Special Report 2008/05

HIPC debt relief: less debt, more growth and development?

Rabobank

In the last few years Sub-Sahara Africa has experienced the strongest economic growth in more than thirty years. This stands in stark contrast to the eighties and early nineties, when many countries in the region were afftected by severe macroeconomic instability and high debt burdens. This Special Report explains how the so-called HIPC debt relief initiative has contributed to this reversal of economic fortunes. While the debt relief itself was useful, it is the conditions that were attached that made the real difference. Actual implementation of IMF and World Bank proscriptions have helped to attain a higher level of macroeconomic stability and growth.

The lost decade

At the beginning of the eighties, many low-income countries[1], especially those in Sub-Saharan Africa, experienced a huge macroeconomic crisis. Most of them had high and volatile inflation rates, huge budget deficits, and unsustainable exchange rate regimes. Economic growth stagnated or declined which, coupled with high population growth, led to declining per capita incomes and increasing rates of poverty in both absolute and relative terms. Between 1981 and 2001, Sub-Saharan African GDP per capita shrank by 14%, while the percentage of people living on less than a dollar increased from 41% to 46% of the population. The number of poor increased by 150 million. The macroeconomic crisis was partly triggered by external economic shocks, but in many cases the underlying causes were unsustainable autarkic and state-led policies, and bad governance. The macroeconomic problems resulted not only in huge budget deficits, but also in balance of payment problems.

[1] Low income countries are classified by the World Bank as those that had a per capita gross national income of less than USD 1,025 in 2005.

IMF and World Bank move in

As most of these countries lacked access to foreign capital markets, they turned to the IMF and World Bank, the Bretton Woods International Financial Institutions (IFI's), to obtain finance. IMF and World Bank in many cases provided loan programs, but attached strict conditions to make sure that policies they deemed unsustainable were reversed. The leverage of IMF lending, moreover, was increased by other donors making their aid conditional upon the conclusion of an IMF program. The conditional lending programs, called structural adjustment programs, became very controversial. Critics argued that they had a blueprint nature with too much focus on privatization and liberalization, were fiscally too tight, were thus unnecessarily harmful towards the poorest, and were too intrusive in general.

However, probably the most fundamental critique of conditionality was that the mechanism itself was ineffective. In many cases, structural adjustment programs were not - or hardly - implemented by governments. Nevertheless, donors would continue to provide new money. Thus, conditionality became a farce. Zambia, whose experiences were quite illustrating, received 18 adjustment loans from IMF and World Bank between 1980 and 1999, but still coped with high inflation and high budget deficits in 2000.

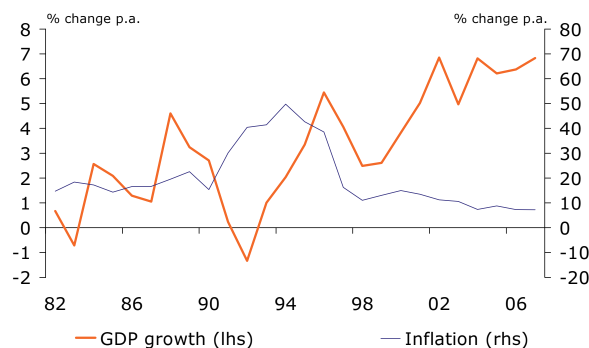
To make sure that countries kept on servicing their debts to IMF and World Bank, donors and these institutions kept on giving them new loans and grants. As a result, debt burdens kept increasing, further aggravated by continued macroeconomic stagnation. Furthermore, incentives for reform were even more weakened by the increasingly repetitive nature of debt reschedulings and debt relief. This repetitive nature created incentives for only partial reforms, as still to be implemented

reforms could be used as a bargaining chip for new debt deals. Thus, a new perverse mechanism was created: money did not flow to countries that were most committed to solve their problems, but to those countries with the highest debt burden.
Understandingly, this vicious circle created pessimism about the prospects of low-income countries, especially those in Sub-Saharan Africa. In a book on the history of the IMF, published by the same Institution, Harold James understandingly calls the experiences of the IMF in Sub-Saharan Africa '*profoundly dispiriting, disappointing, and disillusioning'.* It also led to more and more pessimism about the use of attaching conditions to donor support. Increasingly the view was embraced that outsiders could not enforce reforms. Instead they had to come from within.

The HIPC debt relief initiative

In a new approach, the Heavily Indebted Poor Countries (HIPC) initiave was launched in September 1996. This was the first time all types of creditors, not only the bilateral official and private ones, but also the IFI's that had until then because of their preferred creditor position not participated in debt forgiveness initiatives, agreed to provide debt relief. To ensure that debt relief would provide a once and for all solution to the debt problems, the intiative was strongly conditional: only countries that established a proven macroeconomic track record, in the form of satisfactory compliance with IMF and World Bank programs, could qualify. This meant in practice that countries had to attain amongst others low inflation, and sustainable budget and foreign exchange positions. They also had to implement structural reforms. Countries first had to reach the decision point, at which time it was decided whether the country could participate. The full irrevocable relief took place the moment reached the completion point, after a further build-up of track record.
At first, the HIPC initiative received substantial criticism. In response, in 1999 the initiative was modified to provide faster and deeper debt relief, and to secure that debt savings were mainly spent on poverty reduction.
Nevertheless, the principle of building up a track record before full completion of debt relief was kept as a key element in the approach, although the time needed for this build-up was shortened. To date, HIPC debt relief has been approved for 33 countries, 27 of them in Africa, providing US$49 billion in net present value terms in debt-service relief over time. HIPC more than halved their debt burden. In October 2008 23 countries have reached the completion point, while 10 still have to do so. Additionally, eight countries are potentially eligible for HIPC Initiative assistance. Conflict and weak state capacity hamper progress towards qualification in some countries.

Graph 1: Growth and inflation in Sub-Sahara Africa



Source: IMF, World Economic Outlook database

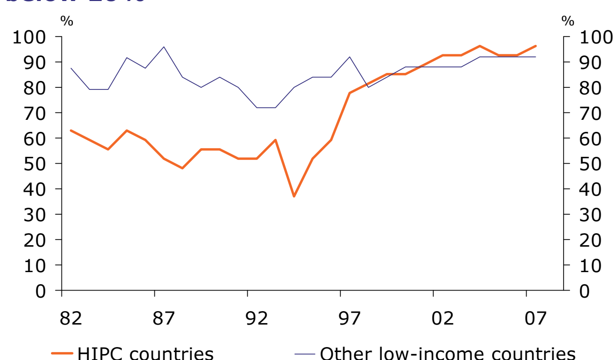
Although there are right now concerns about the impact of high fuel and food prices on many low-income countries, in the last years the pessimism about the prospects of Sub-Shara Africa has quite quickly turned into a cautious optimism. With economic growth rates around 6 percent annually, economies in Sub-Sahara Africa have been growing now at much higher rates than before. Interestingly it seems that is not only high commodity prices, but also better policies that are driving this growth, as countries with adverse terms of

trade effects, but relatively good policies, are doing quite well, too[2]. Indeed, inflation in Sub-Sahara Africa is also at its lowest level in thirty years, and other macroeconomic indicators, such as debt service paid also seem to have improved substantially: for completion point countries these went down from more than 4% of GDP to less than 2% in recent years. Intriguingly, the improvement seemed to start in the mid-nineties, around the time of the inception of the HIPC initiative. The backdrop was not too positive at that time: there were more conflicts in these countries, their terms of trade decreased, and they received less aid. Moreover, given that countries had to build up a track record first, only from the year 2000 on countries would receive substantial amounts of HIPC debt relief. This makes their improving macroeconomic performance from 1996 on all the more impressive.

Success at last

Research[3] shows that there are strong indications that the introduction of the HIPC initiative in 1996 has contributed to this remarkable improvement of macroeconomic policy and outcomes of low-income countries. This is most clearly illustrated by a highly significant relationship between potential eligibility for HIPC and low inflation rates. The strong improvement in inflation rates among HIPCs can also been seen in graph 2, which shows the percentage of low-income countries with inflation below 20%. There is also some evidence that HIPC eligibility improved current account positions, at least when countries had very big current account deficits before the initiative. HIPC also may have helped to increase economic growth, although this evidence is less clear-cut. However, macroeconomic stability is certainly not the only necessary precondition for economic growth. There are also indications that compliance with conditionality of IMF programs in countries that were eligible for the HIPC initiative increased, while it decreased in countries that were not.

Graph 2: Percentage of countries with inflation below 20%[4]



Source: IMF, World Economic Outlook database

This suggests that the HIPC initiative to a large extent succeeded in overcoming the problem of credibility that plagued the conditional IMF reform programs before the introduction of the initiative. The promise of renewed access to finance and of regaining independence and respectability seems to have seems to have provided a real carrot for improving macroeconomic performance, especially as this carrot was only given after countries had established a good track record of this performance. The HIPC framework may thus have helped societies to accept painful reforms, just like the promise of EU accession has boosted reform efforts in many Eastern European countries. However, this analogy also

[2] Regional Economic Outlook: Sub-Saharan Africa, October 2007.
[3] Will be available shortly.

[4] HIPC countries included in graph: Bolivia, Burkina Faso, Burundi, Cameroon, Chad, Democratic Republic of Congo, Republic of Congo, Côte d'Ivoire, Ethiopia, Guinea, Guinea-Bissau, Guyana, Haiti, Madagascar, Malawi, Mali, Mauritania, Mozambique, Nicaragua, Niger, Rwanda, São Tomé and Príncipe, Sierra Leone, Sudan, Tanzania, Uganda, and Zambia.
Non-HIPC countries included in graph: Angola, Bangladesh, Bhutan, Cambodia, Cape Verde, Dominica, India, Indonesia, Kenya, Lao People's Democratic Republic, Lesotho, Maldives, Myanmar, Nigeria, Pakistan, Papua New Guinea, Samoa, Solomon Islands, Sri Lanka, St. Lucia, St. Vincent and the Grenadines, Tonga, Vanuatu, Vietnam, and Zimbabwe. Not all these countries are still low income countries.

holds a warning: just like reforms, especially political ones, were slowed or even reversed once countries entered the EU, macroeconomic policy in HIPCs might deteriorate once they have received the debt relief and no longer need to prove their macroeconomic track record. So far, this has not been the case in countries that had completed the HIPC process, with most of these countries still having strong growth rates and relativily low inflation rates. Recent spikes in food and fuel prices, which put strong pressure on inflation rates and budget deficits, provide an interesting test. Soon we will be able to see how sustainable their new-found macro-economic stability will be.

The future

It will be hard to repeat the success of HIPC. Firstly, most low-income countries do not have high debt burdens anymore. Moreover low-income countries now have more alternative sources of finance from emerging, resource hungry powers such as China, Russia and India, and private investors. Therefore, it will be much harder to enforce reform upon countries. Moreover, the kind of challenges that low-income countries now face may be less easily tackled by the HIPC approach. For example governance and corruption are harder to measure than macroeconomic policy. Meanwhile, in the coming years improved governance will be crucial for further growth and development in the region just like better infrastructure and more developed local financial sector.

Nevertheless after HIPC debt relief Sub-Sahara offers more business opportunities. Greater macroeconomic stability has improved the environment for the private sector, as high inflation and unsustainable exchange rate regimes were highly distortive to business. Furthermore, debt levels in Sub-Sahara Africa have decreased substantially, especially after the international financial institutions cancelled all the debts of these countries in 2006 (Multilateral Debt Relief Initiative). This has helped ten formerly heavily indebted countries to receive sovereign credit ratings from agencies such Standards & Poor’s and Fitch, which will further increase attractiveness for private investors. Indeed, private capital flows to Sub-Saharan Africa have been increasing in recent years.

Conclusion

The effects of HIPC conditions on policies and institutions may be as least as important as the reduction of debt itself. The success of the HIPC initiative may surprise those who, based on experiences with IMF programs in the eighties and early nineties, argued that donor enforced conditionality cannot change policies. HIPC shows it can in at least some fields, as long as the carrot is big enough and conditionality is designed in the right manner. Sub-Sahara still has to deal with new challenges, especially in the field of governance, infrastructure and local financial sector development. Moreover, the recent food and fuel price spike is a big test for the sustainability of new found macroeconomic stability, while new investor interest may lead to new debt problems. This new sources of finance however also provide opportunities to deal with challenges of low-income countries, especially those in the field of infrastructure. Moreover, the fact that there is now more investor interest in those countries can also be interpreted as a sign of their graduation. Nevertheless, it will be a challenge to maintain and build on the results achieved. In the next article Reintje Maasdam explains whether and how sovereign credit ratings might help.

October 2008

Herwin Loman (030 - 2131105)
H.Loman@rn.rabobank.nl

www.rabobankgroep.nl/kennisbank