ASSESSING A DECADE OF DEBT REDUCTION PRACTICE IN THE GREAT LAKES REGION

by Danny Cassimon [1]

Résumé

Ce chapitre présente une analyse préliminaire de l'incidence de la réduction de la dette, notamment de l'Initiative PPTE, sur le développement des pays de la région des Grands Lacs. Plus particulièrement, l'analyse décrit l'incidence de l'initiative PPTE sur la disponibilité de ressources additionnelles budgétaires, et l'efficacité de la «conditionnalité» utilisée afin de traduire ces ressources en dépenses pro pauvres. Malgré étant éligible dès le début, surtout le Burundi et la RDC n'ont pas pu bénéficier d'une réduction de la dette que dans les dernières années, dû largement aux conditionnalités liées à l'initiative PPTE. En outre, même pour le Rwanda, l'analyse démontre que la réduction de la dette ne va pas amener de façon directe à une augmentation significative des ressources réellement disponible dans le budget, afin de financer de dépenses prioritaires additionnelles. En plus, comme montré dans le cas RDC, une politique de 'micro-ciblage' afin d'assurer que ces ressources sont effectivement utilisées pour des dépenses pro pauvres n'est pas efficace. Dans le long terme, une politique de ciblage du budget, liée au DSRP, a plus de potentiel. Afin de réaliser cet idéal, la conditionnalité liée à l'initiative PPTE, y compris le DSRP, envisage surtout à résoudre les défaillances structurelles non seulement sur le plan économique mais aussi sur le plan politico-institutionnelle de ces pays. Il est clair que la vraie incidence de l'initiative PPTE se situe sur ce plan-ci. Par cela, la réduction de la dette se présente de façon similaire que l'appui budgétaire. Par conséquence, cela implique aussi que les bailleurs de fonds, par l'instrument de la réduction de la dette, se lancent, de façon déguisée, dans l'appui budgétaire dans les pays concernés. Ceci est actuellement surtout le cas pour le Rwanda dans le cadre du successeur de l'initiative PPTE, notamment l'Initiative de Réduction de la Dette Multilatérale (IRDM), lancée au sommet G8 de Gleneagles en 2005.

1. INTRODUCTION

A decade ago, in 1996, the international donor community launched a coordinated initiative to grant (additional) debt relief to a specific set of low-income countries, the Heavily Indebted Poor Countries, or HIPCs. Although mainly bilateral donors, brought together in the Paris Club, already provided debt relief before that date, it was only with this HIPC Initiative that debt relief became an important instrument to promote development and poverty reduction. For, even if the initial focus of the HIPC Initiative was to allow recipient countries to regain external debt sustainability, the enhancement of

[1] We are grateful to Magloire Ntomono-Nzuzi for providing additonial information on the HIPC Initiative in RDC. Part of the conceptual framework is joint work with Robrecht Renard. Of course, we alone assume responsability for all remaining errors.

the Initiative after the G7 Cologne Summit, with the introduction of the Poverty Reduction Strategy Paper (PRSP) framework, introduced a direct link between debt relief and development, as the PRSP framework was part of the 'conditionality' framework to assure (donors) that debt relief (savings) were effectively rechanneled into (country-owned) development priority actions and government spending. As those that granted debt relief were the same than those granting (traditional) aid, debt relief for these countries became an additional instrument of development aid delivery with the aim of supporting development and poverty alleviation, whose virtues should be compared to those other types of aid delivery. This was even strengthened with the introduction of the Millennium Development Goals (MDGs), as calls for more debt relief focused on its role to enable 'scaling up aid' and provide additional financing to reach these MDGs. Indeed, as we will see later on, the explicit goal of the new G8 initiative launched at the 2005 Gleneagles Summit, now called the Multilateral Debt Relief Initiative (MDRI), is to provide additional (aid) resources to recipient countries to meet the MDGs.

As the Great Lakes countries were all classified as HIPCs, debt relief was seen, at least in principle, to have the potential of becoming an important lever for development and poverty reduction in the region. In this article, we briefly assess to what extent a decade of debt relief, through the HIPC initiative and beyond, has indeed managed to fulfill these hopes, by assessing the relative effectiveness of debt relief for development. We provide both an assessment in general, as well as look at the region's experience. Looking at these three countries provides us with the opportunity to make a comparative analysis, as the three countries followed a different trajectory in time: Rwanda managed to assure HIPC debt relief early on, and will now as a post-completion HIPC country immediately receive additional MDRI debt relief, while both DRC as well as Burundi have so far only managed to lock in a HIPC decision-in-principle (in 2003 ad 2005 respectively), and are now only receiving interim HIPC debt relief. As we will show, the donor 'conditionality' modalities surrounding debt relief are to a large extent determining the differential outcome.

The article is straightforwardly structured as follows. Section 2 provides a conceptual framework to assess debt relief from a development perspective. In section three, we apply this framework to taxonomy of debt relief practices, including both the HIPC Initiative and the MDRI. Section 4 then zooms in on the specific experience of Burundi, DRC and Rwanda, in a comparative way. Section 5 concludes by putting the potential role of debt relief for development in (a more modest) perspective.

2. A FRAMEWORK TO ASSESS DEBT RELIEF FROM A DEVELOPMENT PERSPECTIVE

In order to assess debt relief, it is helpful to distinguish between two broad issues. The first one refers to the ‘net overall resource impact’ of debt relief, i.e. the net direct as well as indirect effects of the debt relief on the overall amount of resources available to the recipient country(’s budget). The second component deals with the mechanism used to link these additional resources to development (expenditures); in the case of donor (aid) interventions, this is what is described by the general term ‘conditionality’, i.e. how donors try to influence for what purposes the funds are used. Together, they make up a simple but insightful framework. We will briefly highlight the main elements of the framework before applying it both to different concrete debt relief initiatives in general, as well as to our country case studies.

2.1. Measuring the net overall resource effect of debt relief

In principle, debt reduction, be it in the form of debt service or debt stock reduction, frees resources in the recipient country government budget that can be rechanneled into other spending (or reduce the fiscal deficit)[2]. But this is only valid to the extent that, in the absence of debt relief, debt would have been (fully) serviced. If this is not the case, the resource effect of debt reduction is virtual and refers mainly to an accounting clean-up of historical and future arrears accumulation. Real direct resource savings equal the share of debt service that would have been actually transferred to the creditor in the absence of debt relief. This is typically called the *economic value* (denoted as EV in the rest of the paper) of debt relief, i.e. the present value (PV) of all future debt service payments that would effectively have been paid by the debtor in the absence of debt relief, with present value measured at an appropriate (recipient country) discount rate and allowing for (partial) non-payment (d), or:

$$EV = \sum_{t=0}^{n} \frac{S_t(1-d)}{(1+i)^t} \qquad (1)$$

[2] As such, from a resource viewpoint, operations on debt relief are very much equivalent in nature to a new (aid) money inflow, when the new aid is delivered in grant form through some budget support modality.

Where:

EV: economic value of debt relief, representing the net direct benefit of debt relief;

S_t: contractual debt service in year t (present = year *0*, final year of reimbursement = year *n*) related to the debt relieved in the operation;

d: percentage of future non-payment in the absence of the debt relief operation, i.e. the percentage of defaulting by the debtor that would have taken place in the absence of the present debt relief;

i: the appropriate discount rate from the debtor country's perspective.

This EV is the direct resource effect. The main message underlying this formula is that one dollar of debt relief does not necessary lead to an equivalent one dollar of new resources available (as in budget support).

Nevertheless, even in the extreme case of debt relief being purely virtual, an 'accounting clean-up' can also be advantageous as a result of a series of other indirect effects. For, an excessive debt burden can provoke a series of actions by the government, creating a vicious circle that can be stopped only by reducing debt to a sustainable level (in a broad sense). Excessive debt service might not only severely crowd-out spending on development priorities, it might also provoke sub-optimal fiscal and other government behavior (e.g. excessive domestic borrowing, excessive inflationary financing, excessive taxation of some sectors in the economy) and lessen incentives for economic reform. As a consequence, both private domestic as well as foreign investors might be discouraged to productively invest in the recipient economy. The overall result will be, among other things, a depressed economic growth rate. This is generally referred to as the *debt overhang hypothesis*[3].

In such a context, debt relief can constitute an important element of a package triggering a return to a virtuous circle. As such, on top of real debt savings, debt reduction might ultimately increase resources available to the government due to higher net aggregate flows, originating not only from private sources, but mainly from public sources. This works in two ways. First, a large debt burden might bring about a breakdown in selectivity of donor interventions as donors provide new money in order to allow the country to stay current on debt service payments, rather than for development

[3] The seminal reference is KRUGMAN (1988), "Financing versus Fogiving a Debt Overhang", *Journal of Development Economics* 29, 253-268. However, a lot of authors question the negative strict causality between external debt and growth for low-income countries. Rather, an excessive external debt is one of the symptoms of the systemic development problem of these countries. As such, a lasting solution calls for systemic changes, including tackling institutional, political and other weaknesses, of which debt reduction will also be a necessary ingredient.

purposes. This has been denoted as *«defensive lending»*[4]. Debt relief can restore selectivity as the need for defensive lending abates. Second, following the new aid effectiveness literature[5], once the debt problem is solved, it is optimal to increase interventions in that country since the productivity of one more dollar of aid is higher there.

To sum up, apart from a direct resource effect, measured by the economic value of debt (relief), some positive net indirect effects, covered by the notion of debt overhang used here in a broad sense, might add to the value of a debt relief operation from the viewpoint of the recipient country. On the other hand however, debt relief might also generate some negative indirect effects, such as a negative effect on the government's domestic resource mobilization e.g. because government policy is relaxing its discipline in that field. Consequently, indirect effects are best assessed on a net basis (i.e. the net indirect effects, hereafter denoted by NIE).

From an assessment point of view, the direct and indirect effects of debt relief should be confronted with the direct costs, if any, for the recipient country of engaging in a debt relief operation (hereafter denoted by C). The cost is real and visible e.g. when the country is using its own resources to buy back debt in the secondary market at a discount. But it is more important to realize that such operations can entail considerable, somewhat hidden costs, namely in the form of *new money foregone*. This is particularly relevant in the case of official donor operations on debt relief, where debt relief can have an opportunity cost in the form of (other) aid forgone. In such cases, when debt relief is granted by the donor (on its own claims) without any form of compensation, or when a donor provides aid money to the recipient country for a buyback operation, it is crucial to assess to what extent the donor is not at the same time lowering its other aid operations, i.e. merely substitutes traditional aid interventions for debt relief. From the recipient country perspective, there is no opportunity cost if the donor intervention is truly '*additional',* i.e. where a recipient country buyback funded by donor money, or a donor debt cancellation decision simply adds to the volume of aid that would have been received by the country in the absence of debt relief.

All of the above considerations can be brought together in a simple formula that allows for assessing the net economic benefit of a debt relief intervention (W) for the recipient country, stemming from a range of net overall, both direct and indirect, resource effects:

---

[4] BIRDSALL, N., S. CLAESSENS & I. DIWAN (2003), "Policy Selectivity Foregone: Debt and Donor Behaviour in Africa", *World Bank Economic Review*, 17, 409-435.

[5] See e.g. BURNSIDE, C. & D. DOLLAR (2000), "Aid, Policies, and Growth", *American Economic Review*, 90 (4), 847-868; WORLD BANK (1998), *Assessing Aid – What Works, What Doesn't and Why, World Bank Policy Research Report,* New York: Oxford University Press.

$$W = EV - C + NIE \qquad (2)$$

Where:

W: net economic value of debt relief operations;

C: opportunity cost of debt relief, i.e. domestic resource cost for the debtor or development aid forgone;

NIE: net indirect financial effects of debt relief operations.

The numéraire used in our measure of the value of debt relief is uncommitted recipient government income. The interpretation is straightforward: when W is positive, debt relief is preferable from a recipient country viewpoint.

An important implication of the foregoing is that, due to a substantial debt burden, countries that receive debt relief that turns out to be additional are in fact receiving more aid than otherwise. From a donor perspective, it is important to realize that using debt reduction as an aid intervention can shift interventions towards such countries with a substantial debt, and that this may provoke problems of adverse selection and moral hazard. Moreover, assuming a fixed donor budget for development, it is important to value a debt intervention relative to other possible interventions. In practice, if a donor engages in debt relief operations in a particular country, these are either at the expense of other interventions in the recipient country or in other countries whose needs in terms of debt relief or aid are possibly equally pressing or superior to those of the former. A donor can escape from this difficult relative assessment only to the extent that the use of the instrument of debt relief enables it to attract additional resources that would otherwise not have been available. This could occur either at the level of a single donor or the donor community as a whole. It can be the result of public opinion so strongly in favor of debt reduction that it in fact enables the development community to successfully negotiate a higher development aid budget, or to attract resources from other budgets. This is in principle one of the essential features of major recent debt relief initiatives, and especially the MDG logic: debt reduction should be 'additional' to traditional aid interventions, and as such provide additional resources to meet the MDGs[6], both from a recipient country, as well as from the overall donor budget perspective. The extent to which such

[6] Additionality might be difficult to measure in reality. On the one hand, one has to watch out for symptoms of 'false additionality', such as increases of ODA due solely to the generous OECD/DAC rules with respect to ODA-accountability of debt relief. On the other hand, situations of 'quasi-additionality' can arise, such as increases in the aid budget utilization rate due to the relatively high speed and ease with which debt cancellation can be executed relative to other interventions such as project or even budget support.

overall 'additionality' is likely to occur will prove crucial in assessments of debt relief.

2.2. Conditionality and the link between debt relief and development

Typically, from a donor's perspective, the fact that more resources come available in the recipient country's budget does not automatically mean that they will be used for a desired purpose, in this case a development purpose. In donor jargon, often the term *«earmarking»* is used. Consequently, donors want to influence the utilization of funds, or change recipient country behavior in another way, by using conditionality. However, ways to do that differ, and modalities used have changed over time, reflecting changes in the aid delivery paradigm over time. Overall, it is useful to distinguish between four types of 'earmarking', namely micro-earmarking, sector-earmarking, macro-earmarking and non-earmarked interventions[7].

Micro-earmarking refers to the desire of the donor to micro-determine and monitor the use of the funds. Typically, funds are placed in jointly-managed counterpart funds, typically outside the government budget, using non-aligned (separate) implementation and monitoring mechanisms, bypassing the government's public system. This practice can be considered part of the 'old' project logic, with its attached inherent strengths, such as high donor commitment, ease of monitoring and effectiveness evaluation (both ex ante as well as ex post), and high degree of donor accountability towards home constituencies, but also with its well-known weaknesses, such as fungibility, high transaction costs, lack of long-term capacity building and strengthening of the public management and monitoring and evaluation system, and weak ownership and sustainability.

Sector-earmarking refers to the mechanism in which funds released from debt service obligations are used to support the government budget in specific (jointly established) areas of social intervention, in one specific sector, such as health or education. It is equivalent to sector budget support. It is typically integrated into the government budget, and execution and monitoring is aligned, using as much as possible the government's own systems. Donors might prefer this option because they have a comparative advantage in this sector or because their constituencies attach a specific value to interventions in this case (such as specialized multilateral organizations), because they want to correct for what they feel to be 'prioritization failures', or because they want to concentrate their efforts in a limited number of sectors (as in the case of so-called small bilateral donors). When such

[7] Note that this classification is not specific for debt reduction-related interventions, but is useful for aid interventions in general.

earmarking is done to more than one sector, it is usually referred to as *macro-earmarking*, or '*multi-sector' earmarking*.

For *non-earmarked debt relief*, use of funds released is not tied to specific predetermined activities. It is so-to-say 'deliberate fungibility', where funds from debt relief are pooled with the recipient country's domestic resources in the budget, to be spent on the government's priorities as put forward in national development plans such as for example the PRSP, a MDG plan, etc. We prefer to label them as non-earmarked use, highlighting the essence of (full) alignment with recipient country development priorities, and government systems of implementation and M&E. Here, debt relief is in fact analogous to non-earmarked budget support[8].

In the following, we will see that conditionality with respect to international debt relief practices, as an element of the new aid paradigm, has gradually shifted from micro-earmarking to non-earmarked modalities.

3. APPLICATION TO A DECADE OF DEBT RELIEF PRACTICE

In this section, we apply our framework to taxonomy of debt relief practices. Before focusing on the debt relief initiatives put forward in the last decade, namely the HIPC Initiative and its successor, the MDRI, we confront it with earlier practices.

3.1. Pre-HIPC debt relief practices

Notwithstanding isolated operations (typically by bilateral creditors), debt relief practices started only as a commonly-agreed option towards the end of the eighties, when bilateral creditors (grouped in the 'Paris Club') decided on 'common terms' to guide debt rescheduling operations for low-income countries on bilateral debt, which included (progressively increasing) fixed percentages of debt relief, even on non-concessional claims: from 33% of implied debt relief (the so-called Toronto terms) up to 67% (Naples terms) from the mid-nineties on. However, these rescheduling operations involved debt relief on debt service due during a limited so-called 'consolidation period' of a few years, and did not involve the stock of debt.

From applying our assessment framework, it has to be concluded that these early operations, so-called «consolidations», had almost no impact whatsoever, and could easily be compared to 'rearranging the deck chairs on a

[8] In fact, here, as we will see later, debt relief is an extreme form of non-earmarked general budget support, as frequently budget support conditionality includes continuous policy dialogue and annual bargaining over the amount of funds based whereas debt relief (involving cancellation of debt service due for sometimes up to 40 years to come) is given irrevocably once the recipient country has fulfilled certain entry conditions.

sinking Titanic'. They have to be characterized as 'marginal' operations, also in an economic sense: they did not generate substantial resource savings for development as the probability that this dollar of debt forgiven would have been repaid by the debtor government in the case without relief (the economic value, EV) was close to zero. Moreover, since the size of the transaction is small, such debt relief does not change the economic behavior of debtor governments nor of external finance providers but will, on the contrary, generally consume donor resources that could otherwise have been used for alternative causes. Consequently, also the indirect effects as well as additionality will generally be marginal. Finally, the conditionality attached did not link the scarce resource savings to development in an effective way: conditionality focused on IMF programmed compliance, which was only indirectly linked to development; when donors did attach some earmarking to development, it was of a micro-earmarked nature, typically through the use of 'counter value funds'; assessment studies of this practice[9] have clearly shown that this approach resulted in a number of problems hampering the use of the debt relief savings, sharing many of the pitfalls of conventional project aid.

One of the main lessons of this early practice was that debt relief should be 'large' (enough) in order to make a difference. Since then, the international debt relief practice, both for official as well as private debt, has increasingly focused on 'large-scale' operations. For low-income countries, this resulted in the Paris Club agreement to deepen bilateral debt relief by increasing the embedded share of debt relief percentage to 67% relief and apply it to stock debt relief, instead of to debt service over a limited consolidation period (Naples stock terms), soon followed in 1996 by the HIPC Initiative.

3.2. The HIPC debt relief initiative

On top of Naples stock debt relief already promised by the Paris Club, the HIPC-Initiative pledges additional relief for a specific sample of low-income countries (only), the heavily-indebted poor countries, for them to reach debt sustainability, by reducing their debt to a common threshold debt level. Fair burden sharing between creditor (classes) is acknowledged as *all* creditors have to reduce their claims in an equiproportional way. Table 1 (left column) provides a brief overview of the main characteristics of the HIPC Initiative; a flow chart presentation of the stages is added as annex. It was enhanced in 1999, with threshold debt levels being lowered (in external terms, down to a present value (PV) of debt to exports ratio of 150%; in fiscal terms

[9] See e.g. ROEMER (1989), "The Macroeconomics of Counterpart Funds Revisited", *World Development*, 17 (6), 795-807.

down to a PV of debt to fiscal revenues ratio of 250%). At that moment, a more direct form of conditionality to link debt relief to development was formally introduced, in the form of the PRSP requirement. Currently, 10 years down the road, 19 countries, of which Rwanda, have fully completed the HIPC process, having reached the so-called «completion point», and received irrevocable debt stock relief down to the threshold level[10]. Furthermore, 9 countries, including Burundi and DRC, are halfway, having reached a decision point agreement in which the amount of HIPC debt relief is determined (in principle) as well as additional conditional ties to be complied with by recipient countries in order to reach completion point. In the meantime, these countries receive so-called interim debt relief. Overall, currently committed debt relief amounts to about 35 billion USD in present value terms.

How should we assess the HIPC initiative from the viewpoint of our framework?[11] First of all, the HIPC initiative has shown to be more than an 'accounting clean-up' operation leading only to 'virtual' debt relief. Partly due to the fact that also multilateral creditors (IMF, World Bank, regional development banks) reduced their claims, roughly half of total debt relief can be said to reflect truly real savings (EV), available for additional priority spending. Furthermore, although debt relief is officially claimed to be additional, clear signs of this additionality are only to be witnessed at recipient country level, especially for post-completion point countries where net flows have indeed gone up more than with the amount of debt reduced, but it is difficult to find hard evidence of strict additionality with respect to ODA and donor budgets as a whole. With respect to the indirect effects, it is hard to discern a strong debt overhang effect, defined as a negative strict causal relation between external debt and growth for low-income countries. Rather, an excessive external debt is one of the symptoms of the systemic development problem of these countries. As such, a lasting solution calls for systemic changes, including tackling institutional, political and other weaknesses, but one in which debt reduction will clearly also be a necessary ingredient.

[10] Benin, Bolivia, Burkina Faso, Cameroon, Ethiopia, Ghana, Guyana, Honduras, Madagascar, Mali, Mauritania, Mozambique, Nicaragua, Niger, Rwanda, Senegal, Tanzania, Uganda and Zambia.

[11] See e.g. CASSIMON, D. & J. VAESSEN (2006), "Theory, Practice and Potential for Debt for Development Swaps in the Asian and Pacific Countries", forthcoming in *Economic Systems*. A detailed study and assessment of HIPC is beyond the scope and purpose of this paper. See e.g. OED (2004), *Debt relief for the poorest: An OED review of the HIPC initiative, Operations Evaluation Department*, World Bank, Washington D.C; IEG (2006), *Debt relief for the poorest: an evaluation update of the HIPC initiative. Independent Evaluation Group,* World Bank, Washington D.C.

This last argument brings us to the element of conditionality of HIPC, referring to the conditions that eligible recipient countries should comply with before reaching the HIPC completion point. As shown also in the annex figure, the HIPC Initiative was designed as a multi-stage process including several types of conditionality, ranging from the more conventional track record building of IMF programme compliance, some country-specific completion point 'triggers', as well as specific 'development-linked' conditionality through the PRSP. The basic purpose of this process was indeed to use this debt relief vehicle to continue work on curing these systemic weaknesses of HIPC countries so as to enhance development effectiveness of donor interventions in general, including tackling public governance issues.

The PRSP framework has undoubtedly been the most defining and drastic feature of the HIPC conditionality[12]. Accordingly, one could perceive the HIPC initiative as being a 'debt for PRSP' swap. In principle, in terms of our 'earmarking' taxonomy, this is a clear example of *non-earmarked* debt relief. However, note that, even in the HIPC initiative, 'non-earmarking' is not the automatic option taken. In some countries, where e.g. public financial management systems were felt to be lacking in performance, even HIPC (usually interim) debt relief relied on micro-earmarking, in principle as a transitory mechanism. This was done using the so-called institutional fund mechanism, having all the characteristics of what we call micro-earmarking. Sometimes, donors rely on intermediate types of earmarking, such as the so-called virtual fund mechanism (VFM) in which HIPC relief and its designated expenditures were integrated into the budget, but accounted for in separate budget lines[13].

[12] Established jointly by the IMF and the World Bank in 1999, the PRSP framework has become a precondition for HIPC debt relief as well as for concessional funding. The latter explains why the number of countries that have formulated a PRSP is much larger (close to 50) than the number of countries actually involved in the HIPC initiative.
[13] IMF & IDA (2001), *Tracking of Poverty-Reducing Public Spending in Heavily Indebted Poor Countries*, March 27, 2001, 29p.

Table 1. Basic characteristics of the HIPC Initiative versus alternative proposals

Basic characteristics (enhanced) HIPC-initiative	*Basic characteristics of an alternative*
1. Focused on special target group: HIPCs = heavily indebted poor countries (now 42)	1. Focused on countries with low development level, irrespective of debt level
2. Including all creditors, according to an «equiproportional» burden sharing, after traditional (bilateral) debt relief at Naples stock terms	2. Including all types of debt, [according to economic value (EV)?]
3. Reducing debt to sustainable (= payable) level, as calculated according to PV of debt over exports – and /or PV of debt over fiscal revenues.	3. Reducing debt within a MDG perspective (and beyond?). Criteria reflecting minimum necessary amount of (budgetary) resources to finance «human development» (MDG/PRSP).
4. Conditionality using phasing, ex-ante 'track record' of economic adjustment (IMF) for decision point and a list of specific conditionalities (including developing and executing a PRSP) for completion point.	4. Minimal level of conditionality to get debt reduction (good governance and utilization of effectively freed resources); PRSP conditionality for long-term concessional financing.
5. Additionality in principle of debt reduction, without enforcement mechanism.	5. Increase of structural link between 'traditional' aid operations and debt reduction in order to verify additionality.
6. In-built care for future debt sustainability via rules and conditions of new debt; possibility for 'topping-up' at completion point.	6. Better structural mechanisms to keep future debt sustainable (e.g. 'contingent debt', or insurance mechanisms against negative external shocks).
7. Decision-making by international (donor) community, via IMF and World Bank.	7. Endorsement of PRSP and judgment and calculation of debt relief not the sole responsibility of IMF/World Bank, involving e.g. independent arbitration, or a partnership structure (cfr. EU-ACP).

3.3. Debt relief from a MDG perspective: the MDRI and beyond?

Recently, the G8 during their Gleneagles Summit proposed to go beyond HIPC in granting additional multilateral debt relief in what is now called the Multilateral Debt Reduction Initiative (MDRI). In their proposal they explicitly refer to the purpose of debt relief as a means for generating additional resources to meet the MDGs[14]. The new proposal almost exclusively builds on the HIPC Initiative and will result in the cancellation of all remaining debt outstanding (and disbursed) vis-à-vis three major multilateral creditors, notably IDA (the low-income countries soft loan and grants window of the World Bank), the African Development Fund (the soft loan window of the African Development Bank) and the IMF, for all HIPC countries that have reached completion point status (only). Consequently, currently 19 countries, of which Rwanda, are eligible for this additional debt reduction[15].

A preliminary appraisal of MDRI using our framework points at the following conclusions. Since post-HIPCs were expected to pay remaining debt in full, this additional cancellation will free additional resources for debt reduction, on a (close to) one-to-one basis. As such, in this case one dollar of debt relief comes closest to being equivalent to one dollar of new money in the form of a budget support grant. Not all of this is truly additional money (i.e. having no opportunity cost of foregone aid): with respect to IDA/AfDF claims, the debt service cancellations will be subtracted from the countries' prior allocations of new money, so net flows will not immediately increase. However, since IDA/AfDF are supposed to be compensated for the debt reduction 'dollar for dollar' by additional bilateral contributions, these additional bilateral contributions will increase funds available to IDA/AfDF, to be spent on *all* countries eligible for IDA/AfDF funds, including the post-HIPCs, according to the countries' prior allocation rules. As a result, all (low-income) countries will benefit in terms of slightly higher net flows, as compared to the situation prior to the G8 proposal, and fairness rules are maintained between HIPC and non-HIPC eligible countries. So, most likely, C, in our formula (2), will not be negative. For the IMF, it is decided that it will have to cover the full cost of the initiative with its own resources, but the

[14] As such, the MDRI relates to a different logic as the HIPC Initiative, namely that of a MDG-based logic. See also the second column of table 1, that defines a set of alternative features of a debt relief initiative, of which the MDRI is one possible outcome.

[15] With the exception of IMF relief under MDRI, that also includes low-income countries with a per capita income below 380 USD, adding non-HIPCs like Cambodia and Tadjikistan to the list of eligible countries. In the meantime, both IMF and IDA have decided that all eligible countries but one (Mauritania) will benefit from MDRI. See IMF (2005), *The Multilateral Debt Relief Initiative (MDRI) – A First Assessment of Eligible Countries*, December 8, 2005; IDA (2006), *MDRI – Country Eligibility Assessment*, March 17, 2006.

G8 proposal does ensure that the IMF continues to have sufficient financial capacity to continue to assist low-income countries. Finally, indirect benefits of the deal (NIE) are believed to be negligible, as most of them were already realized by HIPC debt relief. Overall, the MDRI can be judged as a positive intervention from a recipient country perspective.

In terms of conditionality attached to MDRI, the basic HIPC conditionality premise continues to hold: ex-post process conditionality applies, as the debt relief is granted once entry conditions are fulfilled. The conditions are broadly identical to the HIPC process: macro-economic stability, overall poverty focus linked to the PRSP, and a minimal quality of the public sector management. There is however an important 'secondary' conditionality effect: for beneficiary countries (only), the composition of future net flows will change, as a larger part of it will now be in the form of cancelled debt service, rather than new grants or concessional loans. Since debt stock reduction is analytically equivalent to (multiyear) general budget support in grant form, post-HIPCs will receive a higher share of their new money in this form, as a result of the initiative, with less (short-term) 'conditionality' strings attached.

4. THE IMPACT OF DEBT RELIEF IN THE GREAT LAKES REGION

In this section, we analyse more in detail the specific country experiences of Burundi, DRC and Rwanda with respect to debt relief, and its potential impact on development. Although the three countries were all considered eligible for the HIPC Initiative from the beginning, practices largely diverged, and as such, the impact of development largely differs between countries. First, we will look into some detail at the comparative chronologic debt relief trajectory of the three countries, as summarized in table 2. Section 4.2 describes in more comparative detail its impact on development.

4.1. A chronological overview of debt relief practices in the Great Lakes region

As shown in table 2, Rwanda managed to lock in a debt reduction deal early in the HIPC Initiative as it did not take long after the genocide crisis to re-establish structural relations with the IMF, which was the crucial prior condition on the road to receive a HIPC decision point agreement: during the second half of 1997, Rwanda engaged in an IMF staff monitored programme (SMP), followed by an Enhanced Structural Adjustment programme (ESAF) from mid-1998 on. Consequently, Rwanda managed to

receive a debt reduction agreement in the Paris Club (at Naples terms) at the end of 1998, and it was one of the first HIPCs to reach decision point status after the enhancement of the HIPC Initiative in 1999, and to start benefiting from additional so-called 'interim' debt relief under HIPC from IMF, World Bank, and the African Development Bank. Despite being postponed several times, Rwanda finally managed to reach HIPC completion point in 2005, receiving in an irrevocable way a reduction of its external debt of about 700 million USD (in present value), which allowed the country to reduce debt (in principle) to its sustainability threshold (150% of exports). Part of this debt relief was to be rechanneled into higher priority sector spending, as pointed out in the country's PRSP.

As highlighted in table 2, both DRC and Burundi were able to re-establish structural relations with the IMF and the whole international donor community only in 2001, and, by consequence, only started to benefit from debt relief from 2002-2003 (DRC) et 2004-2005 (Burundi) on. DRC started a Poverty Reduction and Growth Facility (PRGF) programme with the IMF in 2002, managed to receive a Paris Club consolidation agreement at Naples terms in September 2002, and reached decision point status in the HIPC Initiative in July 2003 (including bilateral donor interim relief at Cologne terms) having successfully established a one-year track record with the IMF under PRGF. Similarly, Burundi started an IMF PRGF programme and received a Paris Club Naples terms consolidation agreement at the beginning of 2004, and managed to reach decision point status under HIPC (including additional Paris Club Cologne terms interim debt relief) around mid-2005. Both of them are still working to comply with all the completion point triggers, including drafting and executing a PRSP; for both countries, the drafting process is completed, notwithstanding some remaining formalities. As such, both countries could tentatively reach completion point at the end of 2006 (Burundi) and the beginning of 2007 (DRC), although lack of complying with conditionality triggers could easily result in postponing these dates[16].

Additionally, Rwanda, being a post-(completion point) HIPC, is able to immediately benefit from additional debt relief under the MDRI, cancelling all remaining debt vis-à-vis IMF, IDA and the African Development Bank. In the case of Rwanda, MDRI will further reduce the external debt burden of the country from around 215 million USD to 67 million USD in present value (about 46% of annual exports). Other HIPC countries, such as Burundi and DRC will in principle receive this additional MDRI debt relief once they achieve a completion point agreement under the HIPC Initiative.

[16] Including (partial) suspension of interim debt relief, as now is the case for DRC as it is declared off-track on its IMF PRGF programme.

In the following section, we will briefly assess the preliminary impact of this (differential) debt relief practice on development for the three countries involved, from the perspective of our assessment framework of section 2.

Table 2: Crucial dates with respect to debt relief initiatives in the Great Lakes region (1996-2006)

	Burundi		*DRC*		*Rwanda*	
1997					1997	IMF-SMP
1998					24/06/98 21/07/98	IMF-ESAF PC-Naples-cons.
2000					22/12/00	DP-HIPC
2001	03/09/01	IMF-SMP	07/2001	IMF-SMP		
2002	09/10/02	IMF-post-conflict assistance	12/06/02 13/09/02	IMF-PRGF PC-Naples-cons.	*07/03/02* 12/08/02	*PC-Cologne cons.* IMF-PRGF
2003			23/07/03 *22/11/03*	DP-HIPC *PC-Cologne-cons.*		
2004	23/01/04 04/03/04	IMF-PRGF PC-Naples cons.				
2005	29/07/05 *15/09/05*	DP-HIPC *PC-Cologne cons.*			13/04/05 21/12/05	CP-HIPC MDRI-IMF
2006	12/06	CP-HIPC ? (+MDRI)			28/03/06	MDRI-IDA
2007			01/07	CP-HIPC ? (+MDRI)		

Notes: IMF: SMP: staff-monitored program; ESAF: Enhanced Structural Adjustment Facility; PRGF: Poverty Reduction and Growth Facility. PC: Paris club: cons. = debt service rescheduling agreement for limited consolidation period. Naples terms involve a 66% debt reduction – Cologne terms involve a 90% reduction. DP-HIPC: Decision point HIPC Initiative; CP-HIPC: Completion Point HIPC Initiative; MDRI: Multilateral Debt Reduction Initiative, either with respect to IMF debt, either with respect to World Bank debt (IDA).

4.2. Assessing Great Lakes region debt relief from a development perspective

This section provides a brief preliminary comparative overview of the likely impact of current debt relief practice on development for the three countries involved, from the perspective of our framework. First we focus on the net overall resource effect of debt relief, followed by a preliminary assessment of the effectiveness of the (conditionality) link between debt relief and development.

4.2.1. The net overall resource effect of debt relief

Table 3 provides a brief overview of the debt stocks of the three countries before the HIPC Initiative, as well the amount of debt relief embedded in the HIPC Initiative (including the MDRI for Rwanda). As the table shows, the three countries all qualified for HIPC under the exports window; HIPC aims at bringing all countries back to the same level of debt sustainability, i.e. by lowering their present value of debt–to-exports ratio to 150%. As such, the implied debt relief is different for each country, with Burundi necessitating the largest amount of relief in relative terms (because of its very high debt-exports ratio). Rwanda, which already passed through completion point, needed a so-called ‘topping-up’ of debt relief at completion point, in order to bring the country to the debt sustainability threshold of 150% at completion point. This increased the amount of debt relief granted to Rwanda by about 240 million USD (in present value, PV). For Rwanda, it is estimated that MDRI will provide about 147 million of extra debt relief (again in present value terms).

Table 3: Debt relief embedded in the HIPC/MDR Initiative (Million US dollar and %)

	Burundi (dec. point)	*DRC (dec. point)*	*Rwanda (compl. point)*
Debt stock before HIPC (PV)	902	7868	1009
PV-of debt to exports ratio (%)	1772	758	756
Total HIPC debt relief (PV)	826	6311	452 (DP) 243 (topping)
Add. MDRI debt relief (PV)	n.a.	n.a.	147

Source: author’s calculation on the basis of country HIPC decision and completion point documents.

However, these absolute debt relief figures do not reveal much information on the actual annual budgetized cash savings from debt service relief, as well as the indirect effects of HIPC debt reduction on other donor flows, as highlighted in our assessment framework of section 2. Table 4 provides some estimates of the actual net overall resource effect of debt relief, by looking at annualized data for the three countries. The table provides data of debt service *actually paid* before HIPC, and compares this with debt service *due* after HIPC debt relief. The difference between the two sheds some light on the actual debt service savings of HIPC. If we take, say, the average of 1998/99 as pre-HIPC figures, the table shows, on average, that cash flow savings arising from HIPC debt relief are to a large extent '*virtual*', i.e. do not constitute additional resources available because of a reduction of debt service, even if, the contractual HIPC debt relief granted to these countries can be considerable, both in absolute terms, as well as in relative terms (especially with respect to government revenue, less so in GDP terms). An extreme case is the situation of DRC, where because of a nearly complete debt service standstill before HIPC, debt service payments after HIPC are much larger, and so, in cash flow terms, the direct impact of HIPC is even negative.

However, fortunately, this is not all. Incorporating the indirect effects in general allows for a substantial qualification of our prior conclusion. Table 4 also includes figures on the evolution of the other gross donor inflows (grants and other current aid transfers, as well as disbursements of new concessional loans), both before and after HIPC Initiative implementation. The overall conclusion of the figures is clear – on average, these other gross donor inflows rise after HIPC implementation, and generally overcompensate the possibly negative direct effect. As such, even if this increase cannot be attributed to the HIPC debt relief in a strict causal way, it shows that the net overall resource situation of these three countries is better after HIPC than before. But, again, this improvement cannot be attributed in a direct way to the HIPC debt relief itself, as it is largely virtual.

This general conclusion confirms our general appreciation of the HIPC Initiative in the previous section, namely that this improved net resource situation is due to a process of more systemic changes in the recipient countries, triggered by the (albeit burdensome) conditionality implied in reaching the decision or completion point in the HIPC Initiative. The same goes for the indirect effect on economic growth. Preliminary econometric analysis[17] does not show a significant strict causal effect of

---

[17] See e.g. CHAUVIN & A. KRAAY (2005), *What Has 100 Billion Dollars Worth of Debt Relief Done for Low-Income Countries?*, World Bank Policy Research Paper. The fiscal response effects of HIPC debt relief are marginal, especially when compared to the effects of new inflows of grants or loans, as shown in CASSIMON, D. & B. VAN CAMPENHOUT

(HIPC) debt relief on economic growth. Rather, systemic changes on institutions, public governance etc.., that are also triggered by the HIPC conditionality process in general, and the PRSP vehicle in particular, do seem to have a significant positive effect on economic growth, also in the Great Lakes region. This brings us to the 'conditionality' link with development.

Table 4: Net aggregate resource impact of HIPC debt relief (million USD)

	1998/99	*2000/01*	*2002*	*2003*	*2004*	*2005*	*2006*	*2007*
Burundi								
DS paid (pre HIPC)	0	18.1	25.1	27.8	70.4			
DS due (post HIPC)						24.7	10.5	4.6
HIPC debt relief	0	0	0	0	0	16	36	40
in % exports						*22.2*	*44.9*	*47.0*
in % gov. revenue						*9.5*	*20.6*	*20.0*
in % GDP						*2.0*	*3.8*	*3.5*
Other gross inflows	46	40	61	90	181	157	128	136
in % of GDP			*10*	*15.1*	*27.1*	*19.7*	*13.4*	*11.8*
DRC								
DS paid (pre HIPC)	1.9	0	34.2					
DS due (post HIPC)				126	95	149	201	207
HIPC debt relief	0	0	0	141	175	270	352	392
in % exports				*9.5*	*8.9*	*12.0*	*13.0*	*13.7*
in % gov. revenue				*23.5*	*25.9*	*20.5*	*20.2*	*21.6*
in % GDP				*2.5*	*2.8*	*3.8*	*4.2*	*4.4*
Other gross inflows	..	230	489	623	716	1170	915	973
in % of GDP	..	*4.5*	*8.6*	*10.9*	*11.4*	*16.5*	*10.9*	*10.8*
Rwanda								
DS paid (pre HIPC)	27.5							
DS due (post HIPC)		29.7	15.9	15.5	18.5	10.5	10.6	11.9
HIPC debt relief	0	10.6	12.1	13.5	17.9	29.4	44.3	52.2
in % exports		*7.0*	*9.1*	*9.7*	*9.5*	*14.6*	*19.6*	*20.6*
in % gov. revenue		*6.3*	*6.2*	*6.3*	*6.9*	*9.2*	*13.8*	*14.9*
in % GDP		*0.6*	*0.7*	*0.8*	*1.0*	*1.4*	*2.1*	*2.2*
Other gross inflows	255	250	229	209	330	302	354	350
in % of GDP	*19.1*	*19.2*	*13.0*	*12.1*	*17.8*	*14.4*	*16.7*	*14.7*

Source: IMF & IDA (2006): *HIPC Initiative – Statistical Update*, March 21, 2006, and author's calculations based on IMF Article IV reports and HIPC Decision Point documents of the three countries. DS: debt service.

(2006), "Aid effectiveness, debt relief and public sector response. Evidence from a panel of HIPCs", paper for WIDER Aid Conference (June 2006).

4.2.2. Linking debt relief directly to poverty reduction

So far, we have seen that HIPC debt relief is largely virtual, but indirect effects lead to an increased net resource envelope that can in principle be used to increase priority spending. What can we say about the effectiveness of channelling these debt relief savings towards pro-poor spending to relieve poverty?

The first conclusion, again, is that, in a narrow sense, especially HIPC debt relief does not significantly increase the amount of resources available for pro-poor spending in the budget, again because of this virtual nature. Even if this is the case, in most countries, donors want to monitor the use of debt relief savings in a very strict way, by trying to earmark in some way the actual debt relief savings to monitorable increased pro-poor spending. This is also the case in the Great Lakes region, where donors rely on micro-earmarking of the use of funds, or by using the so-called virtual fund mechanism (as explained in section 3).

Table 5: Annual accounting debt relief versus real savings and actual spending (DRC – million USD)

	2003 (act.)	*2004 (act.)*	*2005 (est.)*	*2006 (proj.)*	*2007 (proj.)*
- From Naples consolidation	118	57	32	0	0
- From capitalization of moratorium interest rates	125	124	62	0	0
- From HIPC Initiative	141	175	270	352	392
- From bilaterals beyond HIPC	22	74	78	110	112
Total debt relief	**282**	**305**	**380**	**461**	**504**
HIPC assistance deposits	17	74.7	195	299	331
Actual HIPC-affected spending	0	35.7	..	..	..

IMF (2006), *RDC - Third review of the PRGF*, and budget information provided by the RDC authorities. HIPC deposits refer to that part of total debt relief that has to be 'compensated' as verifiable additional priority sector expenditures. In the case of DRC, it refers to the full part of the bilateral HIPC debt relief (excluding that beyond HIPC) plus all the multilateral HIPC debt relief that is provided in grant form.

This is highlighted most clearly when looking at the (albeit limited) DRC experience, as shown in table 5. It shows the difference between the total amount of debt relief obtained (including HIPC debt relief), versus the fiscal impact of it, namely the real savings that have to deposited in a special central bank account and that have to be 'compensated' in terms of increased priority spending. The table also shows how much of these resources are effectively *spent* during the same year. The conclusion is evident: even if the

amount of paper debt relief is substantial, only a small part of it has to be compensated. And in the case of DRC, it remains difficult to spend the full amount of debt savings available to the budget.

It is clear that this kind of micro-earmarking and monitoring does not make much sense, among other things due to fungibility issues. As such, as part of the new aid paradigm and within the framework of PRSP, the medium-term goal is to move to non-earmarked tracking of the overall donor inflows (including debt relief) in their relation to the overall evolution of poverty-reducing spending (so-called comprehensive budget tracking).

Table 6 provides an overview of the evolution of poverty-related public expenditure, both actual as well as projected, related to (budgetized) HIPC debt relief as well as other gross official finance inflows. The poverty-reducing expenditures refer to the definition given in the respective country's (I-)PRSPs. The idea is that donors focus on the overall evolution of pro-poor spending. In this respect, the figures for DRC and Burundi are quite sobering, also in the near-future, when even for those countries the PRSP is to take off. In those countries, direct poverty reduction-related spending, although sometimes substantial in government revenue terms, is very limited, say in GDP terms. It is clear that for these countries, the available amount of resources will not have a substantial impact of poverty. There is not even a clear upward trend to be distinguished. And even in the case of Rwanda, where debt relief, both in a direct as well as indirect way, adds to a substantial increase in the net overall resource portfolio, up to about 10% of GDP, the funds that are available for poverty reduction are in absolute terms completely insufficient to make a meaningful difference to poverty reduction. Even the additional debt reduction under the MDRI, which Rwanda is receiving, and which adds to the budgetary resource envelope in a one-to-one way, will not make a substantial difference.

Table 6: Overall poverty reduction spending and net aggregate resources (million USD)

	1999	*2000/01*	*2002*	*2003*	*2004*	*2005 prel.*	*2006 proj.*	*2007 proj.*
Burundi								
Poverty-reducing expenditure	..	27.5	27.1	29.0	33.5	25.2	28.5	30.7
in % gov. revenue		*21.64.*	*24.6*	*23.3*	*25.3*	*14.9*	*16.2*	*15.42*
in % GDP		*0*	*4.3*	*4.9*	*5.0*	*3.1*	*2.9*	*.8*
HIPC DR in % GDP						..	..	..
Other gross inflows in % of GDP			*10*	*15.1*	*27.1*	*19.7*	*13.4*	*11.8*

DRC								
Poverty-reducing expenditure	..	..	26.2	85.2	130	143	280	426
in % gov. revenue		..	*6.3*	*14.2*	*19.3*	*10.9*	*16.0*	*23.4*
in % GDP			*0.5*	*1.5*	*2.0*	*2.0*	*3.3*	*4.7*
HIPC DR in % GDP				*0.3*	*1.1*	*2.6*	*3.2*	*4.0*
Other gross inflows in % of GDP	..	..	*8.6*	*10.9*	*11.4*	*16.5*	*10.9*	*10.8*
Rwanda								
Poverty-reducing Expenditure	75.2	81.5	108	115	137	196	248	268
in % gov. revenue	*39.5*	*46.74*	*54.8*	*53.9*	*52.8*	*61.9*	*76.9*	*76.9*
in % GDP	*3.9*	*.7*	*6.2*	*6.9*	*7.5*	*9.2*	*10.6*	*10.8*
HIPC DR in % GDP		*0.6*	*0.7*	*0.8*	*1.0*	*1.4*	*2.1*	*2.2*
Other gross inflows in % of GDP	*19.1*	*19.2*	*13.0*	*12.1*	*17.8*	*14.4*	*16.7*	*14.7*

Source: IMF & IDA (2006): *HIPC Initiative – Statistical Update*, March 21, 2006, and author's calculations based on IMF Article IV reports and HIPC Decision Point documents of the three countries. DR: (annual) debt service reduction .

5. CONCLUDING REMARKS

From our analysis, it is clear that debt relief, although important, will not have a significant direct impact on poverty alleviation for the region. First of all, similar to pre-HIPC debt relief, also HIPC debt relief is largely virtual, i.e. does not significantly lead to more resources available in the budget. Even the debt relief envisaged in the MDRI, despite being truly additional resources, will not significantly contribute because of its limited extent in absolute and GDP terms, if confronted to overall needs.

Efforts by donors to micro-earmark and micro-manage the scarce additional resources are not an effective way to channel debt relief into development, as shown in the case of DRC. What is more promising is the broad conditionality agenda attached to the HIPC Initiative, especially through the PRSP process, and its non-earmarked nature of comprehensive budget tracking of priority sector actions of the recipient government.

Clearly, this calls for a minimal quality of recipient country institutions and public governance structures, so donors (constituencies) feel sufficiently comfortable when devoting resources of a budget-support type nature to recipient governments, which is the prime motive why donors focus so much on conditionalities in this field.

So, again, what is the more important impact of HIPC and other debt relief initiatives is the more 'systemic' institutional as well as governance changes that are triggered by debt relief, similar to say budget support policy

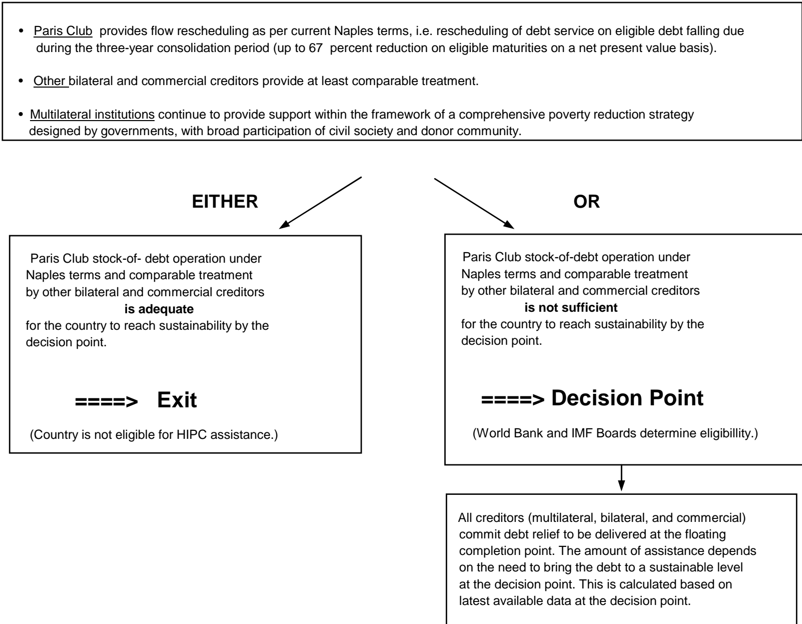
dialogue between donors and the recipient country. Here, maybe the more crucial impact of debt relief, especially under the MDRI, is situated. To the extent that debt relief is subject to the same type of non-earmarked conditionality as say budget support, debt relief is indeed functioning as equivalent, or as a substitute to budget support (in grant form). As such, even donors that may feel uncomfortable with providing budget support in general, or to some recipient countries in particular, are in fact providing that type of support through the vehicle of debt relief. The additional benefit for recipient countries is that receiving budget support through debt relief is a more stable form of budget support, with less strings attached. For regular budget support is subject to annual policy discussions and uncertainty, while debt relief, especially in HIPC and MDRI, is granted in an irrevocable way for the full lifetime of the underlying loan, once some entry conditions are fulfilled.

Antwerp, June 2006

HIPC DEBT INITIATIVE: Flow Chart

First Stage

Country established three-year track record of good performance and develops together with civil society a Poverty Reduction Strategy Paper (PRSP); in early cases, an interim PRSP may be sufficient to reach the decision point.



Second Stage

Country establishes a second track record by implementing the policies determined at the decision point (which are triggers to reaching the floating completion point) and linked to the (interim) PRSP.