INTERNATIONAL MONETARY FUND

Further Debt Relief for Low-Income Countries—Key Issues and Preliminary Considerations

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(In consultation with other departments)

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Contents Page

I. Introduction

1. **The International Monetary and Finance Committee at its 2004 Annual Meetings called on the international community to provide assistance including "further debt relief" to low-income countries for achieving the Millennium Development Goals (MDGs).** It reaffirmed the Fund's "important role" in supporting low-income countries and called on the Fund to consider "further debt relief and its financing."[1] More impetus for this request was provided by various recent proposals (summarized in Annex I). At their meeting in London in February, G7 Finance Ministers expressed their willingness to provide as much as 100 percent multilateral debt relief.[2]

2. **The Fund, together with the World Bank, launched the Initiative for Heavily Indebted Poor Countries (HIPC) in 1996 with the objective of reducing these countries' external debt to sustainable levels.** The Initiative was enhanced in 1999 to provide more debt relief to be used for additional poverty-reducing spending. Unlike traditional debt-relief mechanisms prior to the HIPC Initiative, including debt rescheduling on increasingly concessional terms offered by Paris Club creditors, the HIPC Initiative was the first agreed international framework to reduce the overall debt burdens of poor countries, including multilateral debt. Many official bilateral creditors in industrial countries have also committed themselves on a bilateral, voluntary basis to 100 percent debt forgiveness, beyond their commitments under the HIPC Initiative.

3. **Maintaining sustainable debt positions in the face of additional financing needed to make progress toward the MDGs will be a challenge.** Against this background, the Executive Boards of the Fund and World Bank have endorsed the general principles and key features of a forward-looking debt sustainability framework for low-income countries that incorporates a systematic analysis of key debt-burden indicators under baseline assumptions

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[1] *Communiqué of International Monetary and Financial Committee* (October 2, 2004) states that the "IMF has an important role in supporting—through policy advice, capacity building, and financial assistance, including debt relief—low-income countries' efforts to achieve the macroeconomic stability and high growth needed to make progress toward the MDGs"(paragraph 17). It also states that the "international community needs to support these efforts with more open markets for these countries' exports, increased and better coordinated aid and technical assistance, further debt relief, and sound policy advice" (paragraph 10). The Committee "looks forward to further consideration of outstanding issues in the proposed framework for debt sustainability, before it is made operational, and of further debt relief, including its financing" (paragraph 19).

[2] G7 Finance Ministers Conclusions on Development (London, February 5, 2005) states that "We are agreed on a case-by-case analysis of HIPC countries, based on our willingness to provide as much as 100 percent multilateral debt relief. We also ask the IMF and the World Bank to look at the issue of debt sustainability in other low-income countries."

http://www.hm-treasury.gov.uk/otherhmtsites/g7/news/g7_statement_conclusions050205.cfm and in the event of plausible shocks.[3] The framework also establishes indicative thresholds for these debt-burden indicators, which vary depending on the quality of a country's policies and institutions. The framework is expected to help ensure debt sustainability in the context of additional financing needed for MDG achievement.

4. **This paper outlines the key issues and considerations for further debt relief by the Fund.** It presents the pros and cons of various debt-relief strategies, recognizing that there is no approach that is superior to all others in all respects. Ultimately, if and how debt relief is provided requires judgment about the relative merits and costs of the different strategies. A discussion of the key issues and preliminary considerations is intended to provide Directors with an opportunity to state their views on the merits of further debt relief and on core principles of a possible framework. Based on the outcome of the discussion of this, a follow-up paper could attempt to formalize a more specific proposal, should Directors so desire. Against this background, Section II evaluates debt relief as a form of financing against other financing vehicles, and discusses the pros and cons and various motivations for providing further debt relief. Section III discusses operational modalities for further debt relief, and Section IV highlights the implications of debt relief for the Fund. Section V concludes and provides some further considerations.

II. Further Debt Relief and Other Forms of Financial Assistance

A. Debt Relief Versus Other Financing Vehicles

5. **While the HIPC initiative has sharply reduced debt service and laid the basis for debt sustainability for the qualifying countries (see Box 1), further debt relief could serve some other important objectives.** It could:

- reduce possible remaining debt-overhang problems and reinforce debt sustainability objectives;
- lower the risk that the Fund's provision of advice, resources, and signals to low-income members would be compromised by concerns about debt service on past lending;
- ease balance of payments pressures arising from exogenous shocks;
- offer a vehicle for the international community to provide additional resources in a predictable and easy-to-use form to meet the MDGs.

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[3] See "Debt Sustainability in Low-Income Countries: Proposal for an Operational Framework and Policy Implications" (March 3, 2004), and "Debt Sustainability in Low-Income Countries—Further Considerations on an Operational Framework and Policy Implications" (September 10, 2004).

Box 1. Comparison of Debt Indicators Between HIPCs and Other Developing Countries

The comparability of NPV statistics derived from Global Development Finance (GDF) data (on developing countries) and HIPC documents and staff estimates (on HIPCs) is limited by the use of different methodologies to account for debt relief and differences in debt coverage. Notwithstanding these differences, it is worth noting that:

- Debt relief committed under the HIPC Initiative, once delivered, will reduce HIPCs' NPV of debt-to-exports ratio to about 120 percent, around the developing country average but below the average in non-HIPC low-income countries.
- HIPC relief, including interim assistance, has already lowered HIPCs' debt service to about 10 percent of their exports. Their debt service ratios are well below the similar ratios in non-HIPC low-income countries and significantly below those in other developing countries, reflecting the concessionality of their debt.
- Sustainable debt service-to-exports ratios in HIPCs are lower than that in other developing countries, reflecting HIPCs' high vulnerability to shocks.

Debt Indicators for Developing Countries and HIPCs 1/
(In percent, weighted averages)

	Developing Countries		HIPCs 2/			
	Developing Countries Average 3/ (2001)	Non-HIPC Low-income Countries (2002)	Before Enhanced HIPC Relief 4/	Debt Indicators for 2001	Debt Indicators for 2003	After Enhanced HIPC Relief at the Completion Point 5/
NPV of debt-to-exports ratio 6/	120	143	274	275	206	121
NPV of debt-to-GDP ratio	38	39	61	65	45	29
Debt service-to-exports 7/	19	15	16 8/	10	10	7

Sources: *Global Development Finance*, World Bank; HIPC country documents; and staff estimates.

1/ Figures represent weighted averages. Serbia and Montenegro, Liberia, Somalia, and Turkmenistan have been excluded because of incomplete data. Debt indicators for HIPCs cover public and public guaranteed debt whereas debt indicators for developing countries cover total public and private debt.
2/ The term HIPC countries refers to those 27 countries that have reached the completion or decision point under the enhanced HIPC Initiative by July 2004.
3/ Developing countries comprise low- and middle-income countries according to the World Bank income classification.
4/ Debt stocks are after traditional Paris Club relief before the decision point. Data refer mostly to end-1998 and end-1999 data; for Democratic Republic of Congo, data refer to end-2002.
5/ Data are for 2006, after additional bilateral debt forgiveness beyond the enhanced HIPC Initiative already pledged by industrial country creditors.
6/ Exports are defined as the three-year average of exports of goods and non-factor services up to the date specified.
7/ Exports are defined as exports of goods and non-factor services in the current year.
8/ Average over 1998 and 1999.

6. **On the other hand, debt relief may not be the best way to provide resources to low-income countries.** Debt relief may or may not be associated with increased net resource

flows; it might instead result in a diversion of resources that would have gone to increase direct aid flows. Furthermore, compared to the alternative of higher new aid flows, debt relief:

- allocates external resources by reference to past debt, which may have partly been a consequence of poor policies, rather than by current policies or other definitions of needs, for example investment needs;[4]

- may provide less scope to encourage good policies—to the extent that debt relief is provided irrevocably, it amounts to unconditional support on a fixed schedule;

- could create expectations of further relief down the road, thereby increasing the moral hazard associated with any subsequent lending and hindering the development of a credit culture. This may also prompt creditors to reduce net lending levels in the future.

7. **Any debt relief would leave an important unfinished agenda.** Further debt relief is inevitably only a small part of a broader agenda that involves stronger policies in developing countries, promotion of private sector development and investment, more and better targeted development assistance, and a supportive international environment for growth, including the successful completion of the Doha round. The enhanced HIPC Initiative remains to be fully implemented, lacking full financing and participation by several non-Paris Club bilaterals and some smaller multilaterals, as well as encountering legal action by some private creditors.

8. **For the Fund, further debt relief must be placed in the context of its broader role.** The nature of the Fund's support to its low-income members, the signals it sends to markets, donors, and low-income borrowers, and how it uses its various facilities to support its activities cannot be delinked from debt relief. In particular, the Fund must be able to provide concessional financial assistance for balance of payments needs in support of growth-oriented reform and adjustment programs, including in response to shocks, and to send credible signals to donors.

B. Strategies for Further Debt Relief

9. **There are several conceivable strategies to design a framework for further debt relief.** These strategies start from different perspectives with respect to the objectives of further debt relief and the efficacy of existing mechanisms, notably the HIPC Initiative and the newly developed debt sustainability framework. Objectives could include improving debt sustainability, eliminating rollover pressures, buffering exogenous shocks, or increasing

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[4] Although with the removal of excessive debt through the HIPC Initiative, differences in debt and debt-service ratios across low-income countries have narrowed significantly (see Box 1).

available resources for achieving the MDGs. These objectives are not mutually exclusive, indeed, all could be viewed as consistent with the IMFC call for debt relief to support the MDGs. Nonetheless, the strategies reflect different primary concerns and different views about the viability of low-income countries' current debt situation.

10. **Further debt relief might be premised on the notion that external debt sustainability itself will remain a problem in a large number of low-income countries.** From this perspective, debt relief should be allocated according to some criteria related to debt sustainability, along the lines of the HIPC Initiative or the recently developed debt sustainability framework for low-income countries. The advantages of this approach are that it directly addresses debt sustainability and potentially saves resources relative to more broad-based debt relief.

11. **Specific proposals for linking further debt relief to criteria for debt sustainability, however, have important drawbacks:**

- *It is not clear that debt sustainability is a systemic problem for low-income countries at present.* For countries that have achieved their completion points under the enhanced HIPC Initiative, HIPC debt relief has already provided a "safety cushion" with respect to debt sustainability.[5] As indicated in a recent staff review, despite their vulnerability to shocks, the build-up of unsustainable debt in these countries is preventable, depending importantly on economic policies, including debt management, and the terms of external assistance.[6] For non-HIPC low-income countries, available data suggest that their NPV of debt and debt service-to-exports ratios on average were below the HIPC Initiative thresholds (Box 1). However, for individual countries the risk of debt distress can still be high even after HIPC assistance, and maintaining long-term debt sustainability in the face of large financing needs remains a serious challenge for all. The new debt sustainability framework, along with increases in the availability of grant financing in the context of IDA 14, is designed to help member countries manage future debt and grant financing in a way that uses available aid resources efficiently while minimizing the risk of excessive debt accumulation.

- *If further debt relief were allocated on the basis of a uniform threshold, as under the HIPC Initiative, the resources provided would be based on past borrowing decisions, leaving out those countries that managed to keep their debt at low levels.* While this was considered an acceptable cost of an important initiative to rid poor countries of excessive

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[5] According to recent empirical analysis, the average debt level at which low-income countries have traditionally experienced debt-servicing problems was around 200 percent of exports (see *Debt-Sustainability in Low-Income Countries—Proposal for an Operational Framework and Policy Implications*, March 3, 2004).

[6] See "HIPC Initiative—Status of Implementation" (August 23, 2004, Section VII).

debt burdens, the same argument cannot be easily applied for debt reductions beyond the HIPC Initiative threshold.

- *If further debt relief were provided on the basis of policy-dependent thresholds developed in the new debt sustainability framework, it would primarily benefit those countries with poor policies and institutions and commensurately lower debt thresholds.* This approach would acknowledge the differences among countries in their ability to sustain debt. But by doing this, it would discriminate not only against countries with a history of prudent debt management, but also against those that have successfully strengthened their policies and, as a result, have higher indicative debt thresholds.

- *While the choice of any new threshold would necessarily be arbitrary, it would also be an illusory target, unless all (or at least a large majority of) creditors agreed on coordinated action.*[7] Thus, debt relief tailored to sustainability targets makes little sense outside a creditor framework based on fully coordinated and comparable action, along the lines of the HIPC Initiative, which would be a very difficult and time-consuming undertaking.

12. **Further debt relief might also be premised on eliminating pressures for providing new aid to refinance existing debt-service obligations (so-called "defensive lending").** This motivation for debt relief assumes that new lending is currently to some significant extent motivated by "rollover needs," such that a significant share of aid resources is not allocated to the most deserving countries but instead earmarked to keep high debtors afloat. Based on this assumption, debt relief, "by wiping the slate clean," would have a number of benefits, besides the obvious one of strengthening debt sustainability:

- By freeing the allocation of new resources from rollover considerations, conditionality could be applied more effectively to support strong policies. For the Fund, there could potentially be less pressure for prolonged engagement, which could therefore be more selective. At the same time, transaction costs would be reduced by eliminating offsetting gross payments that are otherwise needed to refinance existing debt service.

- Combined with a shift from loans to grants after further debt relief, it would lessen the moral hazard associated with the anticipation of future debt forgiveness.

13. **The merit of providing debt relief to "wipe the slate clean," however, has to be balanced against a number of considerations, in addition to those enumerated for linking debt relief to debt sustainability.** First, from the Fund's perspective, the problem of

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[7] The Fund alone accounts for a small portion of remaining outstanding debt: at end-2003, for PRGF-eligible countries it accounted for 2.6 percent of all outstanding external debt (public sector and publicly-guaranteed) and 6.2 percent of all outstanding debt to multilateral creditors. The Fund's share of HIPCs' outstanding obligations to multilaterals amounts to 10 percent.

managing high existing debt-service payments of low-income countries is not a serious concern, particularly after full implementation of the HIPC Initiative. The Fund's purpose for lending is to address balance of payments problems and to support macroeconomic adjustment programs, and these needs will continue to exist, with or without debt relief. Second, the implicit assumption behind this approach, namely that low-income countries are doomed to remain stuck in a "lend-and-forgive" cycle, is questionable. Several PRGF-eligible countries are already making net repayments to the Fund, and undoubtedly many others—notably those with strong policies and institutions—will be able to repay their obligations and will over time graduate from aid dependence. Forgiving these countries' debt means foregoing reflows that could instead be used to support other countries. Third, this reduction in the overall aid envelope would be further accentuated by the restriction of new financing to grants—which provide less nominal resources than concessional loans for the same cost to donors. Thus, the approach would only seem suitable as a justification for selective rather than broad-based debt relief. In this case, however, it would provide relief to those countries with particularly weak policies, because these would be the most likely candidates requiring such action.

14. **Debt relief could also be seen as a vehicle to address balance of payments needs arising from exogenous shocks.** Under this approach, debt sustainability is not automatically considered a problem. Debt-service relief would only be provided to deal with temporary liquidity needs. This is likely to benefit mainly non-HIPC low-income countries, since most HIPCs after the decision (and completion) point (will) have a debt service-to-exports ratio of below 10 percent (Box 1). This approach would have the advantages of helping low-income countries to establish a credit culture and avoid the moral hazard and potential inequities associated with broader-based debt relief. In addition, it would be less costly than broad-based debt relief.

15. **For the Fund, however, other mechanisms may be more appropriate for assisting members in the event of shocks.** The Fund would normally handle shocks through the provision of new financing, which allows a more flexible response. Flexibility is important because the reaction to shocks should consider the appropriate degree of adjustment versus financing, and the policy response, which depends on a number of factors, including the degree of persistence of the shock. A Fund arrangement with associated financing may thus be a better vehicle for delivering support in these circumstances. This raises the question, to which Section IV returns, of whether the Fund's instruments for shocks financing need to be augmented.

16. **Finally, debt relief could be motivated directly by the desire to generate additional financing in support of the MDGs.** This approach has the potential merit of channeling international support for debt relief into higher aid flows to provide additional resources to low-income member countries to help them increase poverty-reducing expenditures. In effect, it would delink debt relief from potential debt problems, either of liquidity or sustainability. *A necessary condition would be that the donor community increase its overall aid envelope and does not reduce other aid flows to finance debt relief, in order to ensure the additionality of resources*. The Fund's contribution under this approach would be

to help ease the balance of payments needs resulting from efforts to achieve the MDGs—though Fund debt relief alone would not be sufficient to make a significant difference.[8] The potential problem with this approach is that debt relief may not be the best way of allocating scarce aid resources in support of the MDGs and to deal with protracted balance of payments needs more generally. For example, the provision of debt relief would not necessarily reflect countries' capacity to use additional resources productively. Moreover, to the extent that debt relief raises expectations of repeated operations in the future, it may create prudential concerns for the Fund, apart from its direct balance-sheet implications.

III. Operational Aspects of Further Debt Relief

A. Key Questions

17. **Depending on the objectives, the design of a mechanism for further debt relief would involve key choices related to**: (i) coordination among creditors; (ii) eligibility and scope of the relief; (iii) conditionality; and (iv) future lending policies. Each of the objectives outlined in Section II above—debt sustainability, eliminating rollover pressures, dealing with shocks, or providing additional resources—implies a different set of answers to these key questions. Irrespective of the objectives, however, the Fund's financial integrity and its ability to continue to provide adequate financial assistance to its low-income country membership should not be compromised.

B. Operational Features

Coordination among creditors

18. **Should the Fund provide further debt relief within a comprehensive creditor framework or by itself?** Irrespective of the motivation for further debt relief, action by the Fund alone, given its small exposure relative to other creditors, would neither substantially ease external financing constraints nor substantially affect debt sustainability in most countries. Common objectives and concerted action by key creditors would also be desirable given the Fund's preferred creditor status and its wider leadership role with the World Bank. On the other hand, a comprehensive common framework with all creditors would be cumbersome to negotiate and implement, delaying delivery of relief. One approach could be

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[8] As stated in *Need as a Condition for the Use of Fund Resources* (December 16, 1994) "when assessing whether an ESAF-eligible member has a protracted balance of payments problem, emphasis is placed on various aspects of the county's external position and the components of its balance of payments rather than solely on its overall balance of payments position." The relationship with achievement of the MDGs derives from the fact that, for countries with protracted balance-of-payments problems, ". . . as a transitional consequence of a members' adoption of growth-oriented adjustment policies, it is expected that the traditional indicators of overall balance of payments problems will become manifest."

for the Fund to put forward a mechanism for its own debt relief, the implementation of which could be contingent on some degree of parallel, but not necessarily identical, treatment by a core group of other multilateral and bilateral creditors.

Eligibility criteria and scope

19. **Regarding country coverage, all low-income countries could potentially be made eligible.** Earmarking debt relief to HIPCs only is difficult to defend, because the HIPC Initiative will have already sharply reduced previous cross-country differences in debt indicators, and because member countries that have achieved their HIPC Initiative completion point are not necessarily the poorest, or the ones most prone to shocks or to debt-servicing difficulties.

20. **If further debt relief is intended to reinforce debt sustainability, eliminate rollover pressures, or provide financing to address shocks, eligibility may be best related to an indicator of the debt-servicing burden.** Reinforcing debt sustainability beyond the HIPC Initiative would further improve solvency, suggesting that eligibility be linked to the size of the stock of debt, as under the HIPC Initiative. The same would apply to debt relief provided to "clean the slate." If used to improve the liquidity situation in the face of a temporary shock, then debt relief might be conditioned on both the size of the shock and the debt-service burden.

21. **If the objective of debt relief were to generate new resources to alleviate protracted balance of payments needs in support of the MDGs, eligibility would be more appropriately based on income thresholds.** Depending on resource constraints, gradations of income thresholds could be used to channel the deepest relief to the poorest members.

22. **How much debt relief each country receives would depend on a number of considerations, most notably on how available resources should be allocated given the underlying motivation for debt relief.** To achieve debt sustainability, for example, it would be efficient to reduce debt only to a point at which sustainability was reasonably assured. To provide resources to address protracted balance of payments problems stemming from efforts to achieve the MDGs, the most debt relief that could be financed—even 100 percent—might be appropriate.

Conditionality

23. **What conditionality should be associated with further debt relief?** There are two dimensions to this question. The first is the extent to which eligibility for, or entry into, debt relief should be conditional, and the second is the extent to which the delivery of debt-service relief should be subject to ongoing conditionality. Both entry and ongoing conditionality could help ensure effective use of the resources generated.

24. **The appropriate extent of *entry* conditionality would depend in part on the motivation for debt relief.**

- Extensive entry conditionality could serve to target debt relief towards those most likely to make good use of the additional resources. Moreover, entry conditionality substantially weaker than that associated with the achievement of the HIPC completion point could be seen to imply non-comparable treatment and thus undermine the HIPC Initiative. Substantial entry conditionality could take the form of a requirement that HIPC-eligible countries have achieved the completion point (and, in cases where significant time has elapsed, have subsequently maintained strong policies), and that other eligible countries achieve a comparable standard. Another possibility would be to require the achievement of some minimum standard of public expenditure management.

- Lighter conditionality could speed up the delivery of debt relief. Moreover, if the goal were to alleviate rollover pressures, weaker entry conditionality might provide the best-targeted debt relief, given that such pressures are likely to be strongest with respect to relatively weak performers.

25. **There is also a range of options for the extent of *ongoing* conditionality associated with debt relief. In any case, normal conditionality would still apply in the context of future lending or signaling operations.**

- Substantial ongoing conditionality could help ensure effective use of resources, especially if the intent is to provide additional resources in support the MDGs. For example, adequate performance under a PRGF arrangement or a non-financial program endorsed by the Board might be a requirement for the continued delivery of debt-service relief.[9]

- Lighter conditionality would increase the predictability of debt relief and would be easier to differentiate from new lending under the PRGF, which is allocated on the basis of a higher standard of performance. More broadly, the imperative to deliver on any scheme for debt relief might create difficulties in maintaining adequate standards for conditionality; lighter conditionality would alleviate pressures for prolonged program engagement.

- The absence of ongoing conditionality, in other words an upfront write-off of debt-service obligations, would have the merit of clearly and irrevocably removing the burden of existing debt from poor countries, similar to HIPC relief at the completion

[9] In the context of a Fund-supported program and a Poverty Reduction Strategy, countries could be asked to stipulate the use of additional resources generated by debt relief in support of the MDGs.

point.[10] It thus might be most appropriate to the extent that debt relief is provided to improve debt sustainability or to alleviate rollover pressures.

Future lending policies

26. **The different motivations for debt relief also have potential implications for future lending to eligible countries.**

- If debt sustainability is the primary concern, for example so that further debt relief reduces debt ratios below certain uniform, or country-specific, threshold levels, then a consistent lending policy would attempt to keep debt ratios below these levels on a continuous basis. Indeed, to the extent that debt relief raised expectations for similar action in the future, such a policy would also be warranted to avoid moral-hazard-driven over-borrowing. This could be achieved, in principle, by relying on the new debt sustainability framework—perhaps with lower thresholds if those are used as the basis for debt relief.

- Reliance on the new debt sustainability framework to control future debt accumulation would also seem appropriate if debt relief were primarily motivated by the objective of generating additional resources in pursuit of the MDGs. In this case, however, there would be no obvious reason to adjust the thresholds from their current levels, because to tighten constraints on new borrowing would contradict the purpose of debt relief, namely to generate more financing. In particular, if debt relief were to be provided subject to some form of ongoing conditionality, such that debt remained "on the books," it would only gradually create additional room for new borrowing.

- Much tighter constraints on new borrowing—and indeed, a broad shift of development aid toward grants—would be a logical implication of an approach that aims at removing rollover pressures. This would also mitigate the perception of another "lend-and-forgive" cycle.

IV. Implications for the Fund

A. Costs and Financing of Further Debt Relief

[10] Irrevocable and unconditional debt-service relief is essentially equivalent to upfront debt stock cancellation. In practice, as under the HIPC Initiative, the relief could be financed over time as the canceled debt service falls due. Because Fund exposure matures prior to 2015, flow relief limited through 2015 would imply proportionally more action by the Fund in the context of a coordinated effort with multilateral development banks who provide longer-maturity loans. This could be seen as inconsistent with the Fund's preferred creditor status.

27. **There are three basic options to cover the Fund's costs of any further debt relief:** (i) bilateral contributions; (ii) the institution's own non-PRGF, non-GRA resources (specifically gold); and (iii) resources earmarked for new PRGF lending. Of the three basic financing options, bilateral contributions provide additional resources without weakening the Fund's balance sheet. However, the feasibility of this option depends on donor participation. If adequate bilateral contributions are not forthcoming, ensuring that debt relief would be additional to the current financing baseline could then imply that at least part of the costs would need to be covered by gold sales. Finally, drawing on the resources in the Fund's PRGF Trust Reserve Account reduces the additionality of debt relief and would constrain the Fund's flexibility in allocating its overall envelope of financial assistance. While further debt relief may reduce somewhat the need for future lending, complete reliance on PRGF resources would severely impair the Fund's ability to support low-income members under the PRGF. This would have equity implications by potentially crowding out aid to those low-income countries that receive little or no resources through debt relief.

B. Implications for Future Fund Engagement in Low-Income Countries

28. **Further debt relief could have a significant impact on future Fund financial assistance for low-income member countries.** The level of Fund financing required to meet balance of payments needs for low-income members (currently projected at SDR 0.8-1.2 billion annually through 2010 under current policies) could fall somewhat if the Fund provided debt relief in tandem with other creditors to a broad group of PRGF-eligible countries. There is not necessarily a one-for-one reduction in need, however, for two reasons. First, debt-service relief can only cover a small fraction of the overall needs of countries for achieving the MDGs. Second, the members receiving relief may not be the same as those to whom the Fund would provide financing in support of reform and stabilization, adjustment to shocks, and other such objectives.[11]

29. **Even with further debt relief, there would be a continuing need for traditional PRGF operations.**

- Some members would continue to require PRGF arrangements in support of reform programs with a substantial structural component. This would particularly be the case for those low-income members that have not yet secured initial macroeconomic stabilization and those that would not immediately qualify for debt relief. Others would need new financing to deal with shocks.

[11] Further Fund debt relief may be seen to raise the risks entailed in future lending. However, to the extent that debt relief is provided to furnish additional resources and not to address existing debt problems, it would not necessarily be evidence of lower capacity or willingness to repay. In any case, future Fund lending would be accompanied by appropriate safeguards.

- Other members may require a PRGF arrangement to signal to donors the Fund's endorsement of their policy framework.[12]

- Yet other members may choose not to avail themselves of further debt relief on the grounds that they may wish to preserve their credit standing. These members should continue to have access to appropriate levels of PRGF financing, because the only alternative is recourse to nonconcessional GRA resources.

30. **The provision of further debt relief would reinforce the current need to refine and enhance the Fund's instruments for engagement with low-income members.**

- The Fund has already moved in the direction of providing policy advice and signaling with lower levels of financing (through low-access PRGF arrangements) for PRGF-eligible countries that have achieved basic macroeconomic stabilization and a reasonably strong policy environment. As further debt relief could reduce the need for Fund financing, it would be reasonable to expect more emphasis on the Fund's non-financial assistance. In this context, further reflection may be necessary on the idea of introducing a non-financial program endorsed by the Board that could serve as a credible signal of good policies to both donors and the private sector.

- The Fund's ability to provide financial assistance to low-income countries on concessional terms in response to shocks needs to be strengthened. For a country with a low-access PRGF arrangement in place, augmentation of access would remain the preferred vehicle for shock financing, but low-income members that would have graduated from PRGF-supported programs or would be under another sort of signaling arrangement may benefit from the availability of a concessional shocks facility. Consideration would need to be given to the nature of the facility, including access and conditionality.

V. Conclusions and Further Considerations

31. **Further debt relief holds out the promise of easing concerns about debt sustainability while attracting additional financing needed to reach the MDGs. However, it would also face important limitations and pose a number of particular problems for the Fund:**

- Further debt relief should not be considered in isolation from questions regarding the role of the Fund in low-income countries, including the need for resources for ongoing PRGF operations.

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[12] A forthcoming paper on "Fund Signaling and Donor Coordination in Low-Income Member Countries" will be the basis for an Executive Board discussion after the Spring Meetings.

- Irrespective of its motivation, debt relief allocates scarce resources on the basis of past borrowing decisions rather than current policies or needs, making it in many ways inferior to other forms of financing. Moreover, debt relief by the Fund alone would be too small to have a significant impact on any of the objectives outlined above and would be difficult to reconcile with the institution's preferred creditor status.

- Reinforcing debt sustainability on a broad scale may not be required beyond the HIPC Initiative, and the risk of future debt problems could be managed through the new debt sustainability framework.

- Rollover pressures are not an obvious problem for the Fund's engagement in low-income countries, and eliminating them on a wider scale would risk reducing the volume of the overall aid envelope.

- Provision of debt relief for shocks may not provide sufficient flexibility for achieving an appropriate adjustment-financing mix, and it presupposes that the member has sufficient outstanding obligations.

- Securing additional resources to support the MDGs, even if provided as balance of payments support, could be perceived as blurring the delineation between the Fund's responsibilities and those of a development institution.

While these concerns may not necessarily outweigh the potential benefits of debt relief, they would need to be taken into account in the design of any future debt relief initiative.

32. **It is also important that the Fund not embark on an initiative for further debt relief without first securing adequate financing.** In view of the magnitude of its costs, further debt relief by the Fund could require the sale of a significant share of its gold holdings or a major round of new donor contributions, neither of which is assured and both of which could take a long time to settle. Absent guaranteed financing, a commitment to further debt relief would risk severely impairing the Fund's ability to perform its appropriate role in low-income member countries—especially as the Fund's current commitments under the HIPC Initiative are not yet fully funded.

33. **Further debt relief by itself can play only a minor role in addressing the problems faced by low-income countries.** Any debt-relief initiative needs to be supported by stronger policies in developing countries to foster private sector development and investment, more and better-targeted aid, and an international environment conducive to growth, including successful completion of the Doha round. Debt relief represents an opportunity to galvanize the international community to provide additional resources to meet the MDGs, but unless it succeeds in this objective, it may not be the best way of allocating scarce aid resources to these countries. To the extent that debt relief instead draws resources away from existing or future operations, gains for some countries would be offset by losses

for others, and the ultimate purpose of the initiative would be undermined and an important opportunity missed.

34. **To preserve the potential benefits of debt relief, it will also be important to institute mechanisms to avoid excessive borrowing in the future.** This is the purpose of the new low-income country debt sustainability framework, which is designed to limit the risk of debt distress in the future. How debt relief affects the assessment under this framework depends, in part, on the way it is provided. If debt relief is provided over time, subject to some form of ongoing conditionality, debt would remain "on the books," and the relief would only gradually create additional room for new external financing (as would any increased grant flow that was devoted to debt servicing). In this case, the debt sustainability framework in its current form would be expected to play its intended role. If debt relief were provided upfront, however, and motivated by concerns about sustainability or rollover pressures, it would be appropriate to reconsider the modalities of the framework, in particular the choice of the thresholds. In any case, the room for additional borrowing should be assessed on the basis of a country's risk of debt distress, and remain subject to minimum concessionality requirements under PRGF arrangements. Irrespective of debt relief, the challenge will be to work with all creditors and donors to ensure that the risk of debt distress is contained and that the room for new external financing is used productively, not only in program but also in non-program countries.

35. **Finally, should additional debt relief be considered desirable, it would be important to proceed quickly to agree on modalities, financing, and participation by creditors.** This would help avoid the potential moral hazards for debtor countries to accumulate additional debt once it is known that an initiative of further debt relief is underway. More generally, protracted deliberations on the modalities of debt relief and its financing could impede the Fund's work in other areas of high priority until the broader implications of debt relief were resolved. It is also important to note that debt relief under the enhanced HIPC Initiative is not yet fully implemented, including securing financing for the operations. Further debt relief should not distract from or weaken efforts to fully implement and complete the Initiative.

VI. Issues For Discussion

36. Directors may wish to focus on the following issues:

- Do Directors see a potential net benefit of further debt relief?

- If further debt relief is desirable, what weights would Directors attach to the importance of the various motivations for further debt relief—preserving debt sustainability, eliminating rollover pressures, alleviating external shocks, or providing additional resources to enable to attain the MDGs?

- What are Directors' views on the operational features of further debt relief—eligibility and scope and conditionality? Should debt relief be extended to all low-income members or HIPCs only?

- If providing further debt relief is desirable, should the Fund seek to act on its own or make its actions contingent upon parallel action by other creditors? If the latter, should a common framework be sought or independent, roughly comparable action?

- Do Directors agree that the question of debt relief must be considered in a broader context, together with future Fund lending capacity, sources of financing, and the broader role of the Fund going forward?

RECENT PROPOSALS FOR MULTILATERAL DEBT RELIEF AND FUTURE FINANCING

This note summarizes the key elements of recent proposals on further debt relief and financing thereafter.

U.K. Proposal

The U.K. proposal is motivated by a desire to provide additional resources to help low-income countries achieve the Millennium Development Goals (MDGs).

- **The U.K. proposal envisions debt-service relief for low-income IDA-eligible countries until 2015.** Beyond 2015, further debt relief could be considered.
- **The list of eligible countries would be broadened from existing HIPCs to include all low-income IDA-only countries** with sufficiently robust public expenditure management systems to ensure that the savings from the additional debt relief will finance progress towards attaining the MDGs.
- **The U.K. proposal foresees additional bilateral support to finance its share (based on its contribution to the last IDA replenishment) of debt service falling due by eligible countries to IDA and the AfDF.** This support would be granted to countries deemed capable of absorbing direct budget support and guaranteed until 2015, except in exceptional circumstances involving "very serious policy concerns such as conflict situations or serious misuse of aid resources."
- **The Fund's share of additional debt relief would be financed through gold transactions**, thereby preserving existing PRGF resources available for PRGF lending.

Canadian Proposal

The Canadian proposal is motivated by a desire to provide additional resources to help low-income countries to "invest in their future rather than their debt obligations of the past." While similar to the U.K. proposal, it specifically calls for donor contributions to pay for the Fund's share of further debt relief should gold sales adversely affect the Fund's financial position and/or disrupt the gold markets.

- **IDA, AfDF, and the Fund would provide 100 percent debt service relief on their existing claims on eligible low-income countries through 2015.**
- **To qualify, countries need to have sufficiently robust public expenditure management systems with the capacity to absorb direct budget support.** Specifically, HIPCs need to have reached the completion point and non-HIPC IDA-only countries need to adopt a World Bank Poverty Reduction Support Credit (PRSC). Continued eligibility under the proposal requires good performance under Fund-supported programs,

including non-borrowing programs, and acceptable human rights records. As countries graduate above the low-income threshold, they would be phased out of the initiative.

- **The Canadian proposal would be financed through bilateral contributions to cover the debt service to IDA and the AfDF, and also to the Fund in the absence of a consensus on gold sales**. Canada has committed US$172 million over the next five years, representing about 4 percent of all debt payments to IDA and AfDF and is willing to provide additional funding to cover debt service due to the Fund (also 4 percent of the total costs).

French Proposal

The French proposal is based on the premise that low-income countries need additional resources to achieve the MDGs rather than additional multilateral debt relief. The reasoning is that debt relief: (i) only provides a small share of the needed resources; (ii) is detrimental to the development of a credit culture; and (iii) entails moral hazard and inequities. The French proposal does not envisage 100 percent debt relief by multilateral creditors. In addition, the French see a need to preserve IFI financial capacity for their involvement in low-income countries.

- **A grant window within IDA14 and AfDF10 would be created to alleviate shocks faced by post-completion point HIPCs and non-HIPC IDA-only countries.** The extent of debt-service relief would take into account debt relief provided by the Paris Club.
- **The scheme is built on an indicator of debt service rather than the NPV of debt.** Eligible countries would benefit from the grant window if the debt service–to-exports ratio exceeds the agreed-upon threshold of, for example, 15 percent (monitored by the Fund). Both IDA and AfDF will then finance the country with grants only and debt service payments to IDA and AfDF would be lowered for as long as the debt service-to-exports ratio exceeds the threshold. The grant window would compensate IDA and AfDF to preserve their lending capacity going forward. Countries are expected to resume payments when they have fallen back below the threshold.
- **To be eligible for the grant window, countries would be required to neither contract nor guarantee non-concessional loans.**
- **The French proposal would be financed out of IDA and AfDF replenishments.** In addition, the proposal foresees supplementary contributions to the replenishments from donors, either to the grant window or directly to IDA and AfDF.

Japanese Proposal

The Japanese proposal considers debt reduction as detrimental to the development of a credit culture and, in principle, should only be granted if there is a sustainability problem. Debt relief is also regarded as an inequitable way to allocate development resources. To this end, further IFI debt reduction is motivated by a desire to increase the scope for utilizing new loans under the low-income country DSA framework to countries with relatively strong policies. The Japanese proposal does not envisage uniform 100 percent debt relief by multilateral creditors. Japan also sees an increased role for Fund operations in low-income countries.

- **The HIPC NPV threshold would be reduced to 120 percent of exports for all HIPCs that have not yet reached the completion point.** IFI claims on these countries would be reduced (taking account of additional bilateral debt forgiveness) with a view to allowing strong performers to benefit from concessional loans after graduating from the HIPC Initiative.
- **IFI claims on post-completion point HIPCs that cannot utilize loans as determined by the low-income country DSA thresholds would be reduced.** To be eligible for post-completion-point debt reduction, countries must have a "strong policy performance." Debt reduction would be designed to bring the country below the indicative debt distress threshold to, for example, 160 percent in terms of debt/exports.
- **The PRGF Trust would be enhanced to raise its annual lending capacity to SDR 1.0 billion on a self-sustained basis**. In addition, concessionality would be increased by reducing the interest charge from 0.5 percent to zero.
- **Multilateral Development Banks (MDBs) would offer debt rescheduling to deal with exogenous shocks faced by post-completion point HIPCs**. This suggestion is based on the premise that shocks are temporary and lead to liquidity rather than solvency problems.
- **Gold transactions would finance the augmentation of the proposed self-sustained PRGF and the Fund's share of further debt reduction.** Rescheduling of MDB claims in the wake of post-HIPC shocks would be financed through replenishments by bilateral donors.

In addition to debt relief and enhanced PRGF operation, the Japanese proposal also entails a new initiative for private-sector development in Africa:

- **The proposal entails financing mechanisms that would strengthen the ability of MDBs, especially the African Development Bank Group to promote private sector development, improve the investment climate, and foster a credit culture.** In particular, the proposal envisages various initiatives to improve infrastructure, foster SME activities, and strengthen financial institutions.

TABLE 1: MULTILATERAL DEBT RELIEF AND FUTURE FINANCING—A SUMMARY OF RECENT PROPOSALS

	Objective	Eligibility	Mode and Scope Debt Relief	Conditionality		Financing of Debt Relief			Operations Going Forward
				Entry	Ongoing	IDA	AfDF	IMF	
U.K.	Provide additional resources to meet the MDGs	IDA-only low-income countries	100 percent flow relief up to 2015; further debt relief to be considered at that time	For HIPCs, completion point. For others, equivalent standard, such as eligibility for Bank budgetary support	Debt relief to be discontinued only in cases of gross misgovernance	Additional donor resources	Additional donor resources	Gold transactions	No change
Canada	Provide additional resources to meet the MDGs	IDA-only low-income countries	100 percent flow relief up to 2015	For HIPCs, completion point. For others, World Bank PRSC in place	Good performance under IMF program or non-borrowing program	Additional donor resources	Additional donor resources	Additional donor resources; gold transactions if Fund's financial position/and /or gold market not aversely affected	N.A. However, no PRGF resources required
France	Alleviate potential shocks; provide additional resources outside of a debt relief framework	Post-completion point HIPCs and other non-HIPC IDA only low-income countries	Temporary flow relief for countries facing shocks	Debt-to exports ratio above low-income country DSA threshold following a shock	Countries would be required to neither contract nor guarantee non-concessional loans	Reallocation of IDA resources and potentially additional donor resources	Reallocation of AfDF resources and potentially additional donor resources	N.A.	Introduction of shocks financing facility
Japan	Increase strong performing low-income countries' borrowing capacity to foster development of a credit culture; private sector development	Subset of HIPCs with strong policy performance based on CPIA rating	New 120 percent HIPC debt to exports threshold for pre-completion point HIPCs; 20 percentage point reduction in debt to exports threshold for strong performing post completion point HIPCs	Pre-Completion point HIPCs and post-completion point HIPCs subject to high CPIA rating	N.A.	Donor resources through replenishment cycles	Donor resources through replenishment cycles	Gold transactions	Expanded PRGF operations and reduction of rate of charge to 0 percent financed by gold transactions

Table 1. Outstanding External Debt of Low-Income Countries, 2004 1/
(in millions of U.S. dollars, unless otherwise indicated)

	HIPC Initiative status	NPV of PPG debt post-HIPC 2/ (2002)	Per capita GNI (U.S. dollars)	NPV of IDA debt 3/	NPV of IMF debt 4/	NPV of IMF debt/total debt in percent
St. Lucia		405	4,050	13	0	0.0
Grenada		297	3,790	10	8	2.6
Dominica		190	3,360	10	8	4.1
St. Vincent and the Grenadines		169	3,300	7	0	0.0
Maldives		203	2,300	32	0	0.0
Albania		870	1,740	299	80	9.2
Samoa		168	1,600	32	0	0.0
Cape Verde		265	1,490	89	7	2.7
Tonga		49	1,490	4	0	0.0
Vanuatu		55	1,180	8	0	0.0
Total GNI > 1000		**2,670**		**505**	**102**	**3.8**
Honduras	Interim period	2,623	970	509	164	6.2
Armenia		749	950	354	181	24.2
Sri Lanka		7,692	930	1,151	267	3.5
Djibouti		221	910	58	17	7.8
Guyana	Post-completion point	568	900	128	47	8.2
Bolivia	Post-completion point	2,896	890	872	258	8.9
Kiribati		n.a.	880	…	…	…
Georgia		1,378	830	317	228	16.6
Azerbaijan		1,108	810	231	182	16.5
Angola		9,797	740	159	0	0.0
Nicaragua	Post completion point	1,553	730	518	120	7.7
Côte d'Ivoire	Pre-decision point	9,425	660	535	274	2.9
Bhutan		347	660	28	0	0.0
Cameroon	Interim period	2,619	640	289	283	10.8
Congo, Republic of	Pre-decision point	4,887	640	55	25	0.5
Solomon Islands		130	600	24	0	0.0
Lesotho		432	590	140	29	6.8
Moldova		1,234	590	90	113	9.2
Senegal	Post-completion point	1,915	550	1,013	156	8.1
Pakistan		26,462	534	3,296	1,508	5.7
India		82,903	530	13,499	0	0.0
Yemen, Republic of		3,548	520	870	327	9.2
Papua New Guinea		2,399	510	53	62	2.6
Total 500 < GNI < 1000		**164,886**		**24,186**	**4,240**	**2.6**
Haiti		837	480	293	9	1.1
Mongolia		715	480	121	37	5.2
Vietnam		11,354	480	1,311	234	2.1
Sudan	Pre-decision point	15,842	460	121	127	0.8
Comoros	Pre-decision point	192	450	20	0	0.0
Benin	Post-completion point	797	440	408	50	6.2
Mauritania	Post-completion point	785	430	348	68	8.6
Guinea	Interim period	1,351	430	532	105	7.8
Uzbekistan		4,348	420	0	19	0.4
Bangladesh		10,973	400	4,513	168	1.5
Kenya		4,487	390	1,576	83	1.9
Zambia	Interim period	1,801	380	580	732	40.6
Kyrgyz Republic		1,326	330	293	171	12.9
Ghana	Post-completion point	2,534	320	2,178	303	12.0
Lao, P.D.R.	Pre-decision point	1,431	320	170	31	2.2
Nigeria		31,495	320	483	0	0.0
Sao Tomé and Principe	Interim period	37	320	13	3	6.8
Gambia, The	Interim period	306	310	71	21	6.8
Cambodia 5/		2,453	310	208	80	3.2
Togo	Pre-decision point	1,164	310	147	25	2.1
Burkina Faso	Post-completion point	662	300	471	76	11.5
Mali	Post-completion point	1,374	290	735	95	6.9
Tanzania	Post-completion point	2,165	290	1,937	315	14.5
Madagascar	Post-completion point	1,391	290	731	170	12.2
Central African Republic	Pre-decision point	766	260	76	39	5.0
Total 250 < GNI < 500		**100,587**		**17,334**	**2,958**	**2.9**
Chad	Interim period	725	250	236	82	11.3
Uganda	Post-completion point	1,782	240	1,664	139	7.8
Nepal		1,716	240	779	16	0.9
Rwanda	Interim period	415	220	327	77	18.5
Mozambique	Post-completion point	1,352	210	665	126	9.3
Niger	Post completion point	578	200	541	91	15.7
Eritrea		306	190	152	0	0.0
Tajikistan		898	190	114	100	11.1
Malawi	Interim period	1,064	170	786	81	7.6
Sierra Leone	Interim period	245	150	94	154	62.5
Guinea-Bissau	Interim period	114	140	36	14	12.2
Liberia	Pre-decision point	2,473	130	51	78	3.1
Burundi	Pre-decision point	750	100	32	30	4.0
Congo, Dem. Rep. of	Interim period	1,905	100	226	636	33.4
Ethiopia	Post-completion point	1,958	90	1,717	124	6.3
Myanmar	Pre-decision point	4,085	n.a.	399	0	0.0
Somalia	Pre-decision point		n.a.	212	38	…
Total GNI < 250		**20,368**	…	**8,032**	**1,783**	**8.8**
TOTAL		**288,510**	…	**50,058**	**9,084**	**3.1**
Total IDA threshold		**273,988**	…	**47,354**	**8,305**	**3.0**
Total IDA-only 6/		**135,838**	…	**31,584**	**7,040**	**5.2**
Memorandum Items						
Stock of arrears to the Fund 7/						
Liberia					788	
Somalia					344	
Sudan					1,658	
Zimbabwe 8/					319	

Sources: World Bank, Global Development Finance, HIPC Initiative documents; IMF country reports; and World Economic Outlook.

1/ Excludes Afghanistan, Timor Leste, and Zimbabwe. The NPV of total PPG debt refers to 2002.
Data and methodology are consistent with Table 2 of "Debt Sustainability in Low-Income Countries-Further Considerations on an Operational Framework and Policy Implications" (SM/04/318, 9/10/04).
2/ For countries in the interim period the total NPV is estimated after HIPC relief and additional bilateral assistance but before possible topping up.
3/ After estimated HIPC assistance.
4/ After committed HIPC assistance.
5/ Includes disputed debt to the U.S. and debt to Russia before any up-front discount.
6/ Excludes Azerbaijan, Bolivia, Domenica, Grenada, India, Nigeria, Pakistan, Papua New Guinea, St. Lucia, St. Vincent, and Uzbekistan.
7/ Nominal value.
8/ Arrears to the GRA and PRGF Trust.

Table 2. PRGF Eligible Countries: Estimated Debt Service IMF and IDA, 2005-15 1/
(in billions of U.S. dollars)

	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	Total 2005-15
IDA	2.6	2.8	2.9	3.1	3.3	3.5	3.7	4.0	4.1	4.2	4.2	38.4
GNI<US$895	2.5	2.6	2.8	3.0	3.2	3.3	3.5	3.8	3.9	4.0	4.0	36.6
IDA only	1.6	1.7	1.8	1.9	2.1	2.2	2.4	2.6	2.7	2.8	2.8	24.5
IDA-only and GNI<US$895	1.5	1.6	1.7	1.9	2.0	2.1	2.3	2.5	2.6	2.6	2.6	23.5
IMF 2/	1.5	1.4	1.4	1.4	1.4	1.4	1.2	0.8	0.5	0.2	0.0	11.3
GNI<US$895	1.4	1.2	1.2	1.3	1.3	1.3	1.1	0.8	0.4	0.2	0.0	10.3
IDA only	1.2	1.0	1.1	1.1	1.1	1.1	0.9	0.6	0.3	0.2	0.0	8.7
IDA-only and GNI<US$895	1.1	0.9	1.0	1.1	1.0	1.0	0.8	0.6	0.3	0.2	0.0	8.1
Total IMF and IDA	4.1	4.2	4.3	4.5	4.7	4.9	4.9	4.8	4.6	4.4	4.2	49.6
GNI<US$895	3.8	3.9	4.0	4.3	4.4	4.6	4.7	4.6	4.4	4.2	4.0	46.9
IDA only	2.8	2.7	2.9	3.1	3.2	3.3	3.3	3.2	3.0	2.9	2.8	33.3
IDA-only and GNI<US$895	2.6	2.5	2.8	3.0	3.0	3.1	3.1	3.0	2.9	2.8	2.6	31.6
Memorandum Items												
Stock of arrears to the Fund												
Liberia												0.8
Somalia												0.3
Sudan												1.7
Zimbabwe 3/												0.3

Sources: World Bank Loan Department and IMF Finance Department.
1/ All PRGF-eligible countries except Afghanistan, Timor Leste, and Zimbabwe.
2/ Projected debt service figures for 2005-2015 are after HIPC assistance.
3/ Arrears to the GRA and PRGF Trust.