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The HIPC Initiative and Debt Relief: An Examination of Issues Relevant to Nepal

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The HIPC Initiative and Debt Relief:
An Examination of Issues Relevant to Nepal

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Abstract

Set up in 1996, the HIPC Initiative's prime goal was to reduce eligible countries' debt burdens to the thresholds established under the Initiative. In September 1999, the HIPC Initiative was enhanced in order to provide broader, deeper and faster debt relief. There are both costs and benefits associated with participation under the Initiative. At the completion point, full debt cancellation under the MDRI is granted. Nepal has been found to be satisfying all the conditions required to reach the decision point under the Enhanced HIPC Initiative framework. The possible conditions attached to Nepal's entry to the HIPC Initiative, the level of existing concessionary foreign assistance that can be non-concessionary, the reform measures that need to be additionally implemented and the possible debt situation after reaching the completion point of the HIPC Initiative are some of the issues that need further attention.

Key words: HIPC, MDRI, Debt Relief, Poverty, External Debt, Net Present Value

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ACRONYMS

AfDB	African Development Bank
AfDF	African Development Fund
AGOA	American Growth and Opportunity Act
AsDB	Asian Development Bank
CPIA	Country Policy and Institutional Assessment
DAC	Development Assistance Committee
DRF	Debt Reduction Facility
DSA	Debt Sustainability Analysis
FCGO	Financial Comptroller General Office
GDP	Gross Domestic Product
GPRS	Ghana Poverty Reduction Strategy
GSP	Generalized System of Preferences
HIPC	Heavily Indebted Poor Countries
IDA	International Development Association
IEG	Independent Evaluation Group (formerly OED)
IMF	International Monetary Fund
LIC	Low-income country
MDG	Millennium Development Goal
MDRI	Multilateral Debt Relief Initiative
MOF	Ministry of Finance
MTEF	Medium Term Expenditure Framework
NPV	Net present value
NRB	Nepal Rastra Bank
ODA	Official development assistance
OECD	Organization for Economic Co-operation and Development
PRGF	Poverty Reduction and Growth Facility
PRSP	Poverty Reduction Strategy Paper

I. INTRODUCTION

In the aftermath of the swelling up of foreign debt owed by many low-income countries (LICs) throughout the 1970s and 1980s, low growth, declining commodity prices, and other economic shocks resulted in a number of countries possessing unsustainable debt burdens. By 1992, the 33 most indebted LICs incurred debts whose present value had more than doubled in ten years to over six times their annual exports. Beginning in the late 1980s, the Paris Club and other bilateral creditors rescheduled and forgave many of these debts. However by the mid 1990s, with an increasing share of debt owed to multilateral lenders such as the World Bank, the IMF, and regional development banks, a new debt relief initiative was demanded, involving these creditors, to address the concern that poor countries' debts were hindering poverty reduction efforts.

Accordingly, in 1996 the Heavily Indebted Poor Countries (HIPC) Initiative was launched by the IMF and the World Bank, with the goal of ensuring that no poor country incurs a debt burden it cannot manage. The Initiative demanded coordinated action by the international financial community, including multilateral organizations and governments, to lower to sustainable levels the external debt burdens of the most heavily indebted poor countries. After a detailed assessment, the HIPC Initiative was enhanced in September 1999 to provide deeper and more rapid relief to a wider group of countries, and to reinforce the relationships between debt relief, poverty reduction and social policies. The continued efforts by countries toward macroeconomic adjustment and structural and social policy reforms—including higher spending on social sector programs such as basic health and education—comprise the core aspects of the Enhanced HIPC Initiative.

In 2005, major progress was witnessed in extending and deepening debt relief to the poorest countries, particularly in Africa. In June 2005, the G8 proposed that three multilateral institutions—the African Development Fund (AsDF)[1], the International Development Association (IDA), and the International Monetary Fund (IMF)—cancel 100 percent of their debt claims on countries that have reached, or will eventually reach, the completion point under the Enhanced HIPC Initiative. The main objective was to free up additional resources to help these countries reach the millennium development goals (MDGs). The G8 proposal, called the Multilateral Debt Relief Initiative (MDRI) is expected to deepen the debt relief provided under the HIPC by further cutting the debt of poor countries, while simultaneously providing full compensation to safeguard the long-term financing capacity of AsDF and IDA.[2] This Initiative is expected to double the volume of debt relief already expected from the Enhanced HIPC Initiative. The major characteristics of the HIPC Initiative and the MDRI are illustrated in Appendix 1.

According to the HIPC criteria, Nepal has been found to be satisfying all the conditions required to reach the decision point based on income and indebtedness criteria applied to

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[1] The African Development Fund was established in 1972 following an agreement between the African Development Bank and certain non-regional member countries to provide loans on concessional terms to less developed regional member countries. Resources of the African Development Fund are made available on concessional terms to support development activities aimed at creating an enabling environment for sustainable growth as well as contributing to poverty reduction in low-income African countries.
For details, refer to African Development Bank Group (2006).

end-2004 data. The NPV of external debt for end-2004 was estimated at almost 200 percent of exports of goods and services. Nepal could begin receiving interim relief on a provisional basis if it decides to enter the Enhanced HIPC Initiative.

Nepal's entry into the Enhanced HIPC Initiative could help release its resources from debt servicing obligations that will enable the country to implement poverty reduction programs more effectively. The rest of the paper is organized as follows. The next section discusses the operational framework of the HIPC Initiative. After a brief analysis of the MDRI, some recent developments under these Initiatives are examined. Section III spells out the benefits and costs associated with the HIPC Initiative. Two country experiences (Ghana and Zambia) are also scrutinized. Before concluding, Section IV reviews the external debt situation of Nepal and discusses some pertinent issues that need to be taken care of prior to the country's participation under the HIPC Initiative, if it so decides.

II. The Operational Framework of HIPC and Recent Developments

The HIPC Framework

In general, in order for a country to qualify for the HIPC Initiative assistance it must satisfy a set of criteria. Specifically, it must: (1) be IDA-only and PRGF-eligible, (2) face an unsustainable debt burden, beyond traditionally available debt-relief mechanisms[3] (3) be only eligible for highly concessional assistance from the IDA, the section of the World Bank that lends on highly concessional terms, and from the IMF's PRGF; and (4) establish a track record of reform and develop a PRSP through the involvement of the civil society.[4]

For reaching the decision point, the first stage of qualification, a country needs to possess a track record of macroeconomic stability, have developed an Interim PRSP, and cleared any outstanding arrears. At the decision point, the country concurs to a list of completion point triggers, upon which it will 'graduate' from the HIPC Initiative. Moreover at this point, a debt sustainability analysis is conducted to determine the level of indebtedness of the country and the amount of debt relief it may obtain. The amount of debt relief required to bring countries' debt indicators to HIPC thresholds is computed, and countries start getting interim debt relief on a provisional basis.

The interim period between a country's decision and completion points varies depending on how fast a country can implement its poverty reduction strategy and maintain macroeconomic stability. In order to arrive at the completion point, the country is required to maintain macroeconomic stability based on a PRGF-supported program, undertake major structural and social reforms as agreed upon at the decision point, and implement a PRSP satisfactorily for one year. After attaining the completion point, the country obtains the full amount of debt relief, which then becomes irrevocable.

A flowchart of the HIPC Initiative pertaining to its functioning is provided below.

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[3] A country's debt level is unsustainable if debt-to-export levels are above a fixed ratio of 150 percent, or, in countries where exclusive dependence on external indicators may not sufficiently demonstrate the fiscal burden of external debt, the debt-to-government revenues are greater than 250 percent.

[4] Details are provided in World Bank Independent Evaluation Group (2006).

FLOWCHART 1

First Stage

Country establishes a three-year track record of good performance and develops together with civil society a PRSP; in early cases, an interim PRSP may be sufficient to reach the decision point.

- *Paris Club* provides flow rescheduling as per current Naples terms, i.e., rescheduling of debt service on eligible debt falling due during the three-year consolidation period (up to 67 percent reduction on eligible maturities on a net present value basis).
- *Other* bilateral and commercial creditors provide at least comparable treatment.
- *Multilateral institutions* continue to provide support within the framework of a comprehensive poverty reduction strategy designed by governments, with broad participation of civil society and the donor community.

EITHER
Paris Club stock-of-debt operation under Naples terms and comparable treatment by other bilateral and commercial creditors **is adequate** for the country to reach sustainability by the decision point.
====> **Exit**
(Country is not eligible for HIPC assistance.)

OR
Paris Club stock-of-debt operation under Naples terms and comparable treatment by other bilateral and commercial creditors **is not sufficient** for the country to reach sustainability by the decision point
====> **Decision Point**
(World Bank and IMF Boards determine eligibility.)

All creditors (multilateral, bilateral, and commercial) commit debt relief to be delivered at the floating completion point. The amount of assistance depends on the need to bring the debt to a sustainable level at the decision point. This is calculated based on the latest available data at the decision point.

Second Stage

Country establishes a second track record by implementing the policies determined at the decision point (which are triggers to reaching the floating completion point) and linked to the (interim) PRSP.

- World Bank and IMF provide interim assistance.
- Other multilateral and bilateral creditors and donors provide interim debt relief at their discretion.
- All creditors continue to provide support within the framework of a comprehensive poverty-reduction strategy designed by governments, with broad participation of civil society and donor community.

"Floating" Completion Point

- Timing of completion point is tied to the implementation of policies determined at the decision point.
- All creditors provide the assistance determined at the decision point; interim debt relief provided between decision and completion points counts toward this assistance.
- Paris Club goes beyond Naples terms to provide more concessional debt reduction of up to 90 percent in NPV terms (and if needed, even higher) on eligible debt so as to achieve an exit from unsustainable debt.
- Other bilateral and commercial creditors provide at least comparable treatment on stock of debt.
- Multilateral institutions take additional measures, as may be needed, for the country's debt to be reduced to a sustainable level, each choosing from a menu of options, and ensuring broad and equitable participation by all creditors involved.

Source: World Bank Independent Evaluation Group (2006).

The total cost of providing assistance to the 29 countries that have reached the decision point and the 11 countries potentially eligible for debt relief under the Enhanced HIPC Initiative is estimated to be about US$ 64 billion in end-2005 NPV terms. Slightly more than half of this is provided by the bilateral creditors, and the rest will flow from the multilateral lenders. Appendix 1 provides a list of countries that have qualified for, are eligible or potentially eligible and may wish to receive the HIPC Initiative assistance.

For the 29 countries for whom packages have already been approved, debt service paid, on average has dropped by about 2 percent of GDP between 1999 and 2005.[5] While prior to the launching of the HIPC Initiative, eligible countries were, on average, spending slightly more on debt service than on health and education combined, these countries have now increased considerably their expenditures on health, education and other social services and, on average, such spending is now more than five times the amount of debt service payments. Though country-wise studies demonstrate that these countries are seeing clear gains, difficult problems, however, still persist for some countries.[6]

Serious problems also exist in HIPCs that have not yet been able to reach their decision points. A few of these countries are plagued by uneven policy records or poor governance, which subsequently may be attributed to grave problems such as civil conflict. Some others (such as Liberia and Sudan, which are both afflicted by civil conflict) have debts too large to write off given current funding for the Initiative. The expiration of the sunset clause on December 31, 2006 could, hence, imply that some countries on the list may not be able to benefit from debt relief under the Initiative, since they would not have met the policy eligibility criterion.

The Multilateral Debt Relief Initiative

The HIPC Initiative was supplemented by the MDRI in 2005. The aim of the MDRI is to render additional support to HIPCs to reach the MDGs and at the same time ensuring that the financing capacity of the international financial institutions is preserved.

The MDRI permits for 100 percent debt relief by three multilateral institutions—the IMF, the IDA of the World Bank, and the AfDF—for countries completing the HIPC process. As of August 2006, all the 19 post-completion-point HIPCs have qualified for MDRI debt relief from IDA, the IMF and the AfDF. These countries have already received debt relief from the IDA and the IMF and are expected to receive MDRI from the AfDF soon.[7] The other 21 HIPCs would be eligible for debt relief under the MDRI once they make it to the completion point.

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[5] Details are given in IMF (2006).

[6] In war-ravaged Rwanda and Ethiopia, for example, pressing reconstruction demands may imply large new loans at the same time that old debt is being reduced.

[7] Moreover, the IMF also provides MDRI debt relief to non-HIPCs whose income per capita is below US$ 380 in order to ensure conformity of treatment in the use of IMF resources through the "MDRI-I Trust". HIPCs with per capita income exceeding US$ 380 will receive MDRI relief from bilateral contributions administered by the IMF through the "MDRI-II Trust". While the MDRI-I Trust draws on resources from the 1999-2000 off-market sales of the Fund's gold, the MDRI-II Trust draws on transfers of contributions originally rendered to fund concessional lending to low-income countries under the PRGF. As non-HIPCs, Cambodia and Tajikistan have also been able to obtain MDRI debt relief from the IMF. For more elaboration, see IMF and IDA (2006).

The cost of the MDRI debt relief to the 40 HIPCs is about US$24.9 billion in end-2005 NPV terms (equivalent to US$ 48.9 billion in nominal terms) of which the shares of IDA and the IMF are almost 70 percent and 16 percent, respectively.

Recent Developments

The IMF and IDA identified 11 countries that satisfied the income and indebtedness criteria at end-2004 and could be considered for debt relief under the Initiative. These include seven countries that had been identified as HIPCs in previous HIPC Initiative reports (Central African Republic, Comoros, Côte d'Ivoire, Liberia, Somalia, Sudan, and Togo) and four other countries (Eritrea, Haiti, the Kyrgyz Republic, and Nepal).

The cost of HIPC Initiative debt relief for these 11 countries is estimated at US$21 billion in 2004 NPV terms. Of this, the World Bank's and IMF's shares amount to about US$2.9 billion and US$2.1 billion, respectively. About 25 percent of the total cost corresponds to the six countries that have met all HIPC Initiative eligibility requirements (Central African Republic, Côte d'Ivoire, Haiti, the Kyrgyz Republic, Nepal, and Togo).

As of April 7, 2006, three countries (Bhutan, Sri Lanka and Lao PDR) that technically met the income and indebtedness criteria at end-2004 refrained from availing themselves from participating in the Initiative for different reasons.[8] Among the factors cited by Sri Lanka for not participating under the HIPC Initiative were, firstly, that as Sri Lanka was moving to the status of lower middle-income countries group and per capita income reaching above US$ 1,000, it would not have recourse to low cost concessional credit facilities from multilateral institutions and bilateral donors. In this context, in the future the country may have to borrow in the international financial markets for external financing, for which it is desirable to obtain a credit rating from world class international credit rating agencies. Inclusion to the HIPC group could have an adverse impact on a country's credit ratings. Two, the inclusion of Sri Lanka in the potential HIPC category may also hinder new concessional loans, FDI inflows and private sector institutions from mobilizing funds in the international markets at competitive rates. Three, some governments and official donors could reconsider their lending policy and might even stop disbursement of funds for already approved and on-going projects as they may have to write off outstanding debt to Sri Lanka, if it applies for the HIPC status.

Bhutan, on the other hand, is of the view that the country's debt situation is actually far from being distressed if the hydropower loans which are self-liquidating are segregated. Overall, the debt position is not that dismal. Moreover, its bilateral lenders may not provide loans in the future, in fear of having to forgive their debt. This could cost Bhutan more than what it would benefit from debt forgiveness.[9] For Laos, its reluctance to enter into the HIPC Initiative could be due to concerns related to lower credit-ratings and reduced access to capital markets.

[8] For more details, see IMF (2006a).

[9] The reasons pointed for Bhutan and Sri Lanka for not participating under the HIPC Initiative are based on correspondence between these central banks and the Nepal Rastra Bank.

III. The HIPC Initiative: Benefits, Costs and Country Experiences

General Benefits

Besides reduced external debt burdens, countries that choose to participate under the Enhanced HIPC Initiative benefit from debt relief in a number of ways. For a country deciding whether participation in the Initiative is in order, these benefits must be weighed against some of the potential costs associated with the Initiative. Some other general advantages of participation could include the following:

- Members of the Paris Club normally provide debt relief above and beyond what is called for in the Initiative**.** In the past, many members of the Paris Club have granted total debt write-downs to HIPC countries.
- The reduction in debt service should allow for a significant rise in poverty reducing expenditures. In the countries that have reached the decision point, poverty-reducing expenditures have risen from an average 6.4 percent of GDP in 1999 to an estimated 9.1 percent in 2005.
- At the completion point full debt cancellation under the MDRI is granted.
- Participation in the Initiative enhances creditworthiness. Credit rating agencies do not consider debt reduction obtained through the Initiative as detrimental to creditworthiness. Rather, Standard & Poor's has noted that debt relief obtained through the HIPC Initiative improves a country's creditworthiness. This is likely to be even more important given the additional relief provided through the MDRI.

However, the country should be clear on certain issues and misconceptions before considering participation in the HIPC Initiative. These include the following:

- Countries need to satisfy certain conditions in order to obtain relief under the Initiative**.** Though considerable efforts are devoted to identifying conditions that will maximize the Initiative's impact and safeguard financial resources, these conditions may require strong efforts on the part of the related authorities.
- Some bilateral creditors may scale back new assistance for a few years after they grant debt relief.
- The HIPC Initiative is not a panacea**.** It helps lower poverty by re-directing the savings from debt relief to poverty reducing areas, but it cannot result in the complete eradication of poverty. Likewise, fiscal solvency is not guaranteed by the relief. The Initiative provides debt reduction and improves government balance sheets. Long-term debt fiscal sustainability is based on solid growth that relies on sound government policies, including prudent external borrowing and debt management.
- The completion point triggers normally encompass the following: a) macroeconomic stability; b) implementation of key structural reform measures, including social sector reforms under the World Bank and IMF programs; c) improvements in public expenditure management; and d) more spending in priority areas consistent with

PRSP objectives. Experiences of completion-point countries reveal that waivers have been made on completion-point triggers. For instance three waivers each were made to Ethiopia, Senegal and Zambia (Appendix 3).[10]

On the economic front, real GDP growth in the 27 HIPCs that reached the decision point before 2005 averaged 4.6 percent over the period 2000-5, up significantly from an average rate of 2.6 percent in the 1990s and just 1.8 percent in the 1980s. However, the range of outcomes was broad—annual per capita real GDP growth declined in 9 of the 27 countries.[11]

Foreign reserves help countries to fulfill their debt-service obligations if adverse financial or economic development takes place, thus reducing the risk of a liquidity crisis. Reserves in the 29 decision-point HIPCs as a group have soared since the early 1990s, rising from 2.6 percent of GDP in 1990 to 13.3 percent in 2004, before dropping to 11.9 percent in 2005. In 2004, reserves provided cover for more than six months of imports in one-third of the countries, while in 1990 none of the countries had adequate reserves to cover six months of imports.

More open economies can adjust better to external shocks. The external sector of the 29 decision-point HIPCs has been bolstered by an expansion of trade. Exports by the countries as a group have risen from 20 percent of GDP in the early 1990s to almost 30 percent in 2005.[12]

Limitations of the HIPC Initiative

The HIPC Initiative, whose goal is to provide debt relief to developing countries, has not been fully able to deliver. While there are a few HIPC success stories (for instance, increased primary school enrollment and better access to water resources), the fact is that debt relief under HIPC is not benefiting the people as a whole. For instance, Uganda has fallen three times into unsustainable debt levels and is now paying almost as much in debt servicing as before its participation under the HIPC Initiative. Similarly, Mozambique has found itself borrowing more since debt relief was offered to it, and 60 percent of its national budget depends on external credit.[13]

The HIPC Initiative possesses some other limitations:[14]

- a higher eligibility threshold that has excluded many poor countries from consideration, despite having a clear need for debt relief;
- eligible countries, even after reaching the completion point, are still liable to experience unnecessary delays in getting debt relief because some of the creditor nations and institutions want to limit their own costs as much as possible;

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[10] For more details, see World Bank Independent Evaluation Group (2006).
[11] These data are based on World Bank (2006).
[12] However, this figure is well below the estimated 40 percent for the middle-income countries.
[13] For details see "HIPC has not delivered." Available in: http://www.jubileeusa.org/ international_partners/ declarations/communique33.html
[14] These limitations have been extensively discussed by Olukoshi (1999), Kamidza *et. al* (2002) and ESCAP (2005).

- linking debt sustainability to levels of export receipts while giving less emphasis to the social and human development such as education, health and poverty reduction;
- failure to link debt sustainability to expenditures on social development; and
- continued servicing of debt at unsustainable levels which in turn undermine development priorities and needs of eligible countries; and

The HIPC Initiative has its own conditions, which have to be met by any prospective country before qualifying for the scheme. For example, Mozambique was required to open up its cashew nut industry by sending raw nuts abroad for processing. This happened despite the presence of a local processing plant. As a result, the country received lower prices from its cashew nuts while a large number of Mozambican workers lost their jobs.[15]

The results of the HIPC Initiative have been somewhat slower than expected. The Initiative's debt sustainability analysis (DSA) has been criticized for placing too much importance on the role of exports and not reflecting the true burden of debt on social spending.

There are also two main types of IMF conditionality that have generally affected the HIPCs adversely.[16] These include the fiscal criteria and privatization. With regard to the fiscal criteria, most IMF programs include low forecasts for budget deficits, even though there is hardly any evidence to indicate that higher budget deficits, especially when funded by grants, are damaging. The IMF is concerned that raising the budget deficit will help in increasing inflation, although many economists contend that inflation rates of up to 10 per cent do not act as a threat to macroeconomic stability. With respect to privatization, many new IMF programs have conditionalities that were ‘left over’ from previous IMF structural adjustment programs and are thus incorporated into the new programs. In certain cases, privatization led to job losses.

The goal of the Initiative is to enable countries to ‘exit’ from severe debt problems and come into a sustainable situation. Still, there are some doubts as to whether this objective will be achieved. In some instances, the debt burden is heavy, and in some continues to rise, even after the relief has been provided.[17] Again, export projections for HIPC seem to be unrealistic—for example, in four cases exports were projected to rise by over 9 per cent per annum for twenty years. [18]

Long term debt sustainability demands HIPCs to promote export growth and diversification. However, access for HIPC products to OECD markets continues to be a problem. Most HIPCs are very poor countries, thus benefiting under the Generalized System of Preferences (GSP) or are sub-Saharan African countries, thus covered by the American Growth and Opportunity Act (AGOA) or similar schemes conducted by some

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[15] See Kamidza *et. a*l (2002) for further elaboration.
[16] For a comprehensive analysis, refer to Greenhill and Sisti (2003).
[17] Countries where debt service in 2005 was estimated to exceed the 2000 level include Bolivia, Chad, Honduras and Uganda.
[18] See ‘PRSPS are Just PR say Civil Society Groups’ available in: http://www.BrettonWoods project.org/ topic/adjustment/a23prspsstats.html.

other OECD countries. Many of these schemes grant duty and quota free access to a large number of export products originating in these countries. However, stringent rules of origin requirements act as obstacles in realizing the full potential of the preferential arrangements.

A recent paper has highlighted a number of structural factors affecting the external debt sustainability of HIPC completion point countries.[19] It reveals that (i) while comparing favorably with other LICs, the policy and institutional frameworks of completion point countries in general are still quite weak, and their debt management practices remain inferior to international standards; and (ii) their export base remains narrow and fiscal revenue mobilization falls behind, even compared with many other LICs. According to this research, completion point countries will continue to encounter a dilemma due to their large priority financing needs for development on the one hand, and the need to maintain long-term debt sustainability on the other. To attain debt sustainability, these countries need to maintain macroeconomic stability and deepen reforms to improve policy and institutional frameworks, strengthen debt management, mobilize domestic revenues, and generate a climate conducive to attracting foreign direct investment and diversifying exports.

Finally, international credit-rating agencies have started issuing sovereign debt ratings for some LICs. Currently, thirteen of the 29 decision-point HIPCs are rated by the international rating agencies. Benin, Ghana, and Senegal have been rated B+ by Standard and Poor's; Ghana and Mozambique are rated B+ by Fitch. These are the highest ratings among the LICs; being three notches below investment grade, these ratings make it difficult for the countries to expand their access to international bond markets.[20]

An Evaluation Update of the HIPC Initiative[21]

According to the Independent Evaluation Group (IEG) of the World Bank, relief provided under the Enhanced HIPC Initiative has lowered debt ratios to half their levels in eighteen countries. However, in 11 of 13 countries for which data are available, the principal indicator of external debt sustainability has worsened since the completion point.[22] In eight of these countries, these ratios are greater than the HIPC thresholds. The rise in debt ratios is attributed to changes in discount and exchange rates. Improvement in the countries' exports and revenue mobilization have assisted to lower debt indicators, but this improved repayment capacity has been counterbalanced by increases in debt emanating from new borrowing. With new DSAs, six of eight post-completion point countries have just a moderate risk of debt distress, but they all are susceptible to export shocks, and need highly concessional financing and careful debt management.

[19] The structural factors are elaborated by Sun (2004).

[20] The creditworthiness of HIPCs that reach the completion point will be enhanced by additional debt relief under the MDRI. For details, see World Bank, *Op. Cit.*

[21] This section is based on World Bank Independent Evaluation Group (2006).

[22] The 11 countries are Uganda, Bolivia, Tanzania, Burkina Faso, Mauritania, Benin, Niger, Nicaragua, Guyana, Mozambique and Ethiopia. The other two countries studied were Mali and Senegal which have retained their debt ratios since completion point.

A country is deemed as having unsustainable debt and therefore eligible for HIPC assistance if its debt (calculated at NPV) to export ratios are above 150 percent or if its debt to revenue ratio are above 250 percent. The IEG study found that where the ratios are calculated, using debt to exports ratio, the ratios for these countries worsened from an average of 142 percent to 174 percent. Where the debt-to-revenues ratio was used, the ratios deteriorated from 181 percent to 218 percent on average.

Countries not yet at completion point—both decision-point and pre-decision point countries—have, on average, the lowest ratings of all the LICs and are liable to grave challenges in managing their economies that will affect their prospects of garnering the benefit of debt reduction. Fiscal and debt management are the major areas of concern in many HIPCs.

Debt relief was targeted to contribute to poverty reduction. The requisite to devise and implement a country-owned poverty reduction strategy has been an important and beneficial result of the Initiative. These strategies have focused more on social sector spending rather than on a more balanced approach to growth and poverty reduction. However, although HIPC governments are increasing their expenditures on education as a share of GDP and total expenditures, they are spending the same or less, on health, agriculture and transportation.

The HIPCs possess weak capacity to manage their public debt. The performance in public debt management has worsened in all the LICs. Experiences demonstrate that just debt reduction is not a sufficient mechanism to affect the multiple drives of debt sustainability. Sustained improvements in export diversification, fiscal management, the terms of new financing, and public debt management are required, actions that are beyond the purview of the HIPC Initiative.

The HIPC countries' debt management strategies have contributed to debt distress. Officials responsible for debt management in the HIPCs are generally careful to ensure that new loans meet country requirements for concessionality, but are not able to assess the impact of new borrowing on long-term debt sustainability and on macroeconomic scenarios.

Overall, unless debt relief efforts are combined with suitable debt management strategies, appropriate strategies for revenue mobilization and fiscal management as well as policies to stimulate economic growth, debt relief measures will not lift these countries out of the debt trap.

Individual Country Experiences

Experiences of two countries that have reached the completion point of the Enhanced HIPC Initiative are analyzed below. While Ghana entered this Initiative after meeting the fiscal revenue criteria, Zambia reached the decision point after fulfilling the export criteria.

Ghana[23]

Despite economic reforms undertaken since the 1990s, Ghana’s economy posted only modest growth with successive bouts of high inflation and unsustainable balance of payments deficits. The country’s experience was similar to many poor Sub-Saharan African countries, which continued to see worsening economic conditions resulting in unacceptable levels of poverty and high levels of external debt. The factors responsible for this state of affairs included poor domestic policies, deteriorating terms of trade and a high debt burden.

Ghana has had a history of debt servicing problems during which it had difficulties in honouring its external debt servicing obligations. This was due to the fact that a) Ghana was on many cases in arrears in servicing its debt; b) it requested the Paris Club of bilateral creditors to reschedule its debt; and c) it had to turn to borrowing regularly from the non-concessionary window of the IMF such as the Standby Facility.

Ghana's external debt remained unsustainable even after taking advantage of traditional debt-relief mechanisms. At the end of 2000, the NPV of debt-to-revenue ratio was estimated at 570.3 percent and was projected to be above 250 per cent until 2008. With an export-to-GDP value of 37 per cent and a fiscal revenue-to-GDP ratio of 17 per cent, the country qualified for debt relief under the fiscal revenue/openness criteria.

In February 2001, the Government decided to opt for the enhanced debt relief in order to stabilize the economy that was then characterised by rapid exchange rate depreciation, high inflation and low external reserves.

In the aftermath of the adoption of the HIPC Initiative, the level of debt servicing has experienced a declining trend. The amount of debt service payments dropped from US$ 544.8 million in 2000 to US$ 306.6 million in 2001. The figure is below the average of US$ 458.7 million of debt paid during the period 1994-2003. Ghana benefited from a significant reduction in debt servicing in 2003, with a reduction in debt servicing of about 38.1 per cent to US$ 126.2 million in 2003 as against the previous year’s figure in nominal terms.

The sustainability analysis from the completion point document demonstrates that Ghana’s external debt would remain sustainable during the projection period 2004-2023. The trajectory of the NPV of the external debt-to-exports ratio reveals a steep decline from levels above 200 per cent before the completion point, to fairly stable levels below 125 per cent after the completion point. Over the same period, the NPV of external debt-to-government revenue is projected to go down steadily from 350 per cent to 118 per cent.

In accordance with the significant stock of debt decline, debt service after HIPC relief is estimated to average 4.7 per cent of exports and 6.2 per cent of revenue over the period 2004-2023, both with stable profiles. These figures compare favourably with the 10-year average pre-HIPC debt service levels (on commitment basis) of 21 and 30 per cent. External debt-to-government revenue ratio is expected to decrease over the foreseeable

[23] Most of this information is based on Bank of Ghana (2005).

future to acceptable levels. Hence, Ghana's external debt will remain sustainable after the debt relief and cancellations.

Ghana has made some progress in poverty reduction since entering into the Enhanced HIPC Initiative as more funds have been allotted to the development of pro-poor priority areas of the economy. Poverty-related expenditures (constituting about 29.2 per cent and 27.3 per cent of total government expenditures in 2003 and 2004, respectively) have risen significantly since the Ghana Poverty Reduction Strategy (GPRS) was initiated.

Health sector expenditure has also expanded in comparative terms. The expenditure on the health sector rose by 27 percent in 2004 compared to 2003. The share of primary health care in total expenditure on the entire health sector was 77.9 percent in 2003 and 84.4 percent in 2004. The trend in these elements of expenditure divulges that the availability of the HIPC debt relief has made a significant improvement of government expenditure on social services.

Ghana reached the completion point on July 2004 after fulfilling most of the conditions (Box 1). To reach this point, the country had committed to: develop a PRSP and satisfactorily implement the strategy for at least one year; maintain macroeconomic stability; and initiate key structural reforms and social measures monitored under the Initiative, as agreed at the decision point. All but one of the specified triggers was completed. The trigger that was not satisfied concerned the implementation of an automatic adjustment formula for petroleum pricing.[24]

Box 1
Ghana: Triggers for the HIPC Floating Completion Point

Triggers	Status
PRSP. Preparation of a full PRSP and satisfactory implementation for at least one year, as evidenced by the joint assessment of the country's annual progress report.	*Completed.*
Macroeconomic stability. Continued maintenance of macroeconomic stability as evidenced by satisfactory implementation of the PRGF-supported program.	*Completed.*
Use of budgetary savings. The use of budgetary savings from interim debt service relief have been used in the priority areas and monitored in the framework for poverty reduction expenditures. Information on the use of these savings and on poverty expenditures has been published in time to be considered in a public review of GPRS implementation, as input to the annual progress report on the GPRS. The increase in total spending on these priorities must equal or exceed HIPC relief (relief used for domestic debt reduction) during the interim period.	*Completed.*

[24] It was due to the impending elections that the implementation of this reform was deemed infeasible before early 2005, raising the issue as to whether the completion point should have been delayed until the new regime was in place. However, implementation of the new pricing regime was established as a strict condition for the completion of the third review under the PRGF arrangement with the Fund. For details, see IMF (2004).

Governance • Procurement reform. Regulatory and oversight body to implement new procurement code has been established.	*Completed.*
• Internal audit. Operational internal audit capacity has been established through full staffing of existing internal audit positions.	*Completed.*
Public expenditure management • Reports on cash expenditures and commitments by government ministries, departments and agencies (MDAs), classified by function, have been published monthly in the government gazette, following implementation of new reporting system.	*Completed*
• A computer-based financial management information system to underpin the new expenditure reporting system has been installed on a pilot basis in the Ministry of Finance, Controller and Accountant General's Department, and at least two key sector ministries.	*Completed.*
Decentralization of government functions • Devolution of responsibilities to local districts, as evidenced by (i) submission to parliament of a local service bill to enable the decentralization of human resource management to local authorities; and (ii) development of District Composite Budgets in pilot districts.	*Completed.*
Education • The primary gross enrolment rate for girls has increased from 72 percent in 2000 to 74 percent.	*Completed.*
Health • The percentage of households with access to safe water has increased from 40 percent in 2000 to 46 percent in rural areas.	*Completed.*
• Recurrent health expenditures at district and lower level governments have risen from 42 percent of the total recurrent health budget in 2000 to 45 percent.	*Completed.*
Energy Sector • An automatic price adjustment mechanism has been put in place and implemented monthly to reflect changes in international market prices in local currency in the petroleum sector, and includes all axes incorporated into adjustment formula at end-March 2002.	*Incomplete.* Pricing formula was put in place in 2003 but has not been implemented. A new regulatory regime that will give freedom to oil market companies to set prices (according to a prescribed formula), and that credibly removes government influence over pricing decisions, would be announced by the cabinet.
• A strategy for achieving full economic pricing in the electricity sector, including lifeline pricing to ensure affordability for low income users, has been implemented.	*Completed.*

Source: IMF (2004).

Zambia[25]

When Zambia signed a new agreement with the IMF after a two-year hiatus in June 1989, the debt to GDP ratio was over 200 percent and resulted in a period of hyperinflation and the virtual collapse of the currency. In the 1990s, with a change of government and the introduction of a multi-party political system, Zambia undertook free-market reforms. As part of the World Bank and IMF's enhanced structural adjustment program, the country quickly went for a massive privatization of state-owned enterprises, turning 80 percent of the economy over to the private sector; the *kwacha*, the local currency, depreciated as the exchange rate and interest rates were floated; trade barriers were dismantled; civil service was restructured and downsized; subsidies were prohibited and cost recovery measures in the social sector were introduced.

As an upshot of the above measures, inflation fell from 93 percent in 1991 to 16 percent in 2002 and the country registered an economic growth of 3.5 percent in 2000, rebounding from a contracting economy in the early 1990s. The social cost though was huge as many lost their jobs, and fewer people could afford even the most basic of services.

To make things worse, by December 2000 the country's debt totaled US$ 7.3 billion and Zambia was barely able to make its payments on its burden. With US$ 606 million in debt payments due in 2001, the country was accepted into the first stage of the HIPC program in 2000. On reaching the decision point, it instantly received a 50 percent debt reduction.[26]

The country reached the completion point in April 2005 after an 'on-off-on-off' experience with the IMF and the World Bank prescribed policies. The completion point triggers are spelled out in Box 2.

Box 2

Zambia: Completion Point Triggers

HIPC Program	Comments
Poverty Reduction	
The adoption of a PRSP to be prepared through a participatory process and satisfactory progress with implementing and monitoring the PRSP for at least one year based on an annual report.	*Implemented.*
Macroeconomic Performance	
Maintenance of stable macroeconomic environment as evidenced by satisfactory performance under a program supported by PRGF performance.	*Implemented.*

[25] Most of this information is taken from Bloemen.

[26] Normally, countries are first forced to wait till they have qualified by satisfying certain conditions, usually a three-year process, before they actually were eligible for debt relief. But in Zambia's case, creditors knew that the country would simply not be able to meet the payments due in 2001.

Social Sectors	
Progress in Combating AIDS	
Full staffing of secretariat for National HIV/AIDS/STD/TB Council	*Implemented*.
Integration of HIV/AIDS awareness and prevention programs in the pre-service and in-service programs for at least ten key ministries.	*Implemented.*
Progress in Education Reforms	
Increasing the share of education in the domestic discretionary budget from 18.5 percent in 1999 to at least 20.5 percent.	*Implemented*.
Raising the starting compensation of teachers in rural areas above the poverty line or for a household, as defined by the Central Statistical Office.	*Implemented.*
An action plan for increasing student retention in Northern, Luapula, Eastern, Northwestern, and Western Provinces.	*Implemented.*
Progress in Health Sector Reforms	
Implementation and scaling-up of an action plan for malaria.	*Implemented.*
Procedures and mechanisms for the procurement of drugs reorganized to be fully transparent and efficient	*Implemented.*
Timely release of complete, detailed, annual health expenditure data.	*Implemented.*
Actual cash release to District Health Management Boards to be at least 80 percent of the amount budgeted.	*Implemented.*
Key structural Reforms	
Restructuring and issuance of international bidding documents for the sale of a majority (controlling) interest in Zambian Electric Supply Company (ZESCO).	*Not implemented*. An understanding was reached in April 2003 between the Government of Zambia, IDA, and the IMF that commercialization of ZESCO would be pursued in lieu of restructuring and privatization as originally envisaged. Satisfactory progress has been made in implementing this alternative strategy.
Issuance of international bidding documents for the sale of a majority (controlling) interest in the Zambia National Commercial Bank (ZNCB).	*Not Fully Implemented*. International bidding documents were issued in May 2002 for the sale of a 51 percent share of ZNCB. Revised bidding documents were issued in March 2003 to reflect the fact that the Government of Zambia decided to alter the structure of the proposed privatization transaction to divest a 49 percent share with management control. The Government selected a preferred bidder and a reserve bidder in May 2003. Negotiations with the preferred bidder were substantially concluded in August 2004; however, the preferred bidder's negotiating team was unable to secure approval of the agreement from its board. No agreement was reached with the reserve bidder. Given preliminary interest expressed by other parties to participate in the divesture of ZNCB, the Zambia Privatization Agency terminated negotiations with the preferred and reserve bidders on March 15, 2005, and would promptly issue a new invitation to bid.

Public Expenditure Management	
Implementation by Ministry of Finance and Economic Development (MoFED) of an Integrated Financial Management Information System (IFMIS) on a pilot basis for at least three ministries and a mid-term review of the pilot program.	*Not Implemented*. Although the IFMIS pilot implementation trigger has not been met, most preparations for pilot implementation have been completed.
Implementation of a Medium-Term Expenditure Framework (MTEF) prepared by MoFED and approved by cabinet.	*Implemented*.

Source: IMF (2005b).

Soon after reaching the completion point, the majority of the Paris Club creditors wrote off 100 percent of Zambia public and publicly guaranteed debt. Preliminary official data show that total external debt declined by 7 percent to US$6.6 billion at end-June 2005 from US$ 7.1 billion in 2004.[27] Moreover, Zambia qualified for write-off of 100 percent of its debt to the AfDF, the IMF and the World Bank under the MDRI.

Zambia's 2006 national budget shows that with debt relief in place and good planning, it is possible to raise allocations to the social sector. For 2006, the budgetary allocations to the social sectors stood at 30 percent of the total budget—the highest in recent years. These increased allocations have been set aside for areas such as recruiting personnel in the education and health sectors, infrastructure development, purchase of drugs, and provision of food supplements especially for people living with HIV/AIDS. The Government has pledged to hire 800 medical personnel and slightly over 4000 teachers. Moreover, 71 percent of the national budget is to be domestically financed leaving 29 percent as donor financing. This implies that debt relief has given the Government fiscal space to satisfy most of its financing needs locally.

Budgetary savings from interim HIPC debt relief have been generally utilized as per the criteria set forth at the decision point. Given that the Bank of Zambia faced large debt service obligations, whose nonpayment could have resulted in a curtailment of non-HIPC donor assistance, HIPC interim debt relief accruing to the Bank of Zambia was designated for debt service payments. The remainder has mostly been allocated to priority poverty-reducing programs, which focused on investments in infrastructure, support for small-scale farmers and food security, and increased expenditures in the social sectors, in particular, education.

The Government created an expenditure tracking system that allows for explicit identification of savings from interim HIPC debt relief. Under this arrangement savings of debt service accruing to the government were directed to priority poverty-reducing programs. To facilitate monitoring, funding for these programs was channeled through a special account at the Bank of Zambia.

The reaching of the HIPC completion point in Zambia prompted a number of economic phenomena and key among them is the appreciation of the local currency—the *Kwacha*—toward the latter part of 2005 and early 2006. However, this seems to be a genuine

[27] For details, see Zulu (2006).

response of the currency to a changing economic climate emanating from Zambia's attainment of the HIPC completion point. Countries that have attained the completion point have generally witnessed appreciations in their domestic currencies against foreign currencies. A trend analysis of selected post-HIPC countries such as Ghana, Tanzania, Uganda and Mozambique discloses all of these countries experienced an appreciation of their local currencies against major convertible currencies.[28]

IV. NEPAL AND THE HIPC INITIATIVE

Background

The debate pertaining to Nepal's participation under the HIPC Initiative has taken a new shape as Nepal was found potentially eligible for debt relief under this Initiative after it met the criteria which included the following: a) the country is IDA-only and PRGF eligible; b) the country has a full PRSP in place since May 2003; and c) the NPV of debt-to-exports ratio is higher than the threshold based on end-2004 data. It is against this background that this section attempts to discuss the recent trends of external debt in the country by analysing the debt burden indicators. Relevant issues that need to be sorted out by Nepal prior to its decision on participation under the HIPC Initiative are also scrutinized.

Outstanding External Debt

The outstanding external debt of Nepal, which stood at US$ 2.66 billion at mid-July 2001 rose to US$ 3.14 billion at mid-July 2006.[29] The external debt has, thus, increased at an average annual growth rate of 3.36 percent in the last five years. But during the same period, the external debt/GDP ratio has declined from 48 percent to 39 percent while the external debt/revenue ratio has declined from 401 percent to 309 percent. Hence, the external debt/government revenue and the external debt/GDP ratios have been more favorable in FY 2005/06 compared to FY 2000/01. However, the external debt/exports ratio has moved up from 229 percent in 2000/01 to 255 percent in 2005/06 (Table 1).

[28] *Ibid*. Other factors for the appreciation of the *Kwacha* include the increase in donor inflows, upsurge in foreign direct investment inflows and reduced demand for foreign exchange by the Government (as the Government no longer requires significant amount of foreign exchange in order to service foreign debt since a large part of it was cancelled at the completion point).

[29] External debt in this section refers to the medium and long-term external debt of the government only. The short-term loans, which includes trade credits and private external debt are very nominal and excluded.

Table 1 : External Debt and Debt Service (US$ in million)

	2000/01	2001/02	2002/03	2003/04	2004/05	2005/06
			(in millions of US$)			
Outstanding external debt stock	**2657.9**	**2800.6**	**2965.7**	**3114.1**	**3096.2**	**3135.9**
of which:						
IDA	1102	1156	1234	1381	1414	1434
AsDB	1043	1132	1147	1207	1199	1235
IFAD	55	57	60	63	62	63
Debt - service	**84**	**85**	**97**	**107**	**112**	**127**
Amortization	61	62	71	78	83	97
Interest payment	23	24	26	29	30	30
			(in percent)			
Debt/GDP	48	51	51	46	42	39
Debt/Exports*	229	303	299	257	260	255
Debt/Revenue	401	427	410	369	318	309
Debt-servicing/GDP	1.5	1.6	1.6	1.6	1.5	1.6
Debt-servicing/Exports*	7.2	9.2	9.7	8.8	9.4	10.3
Debt-servicing/Revenue	12.7	13.0	13.4	12.7	11.6	12.5

* Exports refer to export of both goods and services.

Source: Ministry of Finance and Computations.

Creditor Composition of External Debt

While the share of multilateral creditors in the total external debt of Nepal increased from 85.4 percent in 2000/01 to 89.2 percent in 2005/06, the share of bilateral creditors has decreased from 14.6 percent to 10.8 percent in the same period. Among the multilateral creditors, the IDA is the leading creditor. Of the nominal external debt-stock of US$ 3.1 billion at mid-July 2006, IDA alone accounts for 45.7 percent. The Asian Development Bank (AsDB) is the second largest creditor constituting 39.4 percent of the country's outstanding external debt as at mid-July 2006. Other major multilateral creditors of Nepal include Organization of Petroleum Exporting Countries (OPEC), Nordic Development Fund (NDF), European Economic Community (EEC) and International Fund for Agriculture Development (IFAD). Among the bilateral creditors, Japan is the largest creditor comprising 8.6 percent of the total external debt as at mid-July 2006.

The analysis for Nepal's eligibility for HIPC Initiative undertaken by the IMF is based on end-2004 data. Of the total external debt-stock of US$ 3.25 billion outstanding at end-2004, the IDA constituted about 46 percent while the AsDB accounted for 41 percent. The net present value (NPV) of end-2004 level of external debt after traditional debt-relief stood at US$ 2.15 billion. In terms of debt-burden at end-2004, the AsDB loan constituted the heaviest debt-burden comprising about 47.2 percent of the total NPV of debt followed by IDA loan comprising about 40.4 percent of the total NPV of debt (Table 2).

Table 2 : Debt-stock by Major Creditors as at End-2004.

	Nominal (mil. US$)	% share	NPV (mil. US $)	% share
External debt stock (DOD)	**3250.8**	**100.0**	**2153.5**	**100.0**
a. Multilateral	**2962.9**	**91.1**	**1970.0**	**91.5**
o/w AsDB	1342.7	41.3	1017.3	47.2
o/w IDA	1494.6	46.0	869.3	40.4
o/w IMF	22.1	0.7	16.5	0.8
o/w IFAD	66.0	2.0	41.3	1.9
b. Official Bilateral	**287.9**	**8.9**	**183.5**	**8.5**
Paris Club	252.6	7.8	163.6	7.6
o/w Japan	167.6	5.2	122.7	5.7
Non Paris Club	35.3	1.1	19.9	0.9
o/w Kuwait	6.9	0.2	4.0	0.2

Source: IMF Staff Estimates.

Debt-servicing and Debt-burden Indicators

External debt servicing, which comprises both amortization and interest payment, had gradually risen from Rs. 84 million in 2000/01 to Rs. 127 million in 2004/05. As percentage of GDP, debt servicing has been fluctuating between 1.5 percent and 1.6 percent during the last five years. The debt-servicing/exports ratio has gone up from 7.2 percent in 2000/01 to 10.3 percent in 2005/06 whereas the debt-servicing/revenue ratio has marginally decreased from 12.7 percent to 12.5 percent during the same period (Table 1). The responsible factor for the low ratios of debt servicing to export and revenue as compared to the size of external debt-stock was primarily the high concessionary terms (with an average grant element of close to 50 percent) on the loans contracted to Nepal.[30]

Debt-burden indicators compare debt service and debt stock with various measures of a country's repayment capacity. Repayment capacity may be measured by the GDP, exports and revenues. While the GDP captures the amount of overall resources, exports provide information on the availability of foreign exchange. Revenues depict the government's ability to generate fiscal resources.

[30] The concessionality of loan is tested on the basis of the Development Assistance Committee's (DAC) definition. According to the DAC's definition, concessionary lending refers to lending with original grant element of 25 percent or more using 10 percent rate of discount. However, major development banks such as the World Bank and the AsDB employ their own measuring rod to determine concessionality.

Debt service based indicators are very crucial for analyzing whether or not a country is likely to face debt-servicing difficulties in the short run. They are, however, likely to be inadequate for predicting future debt servicing problems, since the repayment of concessional loans usually increases as a loan matures. Current debt service ratios, therefore, tend to understate the future debt service burden.

Debt stock indicators are generally used to assess potential solvency concerns providing information about future debt servicing commitments and prospective payment difficulties if a country's capactiy to repay does not expand. The debt stock, as measured by the nominal value of the debt or its NPV, is the sum of either the entire stream of future repayments or the sum of discounted future debt service payments. Since the share of concessional debt in total external debt is large for the LICs such as Nepal, the NPV of debt is preferred to the nominal stock as a debt stock indicator for external debt.

The debt-burden indicators are computed differently under the framework of HIPC-DSA and LIC-DSA (low income countries debt sustainability analysis). The HIPC-DSAs, which are conducted at the decision point and again at completion point, forms the basis for determining the amount of debt relief to be granted under the HIPC Initiative. The LIC DSA, on the other hand, is prepared annually for all the LICs, including the HIPCs, and helps decide the terms of each country's IDA financing. For HIPCs, the two DSAs are conducted side by side. One major difference between these two DSAs is that while the LIC-DSA employs a single discount rate, the HIPC-DSA uses currency-specific short-term interest rates for computing the NPV of external debt.

Tables 3 and 4 exhibit the debt-burden indicators of Nepal calculated under the HIPC-DSA and LIC-DSA framework, respectively. Based on the HIPC-DSA data as of end-2004, the NPV of debt to exports ratio of Nepal stood at 198 percent, which is well above the HIPC threshold of 150 percent. Similarly, the NPV of debt/revenue ratio stood at 255 percent exceeding the HIPC threshold of 250 percent. Thus, based on the end-2004 data, Nepal qualifies for the participation under the Enhanced HIPC Initiative. As of mid-July 2006, the estimated NPV of debt to exports ratio and the NPV of debt to revenue ratio of Nepal have decreased to 171 percent (still above HIPC threshold) and 204 percent, respectively.[31]

The indicative threshold regarding debt sustainability under LIC-DSA depends on the Country Policy and Institutional Assessment (CPIA) rating.[32] Nepal is rated as a medium policy performer and thus the indicative thresholds for Nepal are set at NPV of debt/exports ratio of 150 percent and NPV of debt/revenue ratio of 250 percent. At mid-July 2006, the corresponding ratios stood at 169 percent and 205 percent, close to the figures obtained from the HIPC-DSA.

[31] The NPV of debt at mid-July 2006 is estimated while the exports and revenues are the provisional figures.

[32] The CPIA is intended to evaluate the quality of a country's present policy and institutional framework. Quality implies how conducive that framework is to fostering poverty reduction, sustainable growth and the effective use of development assistance. From 1999 to 2003, the CPIA evaluated 20 broad areas, each with 5 percent weight in the overall CPIA rating. The 20 areas were further divided into four categories: economic management, structural policies, policies for social inclusion/equity, and public sector management and institutions. For details, see World Bank Independent Evaluation Group (2006).

Table 3: Debt-burden Indicators (HIPC-DSA)
(in percent)

	HIPC threshold	end-2004	end-2005	Jul-06
NPV of debt/Exports[1]	**150**	197.8	168.8	171.3
NPV of debt/Revenue[2]	**250**	254.9	202.8	204.4
Revenue/GDP[3]	**15**	12.5	12.7	12.8
Exports/GDP[3]	**30**	17.1	16.6	16.4
Memorandum items:				
			(US$ in million)	
Nominal debt stock		3250.8	2979.3	3135.9
NPV of debt (after traditional debt relief)		2153.5	1973.7	2077.4
Exports [1]		1088.5	1169.6	1212.4
Revenue[4]		794.1	895.8	944.7
GDP[4]		6351.4	7033.9	7398.9

Note:
1 Exports refer to last three-year average of export of goods and non-factor services
2 Revenue refers to current year revenue of the central government excluding grants
3 Both numerator and denominator are calculated as average of the last 3 years.
4 Calculated as average of last 3 years

Source: IMF Staff Estimates and Computations.

Table 4: Debt-burden Indicators (LIC-DSA)
(in percent)

	Indicative threshold*	**2003/04**	**2004/05**	**2005/06**
NPV of debt, in percent of				
Exports	**150**	164.9	170.9	169.0
GDP	**40**	29.7	27.5	25.8
Revenue	**250**	236.8	209.5	204.7
Debt-service, in percent of				
Exports	**20**	8.8	9.4	10.3
Revenue	**30**	12.7	11.6	12.5
Memorandum items :				
NPV of debt (LIC-DSA)[+]		2000.5	2038.3	2080.0
Exports		1213.5	1192.9	1230.8
GDP		6731.9	7404.1	8060.7
Revenue		844.7	973.1	1016.3
Debt-service		107.2	112.4	126.6

Note :
+ : IMF staff estimate
* : Based on Nepal's CPIA rating as a medium policy performer.

Source: IMF Staff Estimates and Computations

Estimated HIPC Debt Relief

The amount of HIPC debt relief that a country will be able to receive depends primarily on the level of its NPV of external debt and the ratio of its NPV of external debt to exports at the decision point. Essentially, the amount of HIPC relief is the amount needed to bring the NPV of debt to exports ratio (NPV after traditional debt relief and exports as a three year backward looking average) down to 150 percent. It is assumed that the traditional debt relief from the Paris Club and other bilateral creditors would be on Naples term, that is, reduction of NPV by 67 percent. The possible debt-relief to Nepal under the HIPC Initiative and the MDRI as estimated by the IMF is depicted in Table 5. The estimation is based on the assumption that the HIPC relief would be starting in 2006-2009, and the MDRI relief would be provided at the completion point, assumed in 2009.[33] Based on the data of end-2004, the possible HIPC debt relief to Nepal is estimated to be about US$ 521 million in NPV terms. However, the computation based on the data available as at mid-July 2006 demonstrates that the NPV of debt to exports ratio of Nepal has declined to 171 percent. A quick estimate of the debt relief required for bringing down this ratio to the threshold level (that is, 150 percent) would be about US$ 259 million.

But for Nepal, the MDRI relief package that would follow the completion point is very significant. Under MDRI , 100 percent debt owed by Nepal to IDA and IMF (as at cut-off date) would be cancelled irrevocably. As compared to other Asian countries, the share of multilateral debt in Nepal's total external debt composition is very high (almost 90 percent at mid-July 2006). Moreover, IDA alone accounts for about 46 percent of Nepal's total external debt.

According to estimates of the IMF, Nepal could get a relief of US$ 672 million at NPV terms under MDRI assuming that Nepal would the reach completion point at 2009. Of this, the relief of US$ 660 million in NPV terms would be provided by the IDA while the remaining sum will be provided by the IMF. The total estimated MDRI relief is equivalent to 31.2 percent of Nepal's total external debt burden (in NPV terms) at end-2004. Thus, relief from the MDRI would significantly reduce the debt service of Nepal and help secure additional resource flows to attain the MDGs.

[33] At the present juncture, this assumption may not be very realistic as it is very unlikely that Nepal will enter the HIPC Initiative in 2006.

Table 5 : Potential HIPC and MDRI Debt Relief
(in millions of U.S. dollars)

	NPV terms 1/	Nominal terms 1/ 2/
Total estimated debt relief	1,193	1,755
Estimated HIPC relief	521	765
MDRI debt relief	672	990
IDA	660	971
IMF	12	18

1/ IMF Staff estimates.
2/ Estimated based on grant element of existing debt.

Source: IMF Staff Estimates.

Other Crucial Issues for Nepal

If a country faces a debt crisis, entering into the HIIPC Initiative could assist in lowering the debt distress. However, if the debt situation is manageable, it has been argued by some that costs may outweigh benefits from the country's participation in the Initiative.[34] For instance, problems may emanate when the government wants to raise funds from the foreign capital markets to finance priority investment needs.

Nepal's participation in the HIPC Initiative demands that it satisfy a range of completion point triggers which are basically the conditions for reaching the completion point. It is argued that problems could emanate in implementing the completion point triggers especially in the changed political context where consensus building through a participatory mode is required. However, it should be remembered that the conditions that Nepal would have to satisfy would be finalized through negotiations after Nepal reaches the decision point. It is possible to have a general idea on what would be the possible reform measures required to reach the completion point by reviewing the completion point triggers of the countries that have already entered in HIPC Initiative.[35] Moreover, waivers have been granted in respect of fulfilling the conditionalities as illustrated in Appendix 3.

If Nepal decides to participate, it would be the first Asian country to enter the HIPC Initiative. As under the MDRI where the IMF, the IDA of the World Bank and the AfDF are to cancel 100 percent of their debt claims on countries that have reached, or will eventually reach, the completion point under the enhanced HIPC Initiative, in the Nepalese perspective it is important to be clear on whether or not the AsDB would also be participating. This is because as pointed out earlier the AsDB is the second largest creditor accounting for almost 40 percent of the country's outstanding external debt as at mid-July 2006.

[34] Details are given by Dahal (2006) in the case of Nepal.
[35] For a detailed analysis of the completion point triggers of individual countries, refer to IMF (2006).

Another issue concerns Japan which is a principal bilateral creditor that has been providing support since long.[36] It has been stated that Japan Bank for International Cooperation (JBIC) does not lend to participants. However, in the case of Africa, the Government of Japan expressed its active commitment for the development of the African region by proposing an initiative, "Enhanced Private Sector Assistance (EPSA) for Africa", at the G8 Gleneagles Summit in July, 2005. Under this Initiative, the JBIC has worked with the AfDB to set up a scheme to promote cofinancing, whose objective is to support private sector development in countries that have reached the completion point of debt reduction under the HIPC Initiative.[37] If Nepal and other Asian countries decide on participating under the Initiative, it is possible to explore possibilities of setting up similar schemes between the JBIC and the AsDB.

V. CONCLUSIONS

While the original goal of the HIPC Initiative was to lower high external debt as a constraint to economic growth and poverty reduction, the Enhanced HIPC Initiative of 1999 aimed at providing a viable exit from debt rescheduling in order to promote growth, and to free up financial resources for more social spending to reduce poverty. The Enhanced HIPC Initiative has played its role in lowering the debt stocks of the 19 post-completion-point HIPCs, but only this is not adequate to ensure long-run debt sustainability in these countries. Long-term sustainability also depends on more efforts from both the HIPCs and the creditors to ameliorate export diversification, fiscal and public debt management, and to procure new financing on more generous terms and conditions.

Currently, Nepal is considered one of the eleven pre-decision point countries for participation under the HIPC Initiative. However, the debt-burden situation of Nepal has been gradually improving in the more recent years. The NPV of debt/exports and NPV of debt/revenue, critical ratios for HIPC eligibility, both have declined at mid-July 2006 from what they stood at end-2004, the data taken for assessing Nepal's eligibility for participation under the HIPC Initiative.

For Nepal, the debt relief from participation under the Enhanced HIPC Initiative may not be that valuable when compared to the relief emanating from the MDRI. However, to be eligible for the MDRI relief, it is mandatory for the country to reach the completion point of the HIPC Initiative. Again, as Nepal's debt profile is susceptible to shocks, as an external shock such as a significant depreciation of the rupee or a rapid decline in exports, or both, may lead to a situation of debt distress, participation under this Initiative calls for a re-consideration.

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[36] Japan has played a major role in the international initiative on debt relief for developing countries. According to Japan's Ministry of Foreign Affairs, Japan's total public claims (ODA and non-ODA) to the 40 HIPCs total about US$ 1.5 billion, the largest among the G8 creditors. Thus, as a country fully committed to implementing the Enhanced HIPC Initiative, Japan will be one of biggest contributors in terms of bilateral debt relief under the Initiative. Japan is also committed to supporting HIPCs with a wide range of ODA measures, regardless of whether or not they receive debt relief under the Initiative. Japan's assistance on debt problems of HIPCs are elaborated in Ministry of Foreign Affairs of Japan (2006).

[37] See JBIC (2006) for details.

The possible conditions and the reform measures that need to be additionally implemented if Nepal were to participate under the HIPC initiative, the level of existing concessionary foreign assistance that can be non-concessionary and the possible debt situation after reaching the completion point of the HIPC Initiative are some of the other issues that need a re-examination. Moreover, the country needs to develop a 'debt reform plan' and to strengthen debt management capacity. Experiences of other countries show that after being provided debt relief countries easily fall back into debt distress due to poor public debt management practices.

In the ultimate analysis, the country needs to improve its negotiating capacities and put in place transparent, accountable and participative mechanisms to assure that any available debt relief goes to poverty eradication programs.

Appendix 1

Salient Features of the HIPC Initiative and the MDRI

	HIPC Initiative	MDRI
Country coverage	IDA-only, PRGF-eligible countries with debt indicators above the HIPC Initiative thresholds, which have been engaged in qualifying IMF and IDA- supported programs.	HIPC countries having reached completion point.*
Participating Creditors	All multilateral, official bilateral and commercial creditors of external public and publicly guaranteed debt to HIPCs.	IDA, IMF and AfDF only.
Debt relief provided	External public and publicly guaranteed debt is reduced to the HIPC Initiative thresholds, as calculated at the time of the decision point.**	Debt disbursed before end-December 2004 (IMF and AfDF) and end-December 2003 (IDA) and still outstanding at the time of qualification (after the provision of HIPC Initiative debt relief) is reduced to zero.
Modality of delivery	Different modalities. Most multilateral and Paris Club creditors also provide interim debt relief.	Stock-of-debt operation at or shortly after the completion point.
Total costs of committed debt relief	US$ 41.3 billion in end-2005 NPV terms.	US$ 18.3 billion in end-2005 NPV terms.

* In addition, non-HIPCs with per capita income below US$ 380 also qualify for MDRI debt relief from the IMF.

** In exceptional cases, a country may also obtain additional HIPC Initiative debt relief at the completion point (topping up).

Source: IDA and IMF.(2006).

Appendix 2

List of Countries That Have Qualified for, are Eligible or Potentially Eligible and May Wish to Receive HIPC Initiative Assistance

Post-Completion Point Countries (19)		
Benin	Honduras	Rwanda
Bolivia	Madagascar	Senegal
Burkina Faso	Mali	Tanzania
Cameroon	Mauritania	Uganda
Ethiopia	Mozambique	Zambia
Ghana	Nicaragua	
Guyana	Niger	
Interim Countries (Between Decision and Completion Point) (10)		
Burundi	The Gambia	Sao Tome and Principe
Chad	Guinea	Sierra Leone
Republic of Congo	Guinea-Bissau	
Democratic Republic of Congo	Malawi	

Pre-Decision-Point Countries (11)		
Central African Republic	Haiti	Somalia
Comoros	Kyrgyz Republic	Sudan
Cote d'Ivoire	Liberia	Togo
Eritrea	Nepal	

Source: IMF and IDA (2006)

Appendix 3

Achievement and Waivers of Completion Point Conditions

Country	Waivers	Completion Point trigger waived or delayed
Benin	None	Barely missed targets in health and education; bank privatization, other benchmarks delayed.
Bolivia	One	Missed one fiscal target, but made advancements in tax administration and budget management; faced social unrest.
Burkina Faso	None	All targets met or exceeded
Ethiopia	Three	Severe drought delayed agricultural reform; census needed to confirm education reform; began consolidation of budgets.
Ghana	One	Committed to reform petroleum pricing, but has not implemented it; perception of corruption.
Guyana	Two	Did not reduce by 1,000 the core civil service, but reduced by 2,500 elsewhere; partially completed, and then re-formulated and completed new public sector modernization plan; policy drift during last few years; fiscal progress has eroded.
Honduras	One	Did not comply with Basel Core Principles
Madagascar	None	Barely missed teacher-recruitment target; budgetary execution laws late; repetition rates and primary school completion rates below targets; tax revenue short of target.
Mali	None	Initial delays caused some education targets to be only partially met; recruitment of health sector workers below target.
Mauritania	Five	Technical delays in privatizing utility; did not comply with risk-exposure ratio for banks; missed target for poverty reduction; missed target for survival rate at fifth grade and primary/secondary school enrollment; barely missed child vaccination target.
Mozambique	None	Missed target for strategic plan owing to expanded scope; some setbacks for structural reform.
Nicaragua	One	Has not divested from all public power-generating units, but not advisable anyway.
Niger	Two	Delay in impact evaluation of public health expenditure on poor; did not meet overly ambitious target for repetition rates.
Rwanda	One	Delay in privatization of one state-owned tea factory.
Senegal	Three	Child immunization target missed; utilization rates of primary health care centers missed; fiscal balance target missed, but owing to IMF requirements.
Tanzania	None	Delay in poverty analyses; exceeded requirements for several triggers; observed all quantitative criteria and most benchmarks.
Uganda	None	All conditions met.
Zambia	Three	International bidding documents for power company were not issued; unable to sell national bank; partially met trigger for pilot implementation of financial management information system; unpredictable fiscal policy.

Source: World Bank Independent Evaluation Group (2006).

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