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Debt Relief for Poor Countries

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Efforts to lighten the debt burden of poor countries go back at least two decades. The most recent, the enhanced HIPC Initiative, will provide faster and deeper debt relief to these countries while encouraging them to use the funds saved to fight poverty and raise living standards.

During the 1970s and early 1980s, many developing countries sharply increased their external borrowing. While middle-income countries borrowed mostly from private creditors, especially commercial banks, most low-income countries had less access to private finance and borrowed directly from other governments or official export credit agencies, or obtained private loans insured by the latter.

When many low-income countries began to have difficulty servicing their debts—paying the interest and principal on the scheduled due dates—in the early and mid-1980s, most of the private commercial lenders quickly reduced their exposures, but official creditors were willing to take risks well beyond those acceptable to the private lenders. The informal group of official creditors known as the Paris Club rescheduled many of the payments on their loans as they fell due ("flow rescheduling"), and the IMF, the multilateral development banks, and the export credit agencies offered the debtor countries new loans to support the economic adjustment programs they were now undertaking. The then Soviet Union also continued to provide substantial financing to countries with which it had close ties.

Under the Paris Club flow reschedulings, creditors accepted delays in payments falling due during the term of a policy reform program supported by the IMF. The amounts due were rescheduled for eventual repayment over the medium and longer term. As the 1980s progressed, the Paris Club increasingly agreed to reschedule most or all of the principal and interest payments falling due for poor countries seeking rescheduling. From 1976 to 1988, it agreed 81 nonconcessional flow reschedulings with 27 of the countries now identified as heavily indebted poor countries (HIPCs), delaying payments of about $23 billion (Table 1).

Table 1
Paris Club reschedulings by type of terms, 1976-98

	Date	Number of resched-ulings	Number of countries	Amount consolidated (million dollars)	Stock or flow	Stock operations (million dollars)
Nonconces-sional	Before October 1988	81	27	22,803	flow deals only	...

Toronto terms	October 1988-June 1991	28	20	5,994	flow deals only	...
London terms	December 1991-December 1994	26	23	8,857	flow deals only	...
Naples terms	Since January 1995	34	26	14,664	7 stock deals	2,518
Lyon terms	Since December 1996	5	4	2,775	2 stock deals	709

Source: IMF staff estimates.
... Denotes not applicable.

This approach provided the poor countries with substantial cash-flow relief and financing for their reform programs, but their stock of outstanding debt steadily increased. As a result, the debt service paid by HIPCs increased on average from about 17 percent of exports in 1980 to a peak of about 30 percent of exports in 1986.

Toronto terms to Naples terms

The year 1987 marked a watershed in the wealthy countries' approach to the poor countries' debt burden. The United Kingdom argued that Paris Club commercial loans to poor countries should be rescheduled at below-market interest rates. It was the first time anyone had proposed rescheduling on concessional terms commercially priced debt owed to export credit agencies. Lowering interest rates on outstanding debt would reduce its present value, forcing governments to formally acknowledge and finance losses on the past activities of their export credit agencies. That same year, at the summit of the Group of Seven countries in Venice, Michel Camdessus, then IMF Managing Director, put forward a plan for a new, concessional IMF lending window for low-income countries—the Enhanced Structural Adjustment Facility (ESAF)—to be financed by grants from the wealthy countries.

Both proposals were driven by the desire to keep the poor countries' debts from growing to the point where they would be unsustainable. At that time there was no explicit agreement on how to define an unsustainable debt burden—in part because the question of whether a debt is repayable or unsustainable ultimately depends on the overall combination of net flows to the country, including expected flows of grants and new concessional loans. Nonetheless, most creditors accepted that there was a need to put a cap on new nonconcessional lending and refinancing to the poorest countries. Under a flow rescheduling, creditors could agree to receive no payments at all during the consolidation period (the period of the country's economic adjustment program) except for interest on the rescheduling (moratorium interest); in exceptional circumstances, creditors even agreed to defer this. Even so, with payments being rescheduled at market interest rates, the present value of the debt was not reduced. Although the debtor countries were often able to deal with their cash-flow problems, at least temporarily, many were building up a "debt overhang"—with the associated risk that an excessive stock of debt might act as a disincentive to economic reform since debtors could perceive the creditors to be the major beneficiaries from economic adjustment. There was a risk that requests for higher debt repayments would act as a tax on adjustment and investment.

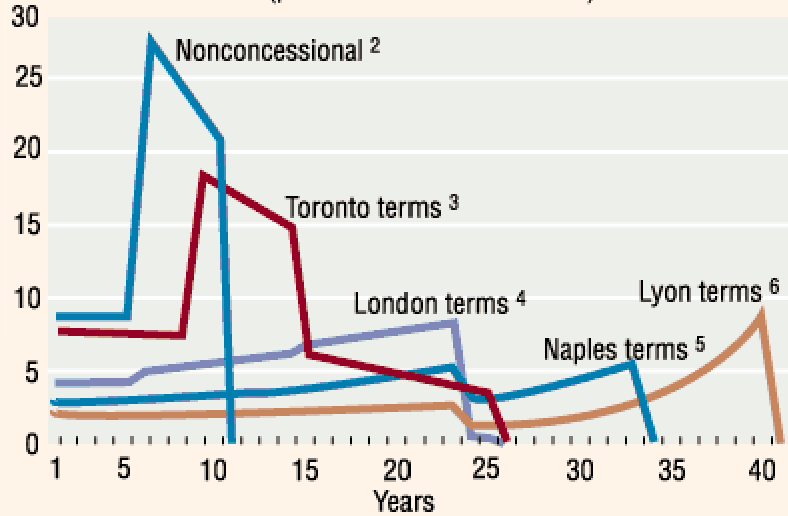
While the United Kingdom proposed lowering interest rates on rescheduled loans, France suggested reducing payments falling due by a third and rescheduling the balance at appropriate market interest rates. Another major creditor, however, was unable at that time to accept any form of present-value reduction that would result in an accounting loss; it therefore agreed to reschedule its loans with longer grace periods—although this would not affect the book value of outstanding loans, which continued to be valued at 100 cents on the dollar. A compromise was reached at the Group of Seven summit in Toronto in 1988. Paris Club creditors could exercise any of the three options, known as the "Toronto terms," which were considered to be more or less comparable.

From 1988 to 1991, the debts of 20 low-income countries were rescheduled on Toronto terms. About $6 billion of payments falling due were either partially canceled or rescheduled at below-market interest rates. By 1990, however, it was clear to many Paris Club creditors that the concessions provided under the Toronto terms would be insufficient to prevent the continued and unsustainable rise of the stock of debt. Although the Paris Club had the tools to continue to provide immediate cash-flow assistance to low-income countries during the period of an adjustment program, the debt-service profiles associated with the agreements were increasingly seen as unrealistic and thus likely to trigger further requests for rescheduling when the payments eventually fell due (see Chart 1). In September 1990, John Major, then U.K. Chancellor of the Exchequer, argued at the Commonwealth finance ministers' meeting in Trinidad that a present-value reduction of two-thirds (67 percent) of the stock of debt would be more realistic, that the full stock of eligible debt needed to be addressed in a single operation, and that the debt relief should be front loaded so that repayment profiles would rise steadily over time—in line with the assumption that the debtor countries' ability to pay would eventually increase.

Chart 1

Repayment profiles for low-income rescheduling countries[1]

(percent of amounts consolidated)



Sources: Paris Club, and IMF staff estimates.

[1] Assuming a market interest rate of 8 percent.

[2] Assuming equal principal repayments over 10 years of maturity and 5 years of grace.

[3] In present-value terms, a reduction of from 0 to 33 percent depending on option chosen by the creditor. Illustration is based on actual distribution.

[4] In present-value terms, a 50 percent reduction. Forty percent of creditors chose the debt-reduction option, 45 percent the debt-service reduction, 10 percent capitalization of moratorium interest, and 5 percent long maturities. Based on actual distribution.

[5] In present-value terms, a 67 percent reduction. Forty-five percent of creditors chose the debt-reduction option, 45 percent the debt-service reduction, and 10 percent capitalization of moratorium interest. The long maturities option is not included, given that any creditor choosing this option undertakes best efforts to change to a concessional option when feasible.

[6] In present-value terms, an 80 percent reduction. Fifty percent of creditors chose debt reduction, while 50 percent chose debt-service reduction.

Instead, in 1991, Paris Club creditors agreed to increase the degree of concessionality to 50 percent—the so-called London terms—with the possibility of extending the concessional terms to the full stock of debt after a certain period—typically three years—of good economic performance. It was not until the Naples economic summit in 1994 that the Paris Club reached a consensus on increasing the concessionality of the reschedulings to 67 percent; since January 1995, the low-income countries' debts have been rescheduled on Naples terms. Between 1991 and mid-1999, 26 rescheduling agreements were signed on London terms and 34 on Naples terms—7 of the latter covering the full stock of eligible debt. About $25 billion in payments were either partially forgiven or rescheduled at low interest rates over the medium and long terms.

The HIPCs, most of which are in sub-Saharan Africa, continued to find it difficult to meet their external debt-service obligations; many still required regular rescheduling of their bilateral debts. They failed to achieve sustainable debt levels despite the various Paris Club initiatives. In the fall of 1996, the IMF and the World Bank launched the HIPC Initiative, which was different from earlier initiatives in that it was the first to involve debt relief from multilateral creditors like the IMF and the World Bank. Under the HIPC Initiative, all creditors would participate in the comprehensive workout of a country's debts, so as to bring the stock of debt down to the sustainability thresholds established by the international community. Paris Club creditors agreed to increase the concessionality of their reschedulings to 80 percent under the Lyon terms. In 1999, following the Cologne Group of Seven summit, the HIPC Initiative was modified to give faster and greater relief to countries with a track record of implementing reform programs. The enhanced HIPC Initiative lowered the debt-burden ratios defining sustainability to a present value of debt of 150 percent of exports or, in some cases, 250 percent of fiscal revenues. Debt service is not normally expected to exceed 15-20 percent of export receipts, and the enhanced initiative strengthened the link between debt relief and spending on poverty reduction programs (countries receiving assistance must draw up a poverty reduction strategy paper with civil society participation and must implement it over a specified period of time). As a result of the enhanced HIPC Initiative, debt-burden ratios for HIPCs are expected to drop to levels not seen since the 1970s.

Cost of debt relief

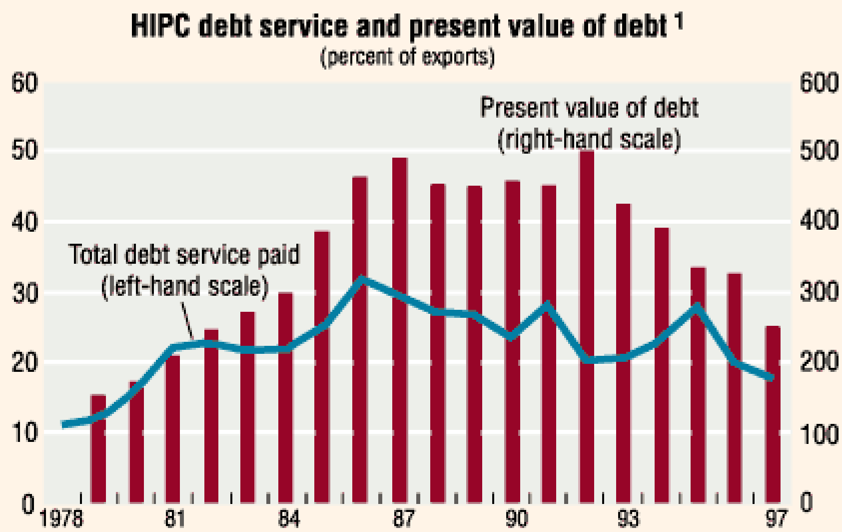
The amount of debt relief low-income countries received from the traditional mechanisms that preceded the HIPC Initiative can be measured in two principal ways: (1) as cash-flow relief, which is generated whenever debt-service payments falling due are canceled, rescheduled, or temporarily deferred; and (2) as a reduction in the present value of outstanding debt. The distinction between these two definitions is important, although it is often shrouded in confusion. The cash-flow relief produced by a flow-rescheduling operation is important for countries facing immediate, severe balance of payments or fiscal constraints, but the relief is limited to the consolidation period and it adds to future debt-service obligations. The present-value reduction measures the discounted stream of all future debt-service payments that are forgiven as a result of the operation and thus captures the concessional element involved, thereby allowing meaningful comparisons to be made between the amounts of debt relief offered by different mechanisms. Estimates of debt relief reported below focus on the present-value effects of the various debt-relief mechanisms.

The Paris Club is estimated to have provided about $19 billion of present-value relief under its concessional rescheduling terms between 1988 and 1999. The debt-reduction facility operated by the International Development Association—the World Bank's concessional financing arm—accounts for a further $4 billion of relief, making a total of about $23 billion, excluding Russia and non-Paris Club bilateral lenders and Paris Club forgiveness of official development assistance loans. These estimates are probably lower than the actual amount of debt relief provided. In addition, Russia provided sizable debt relief on claims it assumed from the former Soviet Union; if this is valued excluding the up-front discount agreed with Paris Club creditors, it would add about $7 billion, making a total of about $30 billion. (Including the up-front discount valued at the official exchange rate, the total increases to $60 billion.)

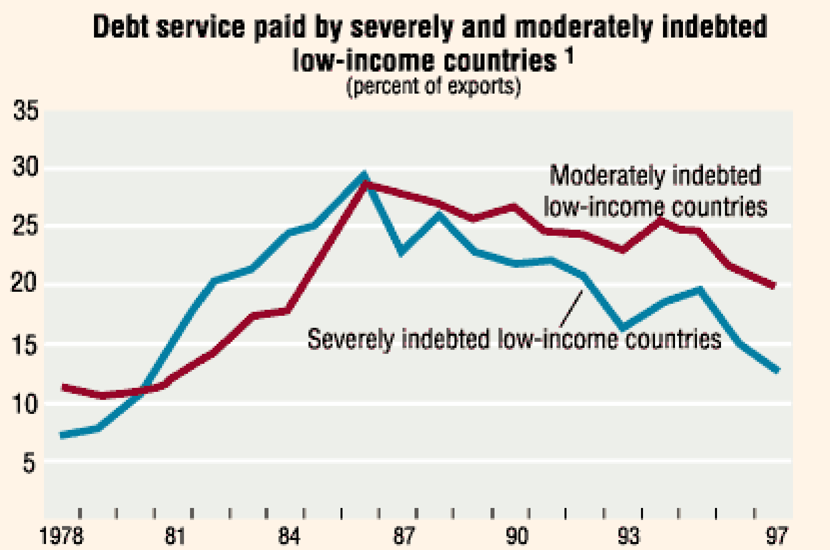
The initiatives that preceded the HIPC Initiative have had a significant effect on the debt burdens of low-income countries. While different definitions yield different average debt-service ratios, it is clear that the various initiatives from 1987 onward helped bring debt-service payments of HIPCs down from about 30 percent of exports in the mid-1980s to roughly half that level by 1997. The average paid debt-service ratios for the heavily indebted poor countries, after peaking in 1986, declined steadily to about 17 percent of exports by 1997 (Chart 2, upper panel).

This decline also reflected stronger export performance in many low-income countries. The aggregate debt service of the group classified by the World Bank as the severely indebted low-income countries fell even more, to 14 percent of exports in 1997, and has actually been consistently below the level paid by the moderately indebted low-income countries, many of which have not rescheduled their debts (Chart 2, lower panel). The HIPC Initiative builds on and reinforces these past debt-relief efforts and is expected to provide total relief of about $27 billion in 1998 present-value terms, over and above the relief provided by traditional mechanisms.

Chart 2
Ratio of debt to exports



Sources: World Bank Debtor Reporting System, IMF *World Economic Outlook*, and IMF staff estimates.
[1] Average of individual ratios for 31 HIPCs for which consistent data are available.



Source: World Bank, 1999, *Global Development Finance* (Washington).
[1] Aggregate debt service as a percent of aggregate exports.

World Bank data suggest that the present value of the debt of the 41 HIPCs at the end of 1997 was about $157 billion (Table 2). Estimates prepared as part of the costing exercise for the HIPC Initiative suggest that the present value of the external debt of these 41 countries after the hypothetical full application of all traditional mechanisms would be about $104 billion. After HIPC assistance, the stock of debt is expected to drop to about $68 billion in present-value terms, or about two-fifths of the outstanding stock of debt at the end of 1997.

Table 2
Stock of debt before and after assistance

	33 countries expected to receive assistance[1]	All 41 HIPC countries[2]
	(billion dollars)	
Nominal debt, end of 1997 *(GDF)*[3]	137	200
Present value of debt, end of 1997 *(GDF)*[4]	101	157
Present value of debt after traditional mechanisms	72	104
Less present value of HIPC assistance	27	36
Present value of debt after HIPC assistance	44	68

Sources: World Bank, 1999, *Global Development Finance* (Washington); and IMF staff estimates.

[1]Excludes Liberia, Somalia, and Sudan.

[2]Includes Liberia, Somalia, and Sudan, as well as Malawi, which was not originally classified as a HIPC. Excludes Nigeria, which is not eligible for IDA assistance.

[3]*Global Development Finance (GDF)* values Russian ruble debt at official exchange rate of 0.6 per U.S. dollar.

[4]*GDF* methodology for calculating present value does not correspond exactly to that used in the HIPC Initiative, which uses detailed loan-by-loan data and currency-specific discount rates.

Progress over the years on reducing the stock of official debt has been slow because of the creditor countries' accounting and budgetary concerns and the need for all the major creditor agencies to achieve a consensus. Different creditors see their relations with low-income countries in different ways, and these differences are reflected in their approaches to achieving the right combination of debt relief, new concessional lending, and grant financing, as well as in their view of the importance of conditionality. Moreover, the mechanisms by which individual creditors finance debt relief are crucially important because debt relief can provide additional net resources only if financing it does not crowd out more traditional forms of aid. Although many countries' debt stocks have been rising well above sustainable levels, Paris Club creditors have been able to use concessional rescheduling techniques to contain the growth of payments actually being requested. Rescheduling has therefore helped to ensure that, after other official support (grants and new loans) is taken into account, net overall official transfers to low-income countries remain highly positive. Thanks to the growing number of reschedulings on concessional terms, the impact of stock-of-debt operations, and the availability of new financing on concessional terms, the present value of debt-to-exports ratios has been falling since 1992.

By resolving the poor countries' debt crisis through these various initiatives, governments in wealthy countries have implicitly acknowledged a significant transfer of resources they have provided in the past to some of the poorest countries. Exports of creditor countries were supplied but not ultimately paid for. While there are strong arguments for transfers of resources to low-income countries, it is doubtful that this was the most effective means of providing them; resources were directed at neither the most efficient projects nor the poorest people. In the future, more disciplined lending and borrowing practices, greater provision of grant financing within a multiyear framework, and the development of nationally owned poverty reduction strategies hold out the prospect for increasing the effectiveness of external assistance—including debt relief—within a more coherent framework for achieving poverty reduction in all low-income countries.

The analysis and cost estimates presented in this article are based on Christina Daseking and Robert Powell, 1999, "From Toronto Terms to the HIPC Initiative: A Brief History of Debt Relief for Low-Income Countries," IMF Working Paper No. 99/142 (Washington: International Monetary Fund).

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