CHAPTER 7

ESAF AND THE HIPC INITIATIVE

On a number of occasions during 1996/97, the Board discussed two related issues associated with the Fund's support for its poorest members: the continuation of the ESAF and implementation of the Initiative to assist the heavily indebted poor countries (HIPCs). It also approved an external evaluation of ESAF by independent external experts (Box 7).

Discussion by the Board of the ESAF centered on ways of financing the continuation of this concessional facility, which provides financial support to countries implementing comprehensive programs of macroeconomic stabilization and structural reform. The HIPC Initiative seeks to ensure that poor, heavily indebted countries that have shown a sound track record of economic adjustment can attain a sustainable debt situation over the medium term. In their discussions of these issues during 1996, Directors gave their unanimous support for the continuation of the ESAF as the centerpiece of the Fund's support for the poorest countries, including in the context of the HIPC Initiative. Most Directors were of the view that, since the interim ESAF and the HIPC Initiative were so closely linked, they should move forward together under a single broad agreement on the financing modalities to be employed by the Fund.

Framework for the Continuation of ESAF

Directors agreed on the following framework for the continuation of ESAF operations (see also Appendix V):

- Use of current ESAF resources would take place at least until about end-2000. A self-sustained ESAF with a commitment capacity of about SDR 0.8 billion a year would begin in the year 2005, or somewhat earlier, financed from the Special Disbursement Account (SDA) as resources are transferred to that account from the ESAF Trust Reserve Account. There would be an interim period of ESAF operations of about four years within the period 2001 to 2004 at an expected commitment level of SDR 1 billion a year. Financing would need to be mobilized to continue ESAF during the interim period.
- The principal of interim-period ESAF commitments would be financed from either the General Resources Account (GRA) or a new round of bilateral lending to the ESAF Trust.
- Interest subsidies for the interim ESAF of SDR 1.7 billion on an "as-needed" basis (that is, the sum of undiscounted subsidy commitments associated with annual commitments of SDR 1 billion during the interim ESAF) would be required.

The HIPC Initiative

On the basis of extensive discussions in their Executive Boards, the Managing Director and the President of the World Bank submitted to the September 1996 meetings of the Interim Committee and the Development Committee a joint report on a Program of Action to Resolve the Debt Problems of the Heavily Indebted Poor Countries. This Program of Action was designed to address the problems of HIPCs that follow sound policies, but for which traditional debt-relief mechanisms would be inadequate to secure a sustainable external debt position over the medium term. The Interim Committee in September 1996 endorsed the Program of Action and requested the Board to proceed quickly with implementation and to report on progress to the Committee in Spring 1997 (see Appendix VI).

The key features of the program include:

- *Eligibility*. The Initiative would be open to all ESAF-eligible and IDA-only[5] HIPCs that pursue or adopt programs of adjustment and reform supported by the Fund and the World Bank in the next two years, after which the Initiative would be reviewed and a decision made whether it should be continued. The Fund

[5] That is, countries that receive funds from the International Development Association but not from the International Bank for Reconstruction and Development (the World Bank).

Box 7

External Evaluation of ESAF

In October 1996 Directors approved an evaluation of several aspects of ESAF-supported programs to be undertaken by independent external experts. These experts are Dr. Kwesi Botchwey, Harvard Institute for International Development; Professor Paul Collier, Oxford University; Professor Jan Willem Gunning, Free University, Amsterdam; and Professor Koichi Hamada, Yale University.

The project, which will be undertaken in the framework of Fund policy for the evaluation of key Fund instruments, is being coordinated by a group of Directors on behalf of the Board. The experts are to concentrate particularly on three topics related to ESAF-supported programs: developments in countries' external positions; social policies and the composition of government spending; and the determinants and influence of differing degrees of national ownership of the programs. The experts are to have full access to all information in the Fund and have been invited to conduct all consultations they judge appropriate. They are expected to complete their report by the end of 1997.

It is intended to undertake other evaluations, which will also be coordinated by a group of Directors on behalf of the Board.

and World Bank Boards would formally decide on a country's eligibility and assistance under the Initiative, subject to assurances of action by other creditors. This *decision point* would typically be reached after three years of strong performance under adjustment and reform programs supported by the Fund and the World Bank (the first stage). To qualify for exceptional assistance under the Initiative, countries would have to face an unsustainable debt situation at the *completion point* after the full application of traditional debt-relief mechanisms and would have to demonstrate an appropriate track record of adjustment and reform. The completion point would be reached after successful implementation of a second three-year period of adjustment and reform (the second stage). The required six-year performance period would be implemented flexibly on a case-by-case basis, with countries receiving credit toward the decision point for programs that are already under way; exceptionally, the second stage of three years might be shortened for countries that have already sustained records of strong performance.

- *Debt Sustainability.* The objective of the Initiative is to bring a country's debt burden to sustainable levels, subject to satisfactory policy performance. Sustainable levels at the completion point would be when the ratios of the net present value (NPV) of debt (public and publicly guaranteed) to exports and of debt-service (on public and publicly guaranteed loans) to exports are below certain country-specific target levels within ranges of 200–250 percent and 20–25 percent, respectively. Country-specific targets within these ranges would be determined in light of vulnerability factors, such as the concentration and variability of exports, and with particular attention to the fiscal burden of external debt service.

- *The First Stage.* The Initiative builds on the existing mechanisms for providing debt relief, including those of the Paris Club under Naples terms. During a first three-year performance period, Paris Club creditors would provide a flow rescheduling under Naples terms (up to 67 percent reduction of the NPV of eligible debt), and there would be at least comparable action by other bilateral and commercial creditors. Multilateral institutions and bilateral donors would continue to provide assistance under adjustment programs supported by the Fund and the World Bank. During this three-year period countries would need to establish a track record of good performance.

- *Possible Country Situations.* Toward the end of the first stage (at the decision point), the staffs of the Fund and the World Bank and the concerned member country would jointly prepare an external debt sustainability analysis in consultation with other creditors concerned. On the basis of this analysis, the Boards of the Fund and World Bank will determine whether strong policies, a Paris Club stock-of-debt operation on Naples terms, with at least comparable treatment by other bilateral and commercial creditors, and continued bilateral and multilateral support are sufficient to put the country in a sustainable external debt position within the following three years (by the completion point). In the event they do, the country would not be eligible for assistance under the Initiative. Alternatively, if the assessment indicated that a country's overall debt burden would not be sustainable by the completion point, it would be deemed eligible for and might request support under the Initiative. In borderline cases, the country might defer the stock-of-debt operation and request a further flow rescheduling under Naples terms, but it would be eligible for additional action at the completion point, if needed to achieve debt sustainability.

- *The Second Stage.* For countries deemed eligible for support under the Initiative, all creditors will commit at the decision point to provide the relief necessary to attain the targeted debt ratios established for that country, in support of continued reform efforts. Between the decision and completion points, the Paris Club—along with other bilateral and commercial creditors—would, on a case-by-case basis, provide flow rescheduling on more concessional terms involving a reduction of eligible debt by up to 80 percent in present value terms. The country would establish a further three-year track record of strong policy performance under programs supported by the Fund and the World Bank. During that interim three-year period some of the exceptional assistance committed by multilateral creditors could be provided in addition to the flow rescheduling on enhanced terms agreed with nonmultilateral creditors.

- *Action at the Completion Point.* The Paris Club will provide, on a case-by-case basis and on the basis of a broad and equitable participation by all creditors, a stock-of-debt reduction of up to 80 percent in present value terms on eligible debt. Consistent with current practice, debtors would seek treatment on debt owed to other bilateral official and commercial creditors on terms at least comparable to those agreed with the Paris Club. Multilateral institutions will also take such measures as are required for the country to reach a sustainable debt situation.
- *Action by All Creditors.* All creditors are expected to participate in providing exceptional assistance beyond current mechanisms, as required, to reach debt sustainability—the fundamental objective of the Initiative. The amount of assistance to be provided by each group of creditors will be decided case by case, based on the need to (1) deliver debt sustainability, (2) share equitably the burden of the additional measures, and (3) preserve the preferred creditor status of multilateral financial institutions. All creditors will be fully consulted on the action that would involve them under the Initiative.

The Fund's Participation in the HIPC Initiative

In their discussion of the foregoing elements of the HIPC Initiative, Directors underscored the central tenet of the Initiative—namely, a commitment by the international community to enhanced debt relief in response to sustained strong policy performance by the country concerned. Directors emphasized that the additional action should be coordinated among all creditors involved with broad and equitable participation, recognizing the preferred creditor status of the multilateral institutions. Directors also agreed that the participation of the Fund in the HIPC Initiative would be through special ESAF operations at the completion point. This would take the form of a reduction in the present value of the Fund's claims on a country through the provision in most cases of escrowed grants—with the possibility of escrowed loans on extended maturities for countries facing debt-service humps. These resources could be used only for debt service falling due to the Fund on a predetermined schedule. Decisions would be made on a case-by-case basis on which of these modalities would be used.

Directors considered that there should be a presumption that ESAF arrangements with HIPC-eligible countries, and especially arrangements during the second stage, would be among the stronger ESAF arrangements. This was seen as appropriate in light of the seriousness of the problems confronting these countries and the need to progress as rapidly as possible with structural reform.

In February 1997, the Board established the ESAF-HIPC Trust to finance special ESAF operations under the HIPC Initiative and interim ESAF subsidy operations (see Appendix X). The resources of the Trust are to consist of grant contributions, loans, deposits, and other types of investments made by contributors to the Trust, transfers from the SDA, and net earnings from the investment of resources held in the Trust.

Use of Fund Reserves

All Directors agreed that, if the need should arise and in light of the amounts of bilateral pledges, the Fund must be prepared in due course to make optimal use of its reserves to secure the full financing for these initiatives. However, it was recognized that a decision was not required at that time. In his summing up of the Board discussion on this issue in September 1996, the Chairman said it was his understanding that there was the needed majority of members of the Board who considered that such optimization of reserves could entail sales of an amount of the Fund's gold up to 5 million ounces, although he noted that a few Directors objected to this. It was also understood that it would be only the proceeds from the investment of the profits from the sale of such gold that might be used to contribute to the financing.

First Country Cases

In April 1997, the Board approved Uganda's eligibility for assistance under the HIPC Initiative with an envisaged completion point one year later. Directors stressed that the shortening, to one year, of the second-stage period between the decision point and the completion point in the case of Uganda should be seen as exceptional, and as reflecting Uganda's extended record of successful policy implementation under previous Fund-supported programs. In April 1998, Uganda is expected to receive assistance (in NPV terms) equivalent to about $340 million from all its creditors. This assistance will reduce Uganda's debt by around 20 percent.

The Fund, in reducing its claims in NPV terms on Uganda by around 20 percent, will provide assistance in NPV terms equivalent to $70 million. This will be provided at the completion point in the form of a grant into an escrow account, to be used exclusively to pay debt service to the Fund. The expectation is that this assistance will be somewhat front-loaded.

The Board also discussed in April the preliminary HIPC Initiative documents for Bolivia, Burkina Faso, and Côte d'Ivoire. These discussions were an opportunity to consider the implementation of the Initiative and some issues that were beginning to arise. In discussing the implementation of the Initiative, Directors were in broad agreement with the factors identified by the staff that should influence the timing of the decision and completion points and particularly stressed their link to policy conditionality, including the objectives of social sector reform and poverty reduction in the debtor countries. Directors emphasized that any shortening of the second stage should be considered as exceptional, and that they would typically expect that period to be three years.

Many Directors acknowledged that a limited number of highly open economies could face the problem of the heavy fiscal burden of debt service despite the achievement of debt sustainability as defined by external indicators. As a result, the Boards of the Fund and the World Bank approved in April 1997 guidelines on implementing the Initiative for very open economies, where exclusive reliance on external indicators may not adequately address the fiscal burden of external debt. In particular, the Boards agreed to consider eligibility under the Initiative, on a case-by-case basis, for a country facing an NPV of debt-to-export ratio below 200 percent at the completion point, provided that the country concerned meets two criteria at the decision point: an export-to-GDP ratio of at least 40 percent and a minimum threshold of fiscal revenue in relation to GDP of 20 percent. For countries meeting these thresholds, the NPV of debt-to-export target will be set at a level to achieve a 280 percent ratio of the NPV of debt to fiscal revenue at the completion point.

Interim Committee Endorsement

At its April 1997 meeting, the Interim Committee welcomed the Board's actions to implement the Fund's participation in the HIPC Initiative through special ESAF operations. The Committee welcomed the actions that the Board had already taken to assist Uganda and its preliminary consideration of three other country cases and encouraged it to implement the Initiative in a way that would ensure a robust exit from the rescheduling process. In this connection, adequate interim financing by all creditors was important. The Committee also noted the importance of strong adjustment and reform policies, as well as social policies, on the part of the countries benefiting from assistance under the Initiative. It called on the Fund, in collaboration with the World Bank, to help these and other developing countries to accelerate the process of structural reform and urged all members to work to secure the resources needed to complete the funding of the Fund's participation in the Initiative as well as the continuation of ESAF.

CHAPTER 8

Special Onetime Allocation of SDRs

There has been broad agreement in the Board for some time that the Fund should make a special “equity” allocation of SDRs to correct for the fact that more than one-fifth of members have joined the Fund since the last SDR allocation in 1979–81 and some other members have not participated in every SDR allocation.

The Interim Committee, at its September 1996 meeting, endorsed the Executive Board’s proposal for a special onetime allocation of SDRs—through an amendment to the Articles—that would raise each member’s ratio of cumulative allocations to quota to a common benchmark level. This would enable all members of the Fund to participate in the SDR system on an equitable basis. The Interim Committee emphasized that such an amendment would not in any way affect the Fund’s existing power to allocate SDRs on the basis of a finding of a long-term global need to supplement reserves as and when that need arises.

In its subsequent work on a draft amendment of the Articles, the Board broadly agreed on three elements of a onetime allocation.

- An allocation would be made to all participants, on the basis of their quotas agreed under the Ninth General Review.
- With respect to those members with overdue obligations to the Fund that have been unable to consent to or pay for the proposed increase in their quotas under the Ninth General Review, the allocation would be calculated on the basis of their proposed Ninth Review quotas rather than on their actual quotas under the Eighth Review.
- The SDRs allocated to a participant in arrears to the Fund would be deposited and held in an escrow account within the SDR Department until the participant had eliminated all of its overdue obligations to the Fund.

As of the end of the 1996 / 97 financial year, the Board had not concluded its consideration of the amount of the special allocation.

At its April 1997 meeting, the Interim Committee welcomed the progress in the Board toward a proposed amendment of the Articles to provide for a special onetime allocation of SDRs. It requested the Board to finalize its work as soon as possible and to report to the Committee at its September 1997 meeting.