction to economic cycles
- whether the funding is conditional or encourages ownership/capacity-building
- the financial cost and value for money of the financing
- whether the supplier of the funds shares the risk
- the potential direct and indirect impact of the funds on poverty reduction, and
- the effect of the funding on catalyzing/displacing other funds.

The current scale of financing and potential for increases/additionality

In terms of current scale, flows to the vast majority of HIPCs (33) are dominated by grants, with only six where the leading flow is foreign direct investment (FDI), and one each where net official and private loans predominate. Nevertheless, scheduled debt service is larger than any individual type of gross flow (including grants) for at least 10 HIPCs. The priority targets for increasing existing flows are therefore aid and debt service.

It is important to realize the small amount of difference that HIPC relief (debt service annual savings) will make to net flows – an average of only 10 per cent of aid flows. Though the contribution to net budget flows is likely to be around 15 per cent of that of aid in the early years, and HIPCs will receive additional debt relief from Naples terms and bilateral debt cancellations, the contribution of HIPC relief to poverty reduction will be small in

financial terms. However, 100 per cent cancellation of debt service would increase this to 20-25 per cent of aid flows – and 25-30 per cent in the early years.

Potential for future increases/additionality of different flows has been growing:

- The aid pledges in advance of the Monterrey Financing for Development Summit – if implemented – could increase annual aid flows by about US\$12 billion by 2005. While this 25 per cent increase in the volume of aid is well short of the doubling necessary to reach the MDGs, it also represents 12 times the relief HIPCs received in 2001 compared to actual debt service.
- There is also growing evidence that HIPCs with abundant natural resources, political and economic stability, and improving infrastructure are attracting very large private sector flows, including FDI and portfolio investment. However, the same analysis indicates that much apparent FDI is funded by debt flows, and that the rates of return demanded are so high as to make net flows much lower.²⁴
- The other prospects for considerable additional debt relief do not look as strong even though it is qualitatively superior: the most that can probably be expected is for debt relief to live up to the promises already made.

Stability/predictability/cyclicality of financing

Previous analysis has concluded that official capital flows, debt relief, and FDI have been the most stable flows, with portfolio flows and bank lending more unstable. However, much recent analysis identifies aid as frequently unpredictable and a source of shocks, especially where it is tied too tightly to adjustment – producing disastrous cuts in anti-poverty spending.²⁵ It has also indicated that in view of dramatic variations in rates of return demanded on FDI, it is much less stable than previously assumed.²⁶ Though some aspects of HIPC implementation are making debt relief less stable, it is likely to be the most stable flow available.

Of course, negative effects of volatility can be offset when government is able to monitor and predict flows and design counteracting macroeconomic policy: given the lack of monitoring for private flows and major problems monitoring aid in many countries, debt relief ranks ahead also in this respect.

Private flows are procyclical (exacerbating booms or recessions). Debt relief and aid should be able to be countercyclical – but unfortunately often flood in to support success stories, or stall when economic policy falters, and therefore become procyclical.²⁷ The impact of aid depends largely on its form. If it is rapidly disbursed to compensate for shocks, aid can be the key countercyclical flow. However, existing mechanisms for compensation (e.g., Compensatory Financing Facility-CFF, Contingent Credit Line-CCL, and Stabex) are so expensive and cumbersome that HIPCs do not or cannot apply for them, leaving the burden on donor program aid as the main countercyclical financing for most HIPCs. Currently HIPC

is countercyclical, especially due to the reassessment and topping up of relief at the completion point, but the restrictions on topping up will tightly limit this role.

Whether the funding is conditional and/or capacity-building

Conditionality is now commonly seen as a negative characteristic of aid and debt relief. But some other external financing is also more conditional than capacity-building. Though most foreign investors build local capacity through transfer of intellectual property and infrastructure provision, they also nowadays demand that the host country (or company which is being purchased) offer incentives or accept conditions set by the investor (such as tax holidays or government assumption of privatized companies' debts). Other finance (bank loans, bonds, portfolio flows) is less conditional but also involves virtually no intellectual property transfer.

Aid and debt relief hold the most potential to transform the donor-recipient relationship into one of mutual respect. Yet a large proportion of aid and almost all debt relief are tied to PRGF programs which contain conditions. If PRGFs are transformed to support nationally designed poverty reduction strategies, they could move from conditionality to capacity-building, supplying international know-how to build national capacity for sustainable development. The mobilization of government officials and civil societies in low-income countries to participate in PRSP processes has inspired many to believe countries can take charge of their own development. However, in some countries where governments and civil societies have not been proactive, PRSPs have continued to be designed largely by external technical assistance. If the BWIs stick to inflexible conditions (see above) and donors continue to pre-design projects and insist on expatriate technical assistance, this advantage of aid and debt relief will disappear. The worst recent aspect is suspension of debt relief for countries that fail to stay on track with PRGFs, which risks making debt relief tighten conditionality, and undermine ownership.

The financial cost and value for money of the financing

Aid, NGO flows, and debt relief are by far the cheapest types of flows. In principle, according to international declarations, aid to HIPCs should be getting cheaper, as most donors have pledged to end loans to HIPCs. However, before and after their completion points, HIPCs are being deluged with offers of expensive and risky loans from various governments, regional organizations, and commercial creditors, on the basis that their debt is now sustainable; and because systems in creditor and debtor countries for monitoring and limiting non-concessional loans are inadequate. Borrowing limits agreed with the IMF provide some protection against HIPCs accepting this type of finance, but they are sometimes not clear enough, and many creditors try (sometimes successfully) to circumvent them. The BWIs have recently placed even more stress on avoiding non-concessional borrowing, increasing the grant element of new borrowing from 35 per cent to 50 per cent, and mobilizing grants rather than loans. But it is not enough to impose conditions on debtors. Creditor forums need to reach more detailed and binding agreements banning such loans.

“Other official finance” (export credits and hard-window official lending) has some subsidy compared to commercial loans and bonds. Portfolio investment has a higher return (cost) than loans, and expected return from FDI in the poorest countries is 15-20 per cent. But in general they are much more expensive than aid or especially debt relief (which due to its entire cancellation no longer has an implicit interest rate).

However, financial cost is too narrow a concept: it is vital to look at the value for money and development contribution of the goods being financed. Untied debt relief and aid are generally preferable, export credits/tied aid/some commercial loans have a poor record, and portfolio/FDI value depends on the commercial viability or acumen of the project/company.

Finally, it is also crucial to look at the transaction costs associated with the financing flow. Though many (including this author) have complained about the transaction costs associated with repeated debt renegotiations, they are generally estimated by HIPC officials to be much lower than those related to project aid, FDI, or other project-specific financing. If debt relief can be sufficient, final, and irrevocable, avoiding the need for repeated revisions to analysis and relief terms, its transaction costs will be virtually nil.

Whether the supplier of the funds shares the risk

Countries are exposed to three main risks from external flows – “payment capacity” (which covers overhang and liquidity), exchange rate, and interest rate. As currently defined in HIPC II, debt relief removes some of the payment capacity and exchange rate risk from debt service due to the reassessment of relief needs at completion point, and absorbs most interest rate risk by fixing rates. Most official flows fix interest rates but transfer the other risks to the borrower – though grants remove all three risks. In theory, suppliers of equity flows bear the payment capacity and exchange rate risk, but in practice, many compensate for diminished payment capacity or exchange rate falls by repatriating higher profits, transferring the risk back to the country. Private loans (and many bonds) expose recipients to all three risks with variable interest rates.

Potential direct and indirect impact on poverty reduction

Much debt relief and aid – notably the HIPC relief – aims to reduce poverty directly, but far too much non-HIPC debt relief and aid go to countries which are not poor or have little interest in fighting poverty. Some private flows target growth to reduce poverty indirectly: they could have a much more direct impact if OECD governments support poverty reduction objectives through a rapid acceleration and enforcement of corporate social responsibility initiatives;²⁸ pending such efforts, aid and debt relief are likely to contribute far more to poverty reduction.

Interaction among different sources of financing

It is vital not to look at different sources of financing in isolation, because they can catalyze or displace one another. Focusing above all on debt relief, the evidence of the positive effect of HIPC reduction on *private capital flows* (where countries are also overcoming key structural and informational barriers to private flows) is rapidly mounting, confirming earlier evidence on Latin American countries' Brady deals.²⁹ There is also growing evidence that *aid flows* have been positively affected by debt relief, insofar as both reflect a good track record on poverty reduction. There is also growing evidence of positive correlation between debt relief and domestic private savings and investment. However, we should not be sanguine about these positive linkages – if countries go off track with poverty reduction programs, they risk sharp falls in all types of financing.

In contrast, the evidence on positive linkages between official and private flows is much weaker (although at a micro level guarantees and co-financing can help). Similarly, the evidence of positive interaction between aid or private flows and domestic savings and investment is patchy or non-existent (though the data on savings and investment are so poor as to make firm conclusions impossible).³⁰

Why debt relief is preferable to other external flows

Overall, on virtually all of the above criteria, debt relief scores higher than other types of flows, making it the preferable form of financing. Ultimately most HIPCs would rather rely on domestic than external financing. They are not alone – if an OECD government told its citizens it would finance growth and poverty reduction largely through external flows, they would kick it out of office! But in many of the countries the current scale and immediate potential for such financing is limited (partly because of the faulty design of past financial sector and tax revenue reform programs). In addition, the cost of domestic debt financing may well be much higher (even when risk-adjusted) than external financing, and it is likely to be highly procyclical. HIPC Ministers have therefore placed much stress on the need to provide them with free access to developed country markets, to increase the value added of their export products, and to procure aid-financed goods from HIPCs themselves.³¹

Pending these steps, if debt relief (and aid grants) can be provided straightforwardly with minimum conditionality and maximum capacity-building and poverty reduction focus, they are likely even to be preferable to and more readily available than much domestic financing.³²

It should be clear from all the preceding analysis that, in the current context, a dollar of debt relief is much more valuable – especially if frontloaded – because it is more stable and predictable, is countercyclical, has no cost, and in the context of the PRGF should be capacity-building and poverty-reducing.

What would HIPC III look like?

The preceding sections have argued that in spite of major progress made by the HIPC Initiative, it remains inadequate to fulfil its own aims, let alone the wider target of financing global poverty reduction to reach the Millennium Development Goals. If the international community is serious about the MDGs, it must take many urgent steps:

Debt relief

An HIPC III would guarantee sufficient, comprehensive, timely, and additional relief for all low-income countries which are serious about poverty reduction. It would:

- Simplify the sustainability criteria to focus on attaining a debt service/budget revenue ratio below 10 per cent from the moment of the decision point, and the maximum freeing of funds for poverty reduction in the next three to five years.
- Analyze domestic and private sector debt, and reduce their burdens as necessary.
- Establish adequate mechanisms for fully compensating HIPCs for external shocks, rather than requiring them to cut poverty reduction spending, by:
 - Making projections in HIPC and PRGF programs more realistic
 - Reassessing sustainability annually before and after completion points and augmenting debt relief as necessary to compensate renewed unsustainability
 - Restoring a safety margin to protect HIPCs against future shocks, by allowing the additional cancellations pledged by some creditor governments to be fully additional, and assessing sustainability net of creditor non-participation
 - Introducing rapid contingency financing through floating additional tranches in IMF PRGF and IDA Poverty Reduction Support Credit (PRSC) programs
 - Accelerating recommendations of the World Bank Task Force on Commodity Risk Management and the Commonwealth Disaster Management Agency
 - Ensuring more predictable and stable aid flows without sudden suspensions.
- Assure greater participation by all creditors, by:
 - agreeing innovative mechanisms for relieving debts to bilateral, commercial, and multilateral creditors without diverting bilateral donor aid
 - combating lawsuits against HIPCs by putting them at the centre of discussions on international debt “standstill” procedures, ensuring that international arbitration forums and debtor and creditor jurisdictions forestall such suits, and providing legal technical assistance to debtors where necessary
 - assuring the full implementation by Paris Club creditors of their undertakings, and preferably assuring cancellation of all bilateral debt
 - encouraging multilateral institutions to fund more HIPC relief themselves, preferably through total cancellation of multilateral debt.

- Accelerate the delivery of HIPC relief and avoiding its suspension, by:
 - Streamlining conditionality far more dramatically, avoiding micro-conditions and interpreting compliance based on overall efforts.
 - Designing more flexible growth-oriented macroeconomic frameworks, which maximize mobilization of concessional funding for anti-poverty spending.
 - Implementing immediately comprehensive Poverty and Social Impact Analysis (PSIA) of all conditionalities, conducted by countries with independent third-party assistance.
- Increase the additionality of HIPC relief by raising multilateral institutions' own contributions, from internal sources which will not reduce new funds for HIPCs
- Broaden the provision of debt relief to a wider range of (especially IDA-only) countries so as to assure maximum global progress toward poverty reduction.

However, though debt relief may be qualitatively superior to other types of financing, it will not be sufficient to assure sustainable global poverty reduction. Measures to increase and improve official and private flows have already been discussed in this meeting, but a vital first step to mobilizing such flows is to expand debt sustainability analysis into poverty reduction sustainability analysis, which examines the financing needs of all IDA-only countries for attaining the Millennium Development Goals and how to mobilize such financing.

The international financial community faces a unique opportunity to achieve massive poverty reduction in the poorest countries: but the degree to which this can happen will depend on finding genuinely additional, stable, predictable, and countercyclical funds, from debt relief, official, and private sources, which can be channelled to or contribute to building national capacity to implement poverty reduction strategies.

It is also vital that HIPCs and low-income countries are better represented in international forums and assert their own views on the HIPC Initiative and their wider needs for financing poverty reduction forcefully. HIPCs have recently begun a dialogue with the heads of the Bretton Woods Institutions and G-7 governments through their own Ministerial Network. The HIPC Capacity-Building Programme will be assisting such advocacy by HIPCs on all aspects of external financing over the next three years, encouraging them to assess the progress of each major creditor or donor, and each type of private capital flow, in financing sustainable poverty reduction.

However, HIPC Ministers acknowledge that it was the incredible energy and commitment of international civil society campaigners, linked to the open-minded leadership of some senior policy-makers in G-7 and HIPC governments and international financial institutions, and the technical expertise of some of their officials, which created HIPC II. A final key issue which deserves much wider debate is how to ensure that this coalition of forces continues to work together in the new millennium, to mobilize the additional debt relief, aid, and private capital flows so that all poor countries which are committed to reducing poverty can not only reach – but preferably far exceed – the Millennium Development Goals.



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Notes

- 1 Sources for this paper are listed in the bibliography – but the main source is my work with officials of 42 developing countries, through the HIPC Debt Strategy and Analysis Capacity-Building Programme (funded by the Governments of Austria, Denmark, Sweden, Switzerland, and the UK) and the work of Development Finance International on aid management and private capital flows. I am most grateful to colleagues in these programs for their input. For more details, see in particular the declarations of their Finance Ministers' network on our website at www.dri.org.uk. However, the views expressed in this paper are entirely personal and do not represent those of the Programme or its donors.
- 2 I have analyzed these issues in more detail in Martin, *Financing Poverty Reduction in HIPCs* (London: Debt Relief International, 2002a).
- 3 HIPC conditionality and poverty reduction are not treated here to avoid overlap with earlier papers.
- 4 Excluding Liberia, Somalia, and Sudan (which are almost certainly eligible for relief if they were to resolve political problems and launch IMF programs) and Angola, Kenya, Viet Nam, and Yemen which have conducted debt sustainability analyses (DSAs) which so far indicate that they are ineligible for the Initiative.
- 5 All of the data on relief in this paragraph are from IMF and World Bank, *The Enhanced HIPC Initiative and the Achievement of Long-term Debt Sustainability*, 2002c.
- 6 Alison Johnson, *The Fiscal Burden of Debt*. Debt Relief International paper to the Commonwealth Secretariat seminar on HIPC Initiative (London: Debt Relief International, 2000).
- 7 See Balliram Baball, *Monitoring Private Sector External Debt: Key Issues and Challenges* (London: Debt Relief International, March 2002) and Matthew Martin, "Analysing the Sustainability of Private Capital Flows", mimeo (London: Development Finance International, March, 2002b).
- 8 Though the Board papers defining HIPC methodology left it open for any DSA to use a different average, based on a more realistic interpretation of export volatility, all have used the three-year average.
- 9 Matthew Martin and Randa Alami, *Long-term Debt Sustainability for HIPCs: How to Respond to Shocks*, Report to DFID, 2000.

- 10 John, Serieux, "The Enhanced HIPC Initiative in 2002." Paper for the Commonwealth Secretariat HIPC Forum Meeting, mimeo, 2002.
- 11 IMF/World Bank, *The Enhanced HIPC Initiative and the Achievement of Long-term Debt Sustainability*, Washington, DC, 2002c.
- 12 Zambia also faces the particular problem of having a huge "hump" of debt service to the IMF, which even dramatic frontloading of its HIPC relief from the IMF has not been able to offset entirely.
- 13 IMF/World Bank, *The Enhanced HIPC Initiative and the Achievement of Long-term Debt Sustainability*.
- 14 Serieux, 2002.
- 15 For similar views, see EURODAD, *Going the Extra Mile*, Brussels, February 2002 and Jeffrey Sachs, "Statement to IMF/World Bank Spring Meetings," April 16, 2000. The final section of this paper deals in more detail with how we might fund the MDGs.
- 16 See for example, *Drop the Debt*, 2001 and EURODAD, 2002.
- 17 See Adam and Bevan and IMF/World Bank, *Review of the Key Features of the PRGF – Issues and Options*; and Staff Analyses, Washington, DC, February 2002a for more discussion of what constitutes post-stabilization countries.
- 18 IMF/World Bank, *HIPC Initiative: Status of Implementation*, March 2002d.
- 19 See Serieux, 2002.
- 20 IMF/World Bank, 2002c.
- 21 IMF/World Bank, 2002.
- 22 World Bank, 2001 and Zedillo, 2001.
- 23 This section expands earlier typologies in Matthew Martin, "Financing Africa's Development in the 21st Century." Gilman Ruthinda Memorial Lecture (Dar es Salaam: Bank of Tanzania, 1999b) and Williamson, 2000.
- 24 Bhinda *et al* 1999; Government of Tanzania, 2001; Government of Uganda, 2002; Government of Malawi, 2002.
- 25 Government of Ghana, *Aid Flows: Budgetary, Balance of Payments and Monetary Linkages*. Report to Consultative Group, November 1999; Johnson and Martin, 2002; Martin, 1996; Mistry and Martin, 1994.
- 26 Nils Bhinda *et al*, *Private Capital Flows to Africa: Perception and Reality* (The Hague: FONDAD, 1999).
- 27 See Dollar, 1999 and Government of Ghana, 1999.
- 28 See Bhinda, "Private Capital Flows, Corporate Responsibility and Global Poverty Reduction," mimeo. (London: Development Finance International, March 2002).
- 29 See Government of Tanzania, *Private Capital Flows to Tanzania in 1999-2000*, March 2002 and Government of Uganda, *Private Capital Flows to Uganda in 1999-2000*, March 2002.
- 30 See Ibrahim Elbadawi and Alan Gelb, "Financing Africa's Development: Towards a Business Plan?" mimeo. Paper for AERC Policy Seminar, February 2002.
- 31 They have also suggested that much can be done at the micro level to provide external capital in ways which complement domestic savings, to help HIPC governments to mobilize tax revenue (by, for example, subjecting aid and diplomatic flows to domestic taxes), and to avoid diverting government counterpart expenditure to unproductive externally inspired projects.
- 32 For more on this, see AERC, "Financial Sector Reform in Africa." Special Edition, *African Development Review*, Abidjan, 1998 and 2001; and Martin, 1999b and Johnson, 2000.