MEMORANDUM

TO : THE BOARDS OF DIRECTORS

FROM : Cheikh I. FALL
Secretary-General

SUBJECT : THE INTERNATIONAL INITIATIVE TO RESOLVE THE DEBT PROBLEMS OF THE HEAVILY INDEBTED POOR COUNTRIES (HIPCs) - (ADB/BD/WP/96/40 - ADF/BD/WP/96/23)

Please find attached hereto the above-mentioned document for consideration by the Boards on 3 April 1996.

As you are aware, the document has been distributed under short notice instead of the established 14-day distribution deadline. It has been found necessary to do so given the importance of the subject to the highly indebted and poor Regional Member Countries which are a majority group on the African continent, and need for coordination of submission of this document to the Boards of concerned Multilateral Development Banks (MDBs).

Management therefore wishes to ask for your indulgence and tolerance in considering the said report at a short notice.

Attch.

cc: The President
MEMORANDUM

TO : THE BOARDS OF DIRECTORS

FROM : Omar KABBAJ
       President

SUBJECT : THE INTERNATIONAL INITIATIVE TO RESOLVE
          THE DEBT PROBLEMS OF THE HEAVILY INDEBTED
          POOR COUNTRIES (HIPC) *

Please find attached hereto, the above-mentioned document.

Attach.

* Questions on this document should be referred to:
  Mr. D. RWEGASIRA, Senior Advisor to the President, Extension 4044.
THE INTERNATIONAL INITIATIVE TO RESOLVE THE DEBT PROBLEMS
OF THE HEAVILY INDEBTED POOR COUNTRIES (HIPC)

1. Background

1.1 While the debt situation of middle-income developing countries improved in general, following the onset of the debt crisis in 1982, there has emerged major difficulties in servicing the relatively high stocks of external debt of a group of low-income countries. Most of these countries are in Africa. The countries, referred to as the heavily indebted poor countries (HIPC), have been jointly identified by the IMF and the World Bank and add up to 41, with 33 of them in Africa. On average during 1992-94, the debt to exports ratio (after taking into account the concessionality of debt) was below 200 per cent for only 4 of the 41 countries, and there were 13 countries for which the ratio was above 400 per cent. The debt structure by end-1994 was dominated by official bilateral debt which in present value terms accounted for 64 per cent, and private commercial debt at 17 per cent. These averages do not, of course, reveal inter-country variations. The international community has responded to the plight of those countries through rescheduling, concessional financing, and debt reduction under the Naples terms of the Paris Club. Given the persistence of the problem, however, it has become apparent within the international community at large that more actions are required. In particular, the Interim and Development Committees of the IMF and the World Bank have asked the two institutions to undertake an analysis of the debt problems of the HIPC to assess whether current initiatives are sufficient and, if not, to develop new strategies.

1.2 Early in their efforts, the Bretton Woods institutions fully recognised the need to address the totality of the debt in seeking solutions and, therefore, consulted widely among all parties. The two institutions have, in particular, liaised closely with the other major MDBs, including ADB, in undertaking the analysis of the debt problems in the HIPC and in shaping possible approaches towards a solution. There have been exchanges of technical information and data as well as consultative meetings at various levels among officials in the multilateral institutions. An outcome of this effort was the preparation of two papers 1, on the scope and nature of the debt problems of the HIPC, jointly by the staff of the IMF and World Bank. The analytical underpinnings of these papers as well as the policy constraints, given the separate mandates of respective institutions, were discussed at a meeting of senior representatives (staff) of IMF and all the major MDBs on 15-16 February, 1996. The papers were later in February considered by the Executive Boards of the Bretton Woods institutions. The subject of multilateral debt was also one of the main agenda items at the meeting of the Heads of the major MDBs (joined by the IMF) on 28-29 February.

1.3 One of the papers -- on debt sustainability analysis for HIPC -- summarises the results of a set of specific country cases for which detailed assessments of debt sustainability have been made in the context of overall medium-term economic and financial prospects for each country. And, a country is said to have a sustainable external position if it may be expected to meet its current and future external obligations in full, without recourse to relief

1 "Debt Sustainability Analysis for the Heavily Indebted Poor Countries" (SM/96/22; SecM96 - 94); and "Analytical Aspects of the Debt Problems of Heavily Indebted Poor Countries" (SM/96/23; Sec 96-94)
or rescheduling of debts or the accumulation of arrears, and without unduly compromising economic growth. In precise terms, debt sustainability for a given country would have, of course, to be determined flexibly on a case by case basis, but the broad thresholds (within a pre-determined time frame) are the debt-export ratio (on present value basis) which should be expected to fall within a range of 200-250 per cent, or below; and the debt service to exports ratio which should fall within a range of 20-25 per cent, or below. Within these prescribed ranges, debt sustainability would be determined in conjunction with various measures of vulnerability factors, including the external debt service burden in the government budget, the diversity of the country’s export base, its reserve coverage, its underlying resource balance, and any other relevant factors. Guided by this overall definition and based on detailed country studies for about half of the HIPC countries as well as on stylised scenarios for most of the remainder, the paper on sustainability analysis attempts to classify the 41 HIPC countries into three categories — in terms of the length of time needed for them to restore their debt indicators to sustainable levels. And, the categorisation or analysis assumes that countries follow through with sound economic adjustment and reform policies, that existing mechanisms for rescheduling and debt reduction of commercial and bilateral official debt are fully exploited; and that adequate concessional financing can be mobilised to meet their external financing requirements. The categorisation for all the 41 HIPC countries is as shown in Annex 1.

1.4 Annex I indicates that four African countries for which detailed analysis is available (Mozambique, Sudan, Zaire, and Zambia) are likely to experience an unsustainable debt situation. This means that it is quickly apparent that even with sound policies, these countries would be unable to work their way out of debt problems for at least a decade under current mechanisms. For three additional countries (Burundi, Guinea-Bissau, and Sao Tome-Principe), preliminary assessments point to a similar conclusion. Furthermore, Annex I indicates that four African countries for which detailed analysis is available (Cameroon, Côte d’Ivoire, Tanzania, Uganda), and five others where preliminary assessments have been made (Congo, Ethiopia, Madagascar, Niger, Rwanda), debt and debt-service ratios remain high over the medium-term (5 - 10 years) and are thus labelled "possibly stressed". The assessments indicate borderline situations for these countries and, therefore, require closer examination of the specific circumstances and risks to arrive at definitive conclusions about sustainability.

2. Need for Concerted Action

2.1 The composition of HIPC countries’ external debt varies widely. Annex II brings together all those countries identified as "possibly stressed" or "unsustainable" in Annex I and shows the breakdown of debt by creditor at end-1994 in present value terms. The breakdown provides useful insights. First, for almost half the countries, debt to non-Paris Club official bilateral creditors accounts for 25 per cent or more of the total. Among African countries, this applies to Ethiopia, Guinea-Bissau, Madagascar, Mozambique, Sao Tome and Principe, Sudan and Tanzania. In some cases, issues of valuation and repayment terms for this debt remain largely unresolved. Second, obligations to IDA constitute a large share of total debt in a number of cases. This is particularly true for Burundi, Niger, Uganda, and Rwanda. And, Cameroon and Côte d’Ivoire have significant debt to the IBRD. The claims of IMF are significant for Burundi, Sudan, Uganda, and Zambia. For the ADB Group, sizeable
shares\textsuperscript{2} of debt are indicated for Burundi, Guinea-Bissau, Rwanda, and Sao Tome and Principe. Third, debt to private creditors is important in Congo, Côte d'Ivoire, Niger and Sudan. The main conclusion deriving from this varied structure of debt in the HIPCs is that a cooperative and concerted approach by bilateral agencies, multilateral institutions, and private creditors is necessary in addressing the unsustainable debt of the low-income countries. The ADB Group, therefore, would have to play a role.

3. **Easing the Burden of Multilateral Debt**

3.1 In current efforts to address the debt problems of HIPCs, multilateral institutions have so far continued to concentrate on providing financing and have not played a role in debt-stock reduction (at least with respect to their own loans), except in so far as providing concessional refinancing lowers debt in present value terms. The additional efforts that have been called for in resolving the debt problems of the HIPCs necessitate that the multilateral institutions re-examine their traditional approaches.

3.2 As indicated earlier, analytical work has been going on within the Bretton Woods institutions, accompanied by wide consultations among the major multilateral financial institutions as a whole. An important outcome of these consultations has been agreement on six general principles that could provide a basis for any specific proposal to help the HIPCs. The six principles are:

(a) that the objective should be to target overall debt sustainability on a case-by-case basis, focusing on the totality of a country's debt;

(b) that action should be envisaged only when the debtor has shown, through a track record of reform and sound policies, the ability to put to good use whatever exceptional support is provided to achieve a sustainable outcome;

(c) that new measures should build, as much as possible, on existing mechanisms;

(d) that additional action for the problem cases should be coordinated among all creditors involved with broad and equitable participation;

(e) that any action to relieve the burden of debt owed to multilateral creditor should preserve the financial integrity of the institutions and their preferred creditor status, and be consistent with the constraints of their charters, in order that the institutions can continue to provide financing to all member countries on appropriate terms; and

(f) that new external finance for the countries concerned should be on appropriately concessional terms, so as to support their efforts to pursue reform and establish a track record of good policy.

\textsuperscript{2} The structure of debt for countries is indicated in Annex II.
These principles, as indicated in Annex III Section I, have been endorsed by the Boards of the IMF and the World Bank.

3.3 Within these principles, the challenge in formulating a strategy to resolve the HIPC's debt problems is seen, as stated in Annex III Section II, largely one of reconciling the need to retain a clear link between additional assistance and policy performance, on the one hand, with the objective, on the other, of providing the debtor with a firm assurance that if it stays the course in terms of policy implementation, it can reach a sustainable debt position within a reasonable time horizon. As is seen so far, the international initiative on the debt of the HIPCs would offer eligible countries an upfront undertaking from the international community to take action to ease the burden of debt, as needed to bring about sustainability, but with the proviso that the undertaking is fulfilled only on the basis of an extended period of proven policy performance. Specifically, the idea is to build on the existing three year track record needed to qualify for a stock of debt operation from Paris Club creditors (this would be the first phase in the process). In the second three year period (second stage) the international community would commit to provide relief on official bilateral and commercial debt (Paris Club creditors could reach 90% reduction); sustained balance of payments and adjustment support from bilaterals and multilateral institutions (on enhanced terms where needed); and new financing from, and action to ease the burden of debt owed to multilaterals if the additional bilateral and commercial debt relief is not sufficient -- to reduce debt burdens to sustainable levels at the end of the second stage. It is important to note that among the options envisaged for easing the burden of multilateral debt, none calls for a write-off (or down) of such debt. The original claims are payable one way or another. It should also be clear that given the comprehensive nature of the debt initiative, its feasibility would depend on broad-based support from all the major creditors.

3.4 In terms of mechanics, it may be seen that the first stage in the process entails largely the use of existing concessional financing and debt relief mechanisms -- corresponding directly to the current procedures that lead up to a stock-of-debt operation from Paris Club creditors. What is required on the part of a given country, therefore, is a monitorable economic programme supported internationally and implemented successfully over a period of three years. Multilateral institutions provide the usual new financing over this period. A number of HIPCs have entered into this first stage. Under the new initiative, potentially eligible countries would have to enter the first stage no later than two years after the approval of the initiative in order to qualify for action.

3.5 Once a country has completed the first stage, and has become eligible to be considered for stock-of-debt operation from the Paris Club, a comprehensive assessment would be made of its debt situation and prospects for sustainability -- on the basis of debt sustainability analysis over a 20-year horizon. The final country assessment would be made by IMF and the World Bank after full consultation with the country and with other multilateral institutions that have significant claims on the country. If the debt analysis suggested that a Naples terms stock-of-debt operation and related financing measures would not be adequate to produce sustainable debt situation, the debtor could elect, with the agreement of creditors, to delay a stock-of-debt operation while it establishes the additional track record needed to qualify for enhanced relief under the HIPC initiative. A country proceeding to the second stage would undertake a further broad based three-year programme
of adjustment and reform with international support. This support, conditioned on adherence to policy commitments would entail Paris Club creditors committing to provide new flow reschedulings for the duration of the second stage involving up to 90% reduction in present value terms. They would also give an assurance that — on completion of the second stage of track record under that initiative — the country would receive a similar present value reduction in its stock of eligible Paris Club debt. Other bilateral and commercial creditors would be expected to grant no less than comparable treatment of their claims on the country. At this decision point a special consultative group, including the principal donors and multilateral creditors to the country would be convened to proceed with a debt work-out for the country. Participants would undertake to implement a set of measures aimed at allowing the country to achieve debt sustainability by the end of the second stage. They would also agree on related measures to contribute to the requisite concessional financing.

3.6 With all these elements in prospect, the final country debt sustainability assessment — made in full consultation as indicated in paragraph 3.5 above — would be used to determine the amount of additional debt relief (beyond that committed by non-multilateral creditors) that is likely to be required by the end of the second stage to achieve debt sustainability. On the recommendations of the Boards of IMF and the World Bank, as well as other participating MDBs, multilateral institutions would undertake to reduce the present value of their combined claims on the country at the end of the second stage by the difference between the level of debt at that point and the level that was deemed to be sustainable, provided the country continued to implement its adjustment programme satisfactorily. This undertaking would thus give the participating country in the second stage an assurance that its debt problems would be resolved decisively by the completion date if performance is sustained. On the successful completion of the second stage, the stock-of-debt operation committed to by Paris Club creditors would take effect. At the same time, the multilateral institutions would convene in order to implement their earlier undertakings.

3.7 It is being proposed under the new debt initiative that each multilateral institution would be expected to contribute in broad proportion to the present value of its outstanding exposure to the country as of the start of the second stage. One approach would be for each institution, acting independently, to choose from a menu of options for reducing the burden of its claims. Another approach which tries to reconcile with the constraints that may arise from financial-market considerations, is the creation of a fund or funds. The MDBs could create a special trust fund or a series of country-specific funds into which the MDBs and bilateral sources could make contributions. The IMF would also be expected to take action to similar effect; various possibilities involving support under ESAF might achieve the needed reduction in present value terms.

3.8 The World Bank is contemplating additional instruments -- beyond traditional concessional assistance, the fifth dimension, and the Debt reduction facility (for commercial debt) -- to assist the HIPCs. One additional step in the context of the new debt initiative would be the setting up and contributing financially to an HIPC Fund (or funds). This fund would receive contributions from bilateral donors and from participating multilateral institutions. The rationale for creating such a fund is seen to rest partly on seeking consistency with financial policies of multilateral institutions. Details on this fund, including possible financing from IBRD net income, are still being examined. A second additional step being considered is the possible provision of IDA assistance, selectively and under certain
conditions, on grant terms -- with the acceptance of contributors to IDA. The main objective would be to restrain the build-up of IDA debt stock during the second stage of programmes in the HIPC countries as already outlined.

4. The Role of the ADB Group

4.1 Participation of the Bank Group in the new initiative would be determined by the resources that may be available for the purpose from the concessional and non-concessional windows of the Group. Whether or not the Bank Group could, as proposed in the new initiative, contribute for a given country in broad proportion to the present value of its outstanding exposure to the country as of the start of the second stage, would also, in turn, depend on the resource envelope the Bank Group could put together.

4.2 On the use of concessional resources, the ongoing ADF 7 Replenishment Consultations have pointed to a possible use of Fund resources -- in the context of policy-based operations -- to assist countries in meeting their interest payments on outstanding ADB loans. Operational modalities on this account would have to be in consonance with measures agreed within other multilateral institutions, as was indicated in document ADF-VII/CM.8/95/25 prepared by Management for the Lisbon meeting of Fund Deputies (October 1995). Deputies could examine further ways in which concessional resources could be used in a stronger or complementary manner to assist eligible HIPC countries in the context of the new initiative. As in the case being envisaged for IDA, resources could, for instance, be made available in grant form on a selective and exceptional basis (with the agreement of contributors to the Fund).

4.3 On the ADB side, all options would have to be carefully explored. However, they will be constrained in the short to medium-term, given the current financial situation of the Bank and the problem of loan arrears. The use of net income, as is being envisaged under IBRD can only be seen perhaps in a token sense. Until the situation improves significantly in absolute and relative terms the possible use of ADB net income cannot be realistically entertained in the short term.

4.4 If, however, the ADB had to contribute, as agreed among all MDBs, there would be need to make special provisions to that effect for the next several years.

5. Conclusions and Recommendations

5.1 As has been indicated, the new initiative to resolve the debt problems of the HIPC countries will require a cooperative and concerted approach, given the composition of the debt stock of these countries. Bilateral donors and multilateral institutions have a particular role in assisting with concerted action on resources and policies necessary for satisfactory economic growth. Debtor countries, on the other hand, would have to ensure that policy commitments are adhered to so that they may establish the necessary track record for eligibility to the enhanced debt initiative.

5.2 The individual multilateral institutions will have to search for suitable resource niches that would allow them to participate in the enhanced initiative. Mechanisms used by each institution should be consistent with the institution's charter, the nature of its mandate, and
with the instruments at its disposal. The actions taken would also have to be structured so as to avoid damaging the institution's standing in financial markets. In this sense, therefore, the rating agencies will be kept in the picture as necessary.

5.3 The Boards are invited to take note of the latest developments in the international initiative aimed at resolving the debt problems of heavily indebted poor countries, and give Management advise and guidance. Management will continue participating in dialogue and consultations with the other multilateral institutions with the view to collectively advancing to more specific and concrete proposals -- as may, for instance, be examined in the Development Committee meeting in April 1996. The Boards will be kept informed about any new developments in the initiative. At an appropriate time, specific proposals relating to the role of the African Development Group in the new initiative will be made for consideration by the Boards of Directors.
## ANNEX I

**Overall Assessments of Debt Sustainability for the 41 HIPC**s

<table>
<thead>
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<th>Countries for which detailed analysis is available</th>
<th>Other HIPC (preliminary assessments)</th>
</tr>
</thead>
<tbody>
<tr>
<td>sustainable</td>
<td>possibly stressed</td>
</tr>
<tr>
<td>Benin</td>
<td>Bolivia</td>
</tr>
<tr>
<td>Burkina Faso</td>
<td>Cameroon</td>
</tr>
<tr>
<td>Eq. Guinea¹</td>
<td>Côte d'Ivoire</td>
</tr>
<tr>
<td>Guinea</td>
<td>Tanzania</td>
</tr>
<tr>
<td>Honduras</td>
<td>Uganda</td>
</tr>
</tbody>
</table>

(13 countries) (5 countries) (4 countries) (5 countries) (7 countries) (4 countries) (3 countries)

¹ The assessment of Equatorial Guinea depends critically on the projected coming-on-stream of new oil production.

# ANNEX II

**Structure of Medium-and Long-Term Public and Publicly Guaranteed External Debt Countries Classified as Possibly Stressed or Unsustainable**

(Percent Shares in End-1994 Debt Stock in Present Value Terms 1/)

<table>
<thead>
<tr>
<th></th>
<th>Paris Club</th>
<th>Multilateral</th>
<th>Private Creditors</th>
<th>NPV of Debt US$ millions end-1994</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Post cut-off</td>
<td>Pre Cut-off</td>
<td>Concessional</td>
<td>Other Bilateral</td>
</tr>
<tr>
<td>Bolivia</td>
<td>8</td>
<td>15</td>
<td>15</td>
<td>1</td>
</tr>
<tr>
<td>Burundi</td>
<td>-</td>
<td>11</td>
<td>1</td>
<td>11</td>
</tr>
<tr>
<td>Cameroon</td>
<td>11</td>
<td>18</td>
<td>31</td>
<td>1</td>
</tr>
<tr>
<td>Congo</td>
<td>6</td>
<td>8</td>
<td>32</td>
<td>13</td>
</tr>
<tr>
<td>Cote d’Ivoire</td>
<td>8</td>
<td>5</td>
<td>8</td>
<td>-</td>
</tr>
<tr>
<td>Ethiopia</td>
<td>-</td>
<td>9</td>
<td>10</td>
<td>49</td>
</tr>
<tr>
<td>Guinea Bissau</td>
<td>1</td>
<td>14</td>
<td>26</td>
<td>29</td>
</tr>
<tr>
<td>Guyana</td>
<td>3</td>
<td>13</td>
<td>15</td>
<td>33</td>
</tr>
<tr>
<td>Madagascar</td>
<td>4</td>
<td>12</td>
<td>30</td>
<td>27</td>
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<tr>
<td>Mozambique</td>
<td>7</td>
<td>16</td>
<td>26</td>
<td>37</td>
</tr>
<tr>
<td>Myanmar</td>
<td>-</td>
<td>71</td>
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<td>5</td>
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<tr>
<td>Nicaragua</td>
<td>1</td>
<td>6</td>
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<td>Niger</td>
<td>4</td>
<td>1</td>
<td>22</td>
<td>14</td>
</tr>
<tr>
<td>Rwanda</td>
<td>-</td>
<td>16</td>
<td>1</td>
<td>10</td>
</tr>
<tr>
<td>Sao Tome &amp; Principe</td>
<td>-</td>
<td>5</td>
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<td>28</td>
</tr>
<tr>
<td>Sudan</td>
<td>8</td>
<td>4</td>
<td>20</td>
<td>32</td>
</tr>
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<td>Tanzania</td>
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<td>20</td>
<td>27</td>
</tr>
<tr>
<td>Uganda</td>
<td>6</td>
<td>5</td>
<td>11</td>
<td>20</td>
</tr>
<tr>
<td>Zaire</td>
<td>4</td>
<td>9</td>
<td>56</td>
<td>4</td>
</tr>
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<td>Zambia</td>
<td>5</td>
<td>19</td>
<td>12</td>
<td>15</td>
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</tbody>
</table>

1/ These data are based on the World Bank’s Debtor Reporting System. They will not always be fully consistent with other debt data referred to in this paper.

Source: "Debt Sustainability Analysis for the Heavily Indebted Poor Countries", (IMF and the World Bank, January 1996)
INTERNATIONAL MONETARY FUND AND THE WORLD BANK

Proposed Action to Resolve the Debt Problems of the Heavily Indebted Poor Countries

Prepared jointly by the staffs of the International Monetary Fund and The World Bank

Approved by Jack Boorman and Michael Bruno

March 6, 1996

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Table 1: Summary of the HIPC Initiative. ........................................ 11
I. Introduction

On February 20 and 22, 1996 the Executive Boards of the Fund and the Bank discussed the debt situation of the forty-one heavily indebted poor countries (HIPC's), on the basis of two joint staff papers. ¹

Directors of both institutions broadly endorsed the proposed analytical framework for assessing the sustainability of external debt in these countries. They agreed that threshold ranges of 20-25 percent for the ratio of debt-service to exports and 200-250 percent for the ratio of the present value of debt to exports were useful indicators of debt sustainability when viewed in conjunction with the various measures of risk and vulnerability outlined in the papers. There was also general acceptance of the proposition that countries with debt indicators remaining above these threshold ranges for more than ten years, despite adherence to sound policies and full use of existing debt relief mechanisms, could be characterized as having an unsustainable debt burden. Conversely, when both debt indicators fell below the threshold ranges within five years, it was reasonable to consider such cases as sustainable. For countries that fell between these two poles—the "possibly stressed" cases—judgments were more difficult to make, and would depend critically on a country-specific assessment of risk factors.

A few directors felt that the country scenarios used in the Debt Sustainability paper could turn out to be excessively optimistic, although there was also a general recognition that these scenarios should continue to be based on the premise that the countries would maintain sound economic policies, since these were going to be prerequisites for any additional relief from the international community. Overall, the sense of both Board discussions was that the papers demonstrated that there was a significant number of HIPC's—at least eight, and some directors argued as many as twenty—for whom the burden of debt was likely to remain above sustainable levels over the medium term, even with strong policies and full use of existing debt relief mechanisms. Directors considered that additional assistance was needed for these countries, to ensure that their adjustment and reform efforts would not be put at risk by continued high debt and debt-service burdens.

The present paper, again prepared jointly by Fund and Bank staff, responds to the Boards' request for a proposed course of action to address the debt problems of the most heavily indebted poor countries. The proposals are intended to conform to the six key principles established at the conclusion of the February Board meetings:

¹ "Debt Sustainability Analysis for the Heavily Indebted Poor Countries" (SM/96/22; SecM96-94) and "Analytical Aspects of the Debt Problems of Heavily Indebted Poor Countries" (SM/96/23; SecM96-94).
• first, that the objective should be to target overall debt sustainability on a case-by-case basis, focusing on the totality of a country's debt;

• second, that action should be envisaged only when the debtor has shown, through a track record of reform and sound policies, the ability to put to good use whatever exceptional support is provided to achieve a sustainable outcome;

• third, that new measures should build, as much as possible, on existing mechanisms;

• fourth, that additional action for the problem cases should be coordinated among all creditors involved, with broad and equitable participation;

• fifth, that any action to relieve the burden of debt owed to multilateral creditors should preserve the financial integrity of the institutions and their preferred creditor status, and be consistent with the constraints of their charters, in order that the institutions can continue to provide financing to all member countries on appropriate terms; and

• sixth, that new external finance for the countries concerned should be on appropriately concessional terms, so as to support their efforts to pursue reform and establish a track record of good policy.

It is envisaged that, following a discussion of the proposals set out in this paper, the views of the Executive Boards—and their consensus on a course of action, if one emerges—would be summarized in a draft paper for the Executive Boards ahead of presentation to the Interim and Development Committee meetings in April.

II. Outline of Proposed Action

The challenge in formulating a strategy to resolve the HIPC’s debt problems consists, to a large extent, in reconciling the need to retain a clear link between additional assistance and policy performance, on the one hand, with the objective, on the other, of providing the debtor with a firm assurance that, if it stays the course in terms of policy implementation, it can reach a sustainable debt position within a reasonable time horizon.
The proposals set out below seek to address this problem by offering to eligible countries an up-front undertaking from the international community to take action to ease the burden of debt, as needed to bring about sustainability, but with the proviso that the undertaking is fulfilled only on the basis of an extended period of proven policy performance. Specifically, the suggestion is to build on the existing three-year track record needed to qualify for a stock-of-debt operation from Paris Club creditors (this would be the first phase in the process). During the following three year period, the Bank and the Fund would support the country in its efforts to undertake a broad based program of macro-economic and structural reforms, which would then lead to a comprehensive treatment of its debts.  

For its part, the international community would commit to provide:

- debt relief from official bilateral and commercial creditors further reducing debt towards sustainable levels by the end of the second stage. Such relief on flow and stock reschedulings by Paris Club creditors could reach 90 percent when necessary. As per current practice, bilateral non-Paris Club and commercial creditors would provide at least comparable treatment.  

- sustained balance of payments and adjustment support from bilaterals and multilateral institutions, including enhanced terms where needed, so as to ease the burden of multilateral debt service during the second stage.

- new financing from, and action to ease the burden of debt owed to, multilateral institutions, sufficient to reduce debt burdens to sustainable levels at the end of the second stage, if the additional debt relief from bilateral and commercial creditors is not sufficient to reach this objective.

While the proposed framework envisages an important role for the multilateral institutions, it protects their status as preferred creditors in two ways. First, special measures would be taken on multilateral debt only after all other creditors—official bilateral and commercial—had committed to providing substantial additional relief on their claims. Agreement on this principle would be a prerequisite for the initiative to proceed. Second, the options considered for easing the burden of multilateral debt all involve the original claims being repaid in one way or another—there is no proposal to write off (or down) multilateral debts.

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2 In the case of the Fund this would involve a further three-year ESAF program.

3 The Paris Club and other bilateral creditors would be asked to provide significantly deeper reductions in the stock of eligible debt than those available under the current Naples terms (which involve up to 67 percent reduction on a present value basis).

4 The preferred creditor status of the multilateral institutions would argue for a complete write-down of the claims of bilateral creditors before action on multilateral debt. However, it is also important to the reestablishment of creditworthiness for the debtor to establish a record of making some payment on its debt to its creditors. In light of this, the 90 percent figure would balance the two objectives.
Given the comprehensive nature of this proposal, its feasibility is predicated upon broad-based support from bilateral creditors, as well as multilateral institutions involved.

III. Assuring External Debt Sustainability by Easing the Burden of Multilateral Debt

In considering possible instruments for relieving the burden of multilateral debt, in cases where debt sustainability is not assured even after all other creditors have provided debt relief on enhanced terms, the following principles have been at the fore:

- First, reducing the present value of future debt-service obligations can be achieved through a variety of instruments.

- Second, the mechanisms used by each multilateral institution to reduce the burden of its claims on a country within the framework of this program should be consistent with the institution's charter, the nature of its mandate, and with the instruments at its disposal. The specific actions to be taken by the multilateral institutions in this framework should also be structured so as to avoid damaging the institutions' standing in financial markets. In this respect it is neither necessary nor desirable for multilateral agencies to write off (or down) claims in order to reduce their burden in present value terms.

- Third, in each country case, there should be broad undertakings from all multilateral creditors with significant claims.

- Fourth, simple and workable procedures will be needed to ensure broad and equitable participation by the relevant institutions.

- Fifth, action by multilateral institutions should not create a moral hazard for the debtor country.

IV. How the Initiative Would Work

1. First stage: use of existing concessional financing and debt relief mechanisms

Two of the key principles which Directors established for any new initiative on debt were that it should build on existing mechanisms to the extent possible, and require a track record of policy performance on the part of the debtor. Consistent with this, it is proposed that the first stage of the initiative should correspond directly to the current procedures that lead up to a stock-of-debt operation from Paris Club creditors.

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5 Table 1 provides an overview summarizing how the HIPC initiative would work.
Thus, as now, a country would need to formulate an economic program to be supported by the Bank and the Fund, and implement it successfully over a period of three years. During this time, the country would also be expected to cooperate fully with its creditors, and remain current on debt service resulting from Paris Club agreements. The limits on external borrowing, attached to the Bank and the Fund arrangements, would be given special emphasis, and would aim at promoting a steady improvement in the debt indicators, while permitting needed inflows of external finance on appropriate terms.

For their part, Paris Club creditors would continue to offer flow reschedulings on Naples terms (reducing the present value of eligible obligations falling due by up to 67 percent), while other bilateral and commercial creditors would be expected to provide relief on similar or more concessional terms. Bilateral donors and the multilateral institutions would also provide new financing, on appropriately concessional terms, as necessary to meet the balance of payments and project-related financing needs of the country’s economic program.

A number of HICPs have already embarked upon this first stage, with adjustment programs supported by the Bank and the Fund. In order to qualify for action under the initiative, the other potentially eligible countries would have to enter into the first stage no later than two years after the approval of the initiative.

2. The decision point: concerted assessment of the debt situation

Once a country has completed this first stage and has become eligible to be considered for a stock-of-debt operation from the Paris Club, a comprehensive (revised) assessment would be made of its debt situation and prospects for sustainability, on the basis of debt sustainability analysis over a 20 year horizon prepared by the Bank and the Fund and agreed with the country authorities. As is presently the case, the debtor could seek, and Paris Club creditors could offer, a stock-of-debt operation on Naples terms, if this action—and at least comparable treatment from other bilateral and commercial creditors—would enable the country to exit the rescheduling process with a sustainable level of debt. However, if the analysis suggested that a Naples terms stock-of-debt operation would not produce a sustainable debt situation, the debtor could elect—if the creditors agree, and on the basis of advice from the Fund and Bank—to delay a stock-of-debt operation while it establishes the additional track record needed to qualify for enhanced relief under the HIPC initiative. It would normally be at this point that the country would seek a decision by the Executive Boards of the Bank and the Fund to confirm its eligibility to participate in the second stage of the initiative.

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*Under the Naples terms, the stock-of-debt operation involves up to 67 percent reduction (in present value terms) in the stock of eligible debt. Countries are considered for such treatment after having established a three-year track record during which they receive concessional rescheduling providing up to 67 percent reduction (in present value terms) on maturities falling due during that period.*
Countries that have already been granted a stock-of-debt operation by the Paris Club on Naples terms prior to the implementation of this initiative could be given, if eligible, the option of establishing a further three-year track record period in exchange for "topping up" of Naples terms and a comprehensive treatment of its debts by all relevant creditors at the end of the period. As of February 1996, Bolivia and Uganda have received stock-of-debt operations under Naples terms.

Eligibility of a country to participate in the HIPC initiative would be based on criteria regarding income (below IDA operational threshold), creditworthiness (IDA-only countries), and indebtedness. Eligibility of a given country would be established through decisions of the Executive Boards of the Fund and Bank. These decisions would be based on the basis of country-specific debt sustainability analysis presented to the Boards of the two institutions, and agreed with the country, according to the methodology for assessing debt sustainability initially set out in the earlier Board paper (SM/96/22; SM/96-94) and summarized in Box 1.

Based on the analysis carried out in the joint Board paper (SM/96/22; SM/96-94), it is expected that eight HIPCs, with a debt situation characterized in these analyses as "unsustainable", are likely to meet the eligibility criteria for participation in the HIPC initiative. Some of the twelve "possibly stressed" countries might also meet these criteria at the time the updated debt sustainability analysis referred to above would be carried out.

A country proceeding to the second stage would undertake a further broad-based three-year program of adjustment and reform, in partnership with the Bank and the Fund. In addition to sound macro-economic management, this program would place particular emphasis on improving the quality of public expenditure, strengthening institutional capacity and enhancing the delivery of social services.

In support of the program, and on condition that the country adheres to its policy commitments, Paris Club creditors would commit to provide new flow reschedulings for the duration of the second stage involving up to 90 percent reduction in present value terms. They would also give an assurance that—on completion of the second stage of track record under that initiative—the country would receive a similar present value reduction in its stock of eligible Paris Club debt. To give further substance to this commitment, the coverage of the stock operation would also be specified at this time. Other bilateral and commercial creditors would be expected to grant no less than comparable treatment of their claims on the country.
At this decision point, a special consultative group, including the principal donors and multilateral creditors to the country, would be convened to proceed with a debt workout for the country. Participants would undertake to implement a set of measures aimed at allowing the country to achieve debt sustainability by the end of the second stage. This would also be the forum for multilateral institutions, as well as bilateral donors, to set out their plans for contributing concessional funding to the country over the period and to agree on a financing plan to meet the country’s external financial requirements in volumes and terms compatible with this objective.\footnote{Ceilings on aggregate non-concessional external financing in the Fund programs would be one of the means for monitoring the concessionality of assistance.}

With all these elements in place, or in prospect, the staff of the Bank and the Fund would provide their Executive Boards an assessment of the country-specific debt sustainability target, consistent with the thresholds defined in Box 1. This would determine the amount of additional debt relief—beyond that committed by non-multilateral creditors—that is likely to be required at the end of the second stage to achieve debt sustainability. This assessment would be made after full consultation with the country and with other multilateral institutions that have significant claims on the country. The methodology for judging sustainability would be consistent with the approach endorsed by the Bank and the Fund’s Directors at the February Board meetings (see Box 1). On the recommendation of the Boards of the two institutions, as well as the Boards of other participating MDBs, multilateral institutions would undertake to reduce the present value of their combined claims on the country at the end of the second stage by the difference between the level of debt at that point and the level that was deemed to be sustainable, provided the country continued to implement its adjustment program satisfactorily. In this context, multilateral institutions could also provide relief on multilateral debt service as it falls due during the second phase, subject to continued good performance.
Box 1. Defining Debt Sustainability

Debt sustainability would be assessed jointly by the Executive Boards of the Bank and the Fund, on a case by case basis. This assessment would be based on the methodology set out in the earlier Board papers (SM/96/22 and SM/96/94):

- The debt-export ratio (on a present value basis) should be expected to fall within a range of 200-250 percent, or below.
- The debt-service to exports ratio should be expected to fall within a range of 20-25 percent, or below.
- Within these prescribed ranges, debt sustainability would be determined in conjunction with various measures of vulnerability factors, including the burden of external debt service in the government budget, the diversification of the country's export base, its reserve coverage, its underlying resource balance, and any other relevant factors.

3. The Second Stage

The undertakings made at the decision point would thus give the participating country, as it enters the second stage and begins to implement its second adjustment program, a clear assurance that its debt problems will be resolved decisively by the completion date if performance is sustained. In the meantime, it would benefit from concerted financial support on enhanced terms, as well as from any interim measures aimed at providing relief on debt service falling due during the second stage.

Aside from ensuring that its policy commitments are fulfilled, a key task for the country during the second stage would be to seek to finalize the envisaged debt agreements with official bilateral and commercial creditors.

On the successful completion of the second stage, the stock-of-debt operation committed to by Paris Club creditors would take effect. At the same time, the multilateral institutions would convene in order to implement their earlier undertakings. In the event that the country's debt situation is, for reasons beyond the authorities' control, significantly different from that envisaged at the decision point, the Boards of the Bank and Fund would make appropriate adjustments to the contribution they provide.
Each multilateral institution would be expected to contribute in broad proportion to the present value of its outstanding exposure to the country as of the start of the second stage. This contribution could take place through interim measures in the course of the second stage, as well as through measures at the completion date, or through a combination of both. One approach would be for each institution to choose from a menu of options for reducing the burden of its claims, each acting independently to make its required contribution by the end of the second stage. This menu could include: the provision of additional grants earmarked for payment of a portion of the multilateral debt service falling due during the second stage of the program; the provision of grants to prepay part of the outstanding stock-of-debt at the completion date; and/or the provision of additional concessional funding in greater amounts and with a greater degree of concessionality, so as to contribute to the needed easing of the debt burden.

It is useful to consider possible action by the multilateral development banks (MDBs) and the IMF separately, given the latter's unique character and specialized instruments.

MDBs could contribute to this initiative in a variety of ways. However, it is important that any action they undertake should not adversely affect their standing in financial markets. In this regard, one option would be for MDBs to create a special trust fund into which they, and bilateral sources, would make contributions. This trust fund would then take on the obligation to prepay or to service a portion of participating countries' multilateral debts in amounts consistent with the required present value reduction in those countries' multilateral debt burdens. Another option might be for the MDBs to create special funds for each debtor country eligible for the initiative.

The IMF would also be expected to take action that would reduce the present value of its claims on a country participating in the initiative. Various possibilities involving support under the ESAF might achieve the needed reduction in present value terms. These are under examination and are discussed further in a separate staff paper to be issued shortly.

Finally, it is proposed that the program would remain available for two years, i.e., potentially eligible countries would have until that time to enter the first stage. At that point, the Executive Boards of the Bank and the Fund would hold a comprehensive review of experience under the HIPC initiative, to decide whether to continue with the program.
Table A. Summary of the IMF Initiative

First stage
- Paris Club provides flow rescheduling as per current Naples terms (67 percent reduction, on a present value basis).
- Other bilateral and commercial creditors provide at least comparable treatment.
- Multilateral institutions continue to provide adjustment support in the framework of Bank/IMF-supported adjustment programs.
- Country establishes first track record of good performance.

Second stage
- Paris Club provides more concessional flow rescheduling including up to 90 percent debt reduction.
- Other bilateral and commercial creditors provide at least comparable treatment.
- A Special Consultative Group meeting is convened to agree on a financing plan and identify additional relief needed for the country to achieve debt sustainability at the completion date.
- Multilateral institutions deliver the financing plan, subject to country's continued performance.
- Multilateral institutions may provide actions to ease debt burden, through interim measures, consistent with a sustainable level of debt.
- Country establishes a second track record of good performance under Fund and Bank programs.

Decision Point
- Paris Club stock-of-debt operation under Naples terms and comparable treatment by other creditors adequate for the country to reach sustainability: country not eligible for HIPC initiative.
- Paris Club stock-of-debt operation (67 percent reduction of eligible stock-of-debt) not sufficient for the country's overall debt to become sustainable: country requests additional support under the HIPC Initiative, and Executive Boards determine eligibility.