International Monetary Fund

IMF Executive Board Discusses Issues Related to the Sunset Clause of the Initiative for Heavily Indebted Poor Countries

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On September 6, 2006, the Executive Board of the International Monetary Fund (IMF) discussed a paper on issues related to the sunset clause of the Heavily Indebted Poor Countries (HIPC) Initiative, which was prepared jointly by staffs of the IMF and the World Bank. Two additional papers were circulated to the Executive Board in the context of the discussion on the sunset clause: the annual review of the implementation of the HIPC Initiative and the Multilateral Debt Relief Initiative (MDRI), and the semi-annual review of financing of the IMF's concessional assistance and debt relief to its low-income members.

Background

The HIPC Initiative was launched by the IMF and the World Bank in 1996 as a comprehensive effort to eliminate unsustainable debt in the world's poorest, most heavily-indebted countries. It was enhanced in the Fall of 1999 to provide for faster, deeper, and broader debt relief. To qualify for debt relief under the Initiative, eligible countries need to demonstrate the capacity to use the expected assistance prudently by establishing a satisfactory track record under IMF—and International Development Association (IDA)-supported programs and by having put in place a poverty reduction strategy.

A sunset clause was introduced at the start of the HIPC Initiative in 1996, restricting eligibility under the Initiative to countries that had started qualifying IMF-and IDA-supported programs within a two-year time period. Its aims were to: (i) prevent the Initiative from becoming permanent; (ii) minimize potential moral hazard arising from excessive borrowing in anticipation of debt relief; and (iii) encourage early adoption of reforms. In September 2004, the Executive Boards of the IMF and the World Bank decided to extend the sunset clause for the fourth time, to end-December 2006, and to limit its application to only those countries satisfying the Initiative's income and indebtedness criteria using end-2004 data. In April 2006, the Boards endorsed and closed the list of countries assessed to have met these two criteria (See PIN No. 06/41).

The MDRI was launched in 2005 to further reduce the debts of qualifying low-income countries and provide them with additional resources to help meet the Millennium Developments Goals. Proposed by the Group of 8 (G-8) countries, the MDRI is separate from the HIPC Initiative, but linked to it operationally. Under the MDRI, three multilateral institutions - the IMF, IDA, and the African Development Fund (AfDF) - provide 100 percent debt relief on eligible claims of countries having reached, or upon reaching, the completion point under the enhanced HIPC Initiative. In addition, the IMF provides MDRI debt relief to all its members with a per capita income at or below $380 (including two non-HIPCs, Cambodia and Tajikistan). The MDRI framework became effective at the IMF on January 5, 2006, and at IDA on July 1, 2006. The AfDF is expected to start implementing the MDRI as soon as financial assurances are in place.

In addition to the provision of debt relief under the HIPC Initiative and the MDRI, the IMF provides concessional financing to its low-income members through subsidized lending under the Poverty Reduction and Growth Facility, the newly-established Exogenous Shocks Facility, and through emergency assistance to post-conflict countries and countries facing natural disasters. The resources for financing the IMF's concessional assistance and debt relief come from bilateral contributions and the IMF itself and are channeled through trusts and administered accounts, which the IMF administers on behalf of contributors.

The total cost of HIPC Initiative debt relief for the 40 countries that have either already qualified or are currently considered eligible or potentially eligible for debt relief under the HIPC Initiative is estimated at US$63.2 billion in end-2005 Net Present Value terms. Of this, US$41.3 billion represents the cost of HIPC Initiative debt relief committed to the 29 countries that have reached their decision points under the HIPC Initiative. About 8 percent of the total committed HIPC Initiative assistance is borne by the IMF. The total cost of MDRI debt relief for the 40 identified HIPCs is estimated at US$24.5 billion in end-2005 terms, of which 17 percent is borne by the IMF. As of end-July 2006, the IMF has already delivered US$5.3 billion (in end-2005 terms) in HIPC Initiative and MDRI debt relief to 19 post-completion point HIPCs and an additional US$182.2 million to Cambodia and Tajikistan.

Executive Board Assessment

Executive Directors welcomed the paper prepared by staff discussing issues related to the sunset clause of the HIPC Initiative. They acknowledged that letting the sunset clause take effect at end-2006 without any modification could leave several countries with debt burdens in excess of the Initiative's thresholds and without a comprehensive framework to deal with these debts. Directors also noted that extending the sunset clause by two years, as has been done in the past, would not be sufficient for all potentially eligible countries to become eligible for the HIPC Initiative, and that a further extension could weaken the Initiative's credibility.

Most Directors agreed to let the sunset clause take effect and to grandfather all countries that are assessed to have met the income and indebtedness criteria based on end-2004 data, including countries that might be assessed to have met these criteria at some point in the future. They considered that such grandfathering constitutes the most practical and balanced approach to ensure that all potentially eligible HIPCs continue to have the possibility of benefiting from existing debt relief initiatives.

Some Directors considered that setting a deadline for HIPCs to reach the decision point under the Initiative would provide a greater sense of closure to the Initiative. However, it was acknowledged that the difficulties faced by some countries would make this option impractical at this time. Directors asked the staff to conduct a stock-taking exercise in a few years' time with a view to reviewing the options for the remaining duration of the HIPC Initiative.

Directors urged the staff to continue to work with country authorities to develop and implement reform strategies and to assist these countries in qualifying for HIPC Initiative assistance promptly. At the same time, they encouraged the countries, for their part, to make every effort to establish a track record of policy performance and implement satisfactorily their poverty reduction strategies so that they can begin receiving debt relief under the enhanced HIPC Initiative and eventually under the MDRI.

Directors recognized that maintaining access to the HIPC Initiative could prolong moral-hazard and "free-riding" concerns. Some Directors suggested establishing a fixed cutoff date for the debt eligible for HIPC Initiative debt relief, so as to mitigate moral-hazard risks. However, most Directors thought that a fixed cutoff date would entail serious drawbacks. It could increase incentives for free riding by creditors and still leave some countries with unsustainable levels of debt even after HIPC Initiative debt relief. Most Directors preferred to continue relying on existing mechanisms to limit and monitor potential moral-hazard and "free-riding" behavior. They welcomed staff's efforts to address these issues in the context of their policy dialogue with member countries and through the use of the debt sustainability analysis for low-income countries. They encouraged staff to continue to remain vigilant and report to them on issues related to potential "free riding" and creditor participation in the HIPC Initiative through country reports and the annual HIPC Initiative and MDRI status of implementation report.

Directors discussed the treatment of HIPC Initiative-eligible countries that have indicated that they do not wish to avail themselves of the Initiative. Several Directors expressed concern regarding the continued eligibility for HIPC Initiative assistance of these countries and suggested that a permanent exit strategy be considered for them, noting that the World Bank staff is prepared to adopt this approach. However, several other Directors acknowledged the need to retain the current rules, which treat uniformly all countries satisfying the Initiative's criteria by maintaining their eligibility for debt relief. In this context, some Directors considered it prudent to bear in mind the potential cost implications for the Fund of a possible provision of debt relief to these countries. On balance, as the Fund staff is working on a possible approach, Directors agreed to consider a permanent exit strategy from the Initiative for such countries as soon as possible.

Directors noted that additional resources will be needed if the Fund is to provide assistance to the identified HIPCs, including the protracted arrears cases. Directors regretted the low participation of commercial and non-Paris Club bilateral creditors in the Initiative, and some Directors also noted with concern the increase in litigation, notably by commercial creditors. Directors called on all creditors to provide their fair share of debt relief under the Initiative, and asked staff to continue to keep the Board apprised of developments in this area. Directors also encouraged staff to step up technical support, raise public awareness of these issues, and continue to monitor closely the debt situation of HIPCs. Directors looked forward to a further discussion of moral hazard and creditor coordination issues in the context of the forthcoming paper on debt sustainability.

On a more practical level, Directors generally encouraged the staff to continue their efforts to streamline the documentation provided to the Boards so as to increase its effectiveness and relevance. To this end, although several Directors indicated the continued relevance of at least some of the information provided in the semi-annual statistical updates on implementation of the HIPC Initiative, most Directors agreed to discontinue the report with the expectation that staff would find alternative vehicles to keep Directors informed of relevant information on a more frequent basis. Directors looked forward to the next report on progress under the HIPC Initiative and the MDRI in 2007.

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