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# Supporting Development through Aid and Debt Relief

Development finance moved to center stage at a series of major international forums in 2005. The High-Level Forum on Aid Effectiveness held in Paris in March set out to change how aid is delivered and managed. The Commission for Africa issued a report in March urging donors to scale up aid for Africa significantly. Expectations for a big push in development assistance with a strong focus on Africa escalated over the course of the year, leading up to the G-8 Summit in Gleneagles, Scotland, in July, where "Africa and Development" was one of two main themes. The United Nations World Summit followed in New York in September to assess progress toward the Millennium Development Goals (MDGs) and reinforce commitments on the part of donor and recipient countries. Multilateral trade liberalization also played a central role in the development agenda in 2005. Although the World Trade Organization (WTO) Ministerial Meeting in Hong Kong (China) in December did not complete the Doha Development Round as planned, "aid for trade" surfaced as a major policy initiative, with new commitments by advanced countries to enrich development assistance.

Broad agreement surfaced at the international forums about the need to provide more aid resources, particularly to poor countries in Africa, and to further reduce the debt burdens of heavily indebted poor countries (HIPCs) in order to free up financial resources for meeting the MDGs. There was also strong emphasis on the importance of debt sustainability in underpinning growth, and thereby alleviating poverty over time. This chapter addresses these broad objectives—namely, enhancing the aid effort, particularly in the context of Africa; providing further debt relief to HIPCs; and helping to ensure that developing countries can maintain sustainable debt levels over time. It highlights recent trends in each of these areas and reflects on how the policy initiatives announced over the course of 2005 are likely to influence development finance over the balance of the decade. The main messages are:

- Official development assistance (ODA) increased sharply in 2005, reaching 0.33 percent of gross national income (GNI) in donor countries, up from a low of 0.22 percent in 2001, just below the 0.34 percent level attained in the early 1990s. Although most of the record $27 billion increase in 2005 is accounted for by debt relief grants provided to just two countries (Iraq and Nigeria), the underlying trend indicates that donors have continued to enhance their aid effort. Based on existing commitments, ODA is expected to decline in 2006–7, as debt relief falls to more normal levels, but then to rise gradually through the end of the decade to reach 0.36 percent of GNI in 2010.
- Donors have taken steps to improve: (1) the *allocation* of aid, by providing more aid resources to the poorest countries, particularly those in Sub-Saharan Africa, where the amount of aid may double by the end of the decade; (2) the *composition* of aid, by providing more grants in place of concessional loans in an effort to reduce countries' debt service burden and improve debt sustainability; and (3) the *effectiveness* of aid, by developing a framework that includes tangible indicators and targets designed to gauge development progress over time.

- Debt relief provided under the HIPC Initiative and the Multilateral Debt Reduction Initiative (MDRI) will significantly reduce the debt burdens of poor countries that qualify. The debt of 17 countries that have already reached the completion point under the HIPC Initiative will fall from 55 percent of GDP (before HIPC debt relief) to 13 percent (after MDRI debt relief). Other poor countries have made considerable progress in reducing their debt burdens from very high levels, but much more needs to be done, particularly in Sub-Saharan Africa.
- Debt sustainability in many of the HIPCs has been enhanced by other factors, including stronger economic growth, foreign reserve accumulation, improved external balances, and higher inflows of foreign direct investment (FDI) and remittances. Going forward, low-income countries, HIPCs and non-HIPCs alike, face the challenge of financing their development plans without compromising debt sustainability over the long term. Countries can enhance debt sustainability by pursuing macroeconomic policies that maintain economic and financial stability and by making progress on structural reforms to improve their policy and institutional frameworks.

## Recent trends and prospects for foreign aid

### *ODA continues to rise*

At the United Nations World Summit in September in New York countries reaffirmed the Monterrey Consensus, recognizing that a substantial increase in foreign aid was required to achieve internationally agreed goals, including the MDGs. Donors continue to deliver on their promise. According to the Development Assistance Committee (DAC) of the Organisation for Economic Co-operation and Development (OECD), net ODA disbursements by DAC member countries increased by a record $27 billion in 2005, reaching $106.5 billion (table 3.1).

Relative to gross national income (GNI) in DAC member countries, ODA increased to 0.33 percent in 2005, up from a low of 0.22 percent in 2001, but still remains slightly below the 0.34 percent level reached in the early 1990s (figure 3.1).

### *The rise reflects debt relief and other special-purpose grants*

However, much of the increase in ODA was due to debt relief grants, which totaled $23 billion in 2005, up from $4 billion in 2004 (table 3.2). This largely reflected nearly $14 billion in debt relief provided to Iraq and a little over $5 billion to Nigeria by their Paris Club creditors. Excluding debt relief, ODA increased by 8.7 percent in real terms, up from average annual rate of 5.6 percent in 2002–4.

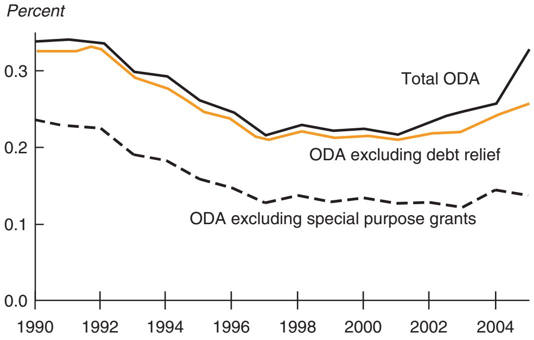
At the UN Conference on Financing for Development in Monterrey in 2002, donors pledged that debt relief would not displace other components of ODA. It is difficult to assess whether donors have honored their pledge in the absence of an explicit counterfactual demonstration of the amount of ODA that would have been provided in the absence of debt relief. The share of debt relief

**Table 3.1 Net ODA disbursements, 1990–2005**
*$ billions*

| | 1990 | 1995 | 2000 | 2001 | 2002 | 2003 | 2004 | 2005[a] |
|---|---|---|---|---|---|---|---|---|
| DAC donors | 54.3 | 58.8 | 53.7 | 52.4 | 58.3 | 69.1 | 79.6 | 106.5 |
| G7 countries | 42.4 | 44.7 | 40.2 | 38.2 | 42.6 | 50.0 | 57.6 | 80.1 |
| United States | 11.4 | 7.4 | 10.0 | 11.4 | 13.3 | 16.3 | 19.7 | 27.5 |
| Japan | 9.1 | 14.5 | 13.5 | 9.8 | 9.3 | 8.9 | 8.9 | 13.1 |
| United Kingdom | 2.6 | 3.2 | 4.5 | 4.6 | 4.9 | 6.3 | 7.9 | 10.8 |
| France | 7.2 | 8.4 | 4.1 | 4.2 | 5.5 | 7.3 | 8.5 | 10.1 |
| Germany | 6.3 | 7.5 | 5.0 | 5.0 | 5.3 | 6.8 | 7.5 | 9.9 |
| Canada | 2.5 | 2.1 | 1.7 | 1.5 | 2.0 | 2.0 | 2.6 | 3.7 |
| Italy | 3.4 | 1.6 | 1.4 | 1.6 | 2.3 | 2.4 | 2.5 | 5.1 |
| *Memo item:* | | | | | | | | |
| EU countries | 28.3 | 31.2 | 25.3 | 26.4 | 30.0 | 37.1 | 42.9 | 55.7 |

*Source:* OECD Development Assistance Committee (DAC).
a. Preliminary.

**Figure 3.1 Net ODA to developing countries, 1990–2005**




*Source:* OECD Development Assistance Committee (DAC).

**Table 3.2 ODA and debt relief grants in 2005**

*$ billions*

| | ODA | Debt relief grants | ODA excluding debt relief grants | Percent change in ODA excluding debt relief grants in real terms[a] |
|---|---|---|---|---|
| DAC donors | 106.5 | 23.0 | 83.5 | 8.7 |
| G7 countries | 80.1 | 20.2 | 59.9 | 8.9 |
| United States | 27.5 | 4.1 | 23.4 | 16.2 |
| Japan | 13.1 | 3.6 | 9.5 | 12.1 |
| United Kingdom | 10.8 | 3.7 | 7.1 | –1.7 |
| France | 10.1 | 3.2 | 6.9 | 0.0 |
| Germany | 9.9 | 3.6 | 6.3 | –9.8 |
| Canada | 3.7 | 0.5 | 3.2 | 17.8 |
| Italy | 5.1 | 1.7 | 3.4 | 40.0 |
| *Memo item:* | | | | |
| EU countries | 55.7 | 27.9 | 27.8 | 3.8 |

*Source:* OECD Development Assistance Committee (DAC).
a. Takes into account inflation and exchange-rate movements.

in ODA has risen from an average of 3.7 percent in the 1990s to 6.6 percent in 2002–4, followed by a sharp increase to 22 percent in 2005. ODA, net of debt relief, has risen relative to GNI in donor countries, but at a more modest pace than overall ODA (figure 3.1). Thus, some, but not all, of the scaling-up in aid can be attributed to debt relief.

Debt relief together with other special-purpose grants—for technical cooperation, emergency and disaster relief, and administrative costs—accounted for three-quarters of the bilateral portion of ODA in 2005, well above the 53 percent average of the 1990s (table 3.3). Excluding the $19 billion in debt relief provided to Iraq and Nigeria, special-purpose grants still accounted for two-thirds of bilateral ODA in 2005. Emergency and distress relief grants increased by $5 billion in 2005, $2.2 billion of which was provided in response to the December 2004 tsunami. However, part of remaining $2.8 billion increase reflects a modification in the definition to include reconstruction grants.[1]

ODA net of special-purpose grants totaled $45 billion in 2005, unchanged from 2004, but up significantly from a low of $30 billion in 2001. However, relative to GNI in DAC member countries, ODA net of special-purpose grants has shown little increase over the past 10 years (1996–2005), averaging 0.14 percent, remaining well below the 0.23 level attained in the early 1990s (figure 3.1). Thus, the increase in the ODA as a percent of GNI over the past few years reflects higher special purpose grants.

### *The shift from concessional loans to grants continues*

Bilateral donors have continued to shift their resources from concessional loans to grants, with the goal of limiting the rise in the debt burdens of aid recipients and thereby prevent a recurrence of

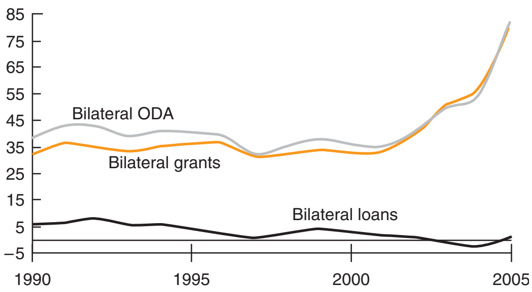
**Table 3.3 Main components of bilateral ODA, 1990–2005**

*$ billions*

| | 1990 | 1995 | 2000 | 2001 | 2002 | 2003 | 2004 | 2005[a] |
|---|---|---|---|---|---|---|---|---|
| Total ODA | 54.3 | 58.8 | 53.7 | 52.4 | 58.3 | 69.1 | 79.6 | 106.5 |
| Bilateral ODA | 38.5 | 40.5 | 36.1 | 35.1 | 40.8 | 49.8 | 54.4 | 82.0 |
| Debt relief | 1.5 | 2.7 | 1.6 | 2.0 | 3.7 | 6.8 | 4.2 | 23.0 |
| Technical co-operation | 11.4 | 14.3 | 12.8 | 13.6 | 15.5 | 18.4 | 18.8 | 21.6 |
| Emergency/distress relief | 1.1 | 3.1 | 3.6 | 3.3 | 3.9 | 6.2 | 7.3 | 12.7 |
| Administrative costs | 2.0 | 2.9 | 3.1 | 3.0 | 3.0 | 3.5 | 4.0 | 4.0 |
| *Special purpose grants:* | 15.9 | 23.0 | 21.0 | 21.8 | 26.1 | 34.8 | 34.3 | 61.3 |
| Multilateral ODA | 15.8 | 18.3 | 17.7 | 17.3 | 17.5 | 19.3 | 25.1 | 24.5 |
| Total ODA less debt relief | 52.7 | 56.1 | 52.2 | 50.5 | 54.6 | 62.3 | 75.4 | 83.5 |
| Total ODA less special purpose grants | 38.4 | 35.8 | 32.7 | 30.6 | 32.2 | 34.2 | 45.2 | 45.2 |

*Source:* OECD Development Assistance Committee (DAC).
*Note:* a. Preliminary.

**Figure 3.2 Bilateral ODA loans and grants, 1990–2005**




*Source:* OECD Development Assistance Committee (DAC).

lending/debt forgiveness cycles that have occurred over the past few decades. Net concessional lending from bilateral donors has averaged close to zero over the past five years (2001–5), implying that disbursements of new concessional loans equaled repayments (interest and principle) on existing loans on average, whereas in the early 1990s new lending exceeded repayments by about $6 billion on average (figure 3.2).

### *Donors are providing more assistance to the least developed countries and those affected by conflict*

Donors have been reallocating development assistance to the poorest countries. The amount of ODA allocated to the least developed countries (LDCs) has increased substantially since the late 1990s, while that allocated to other low-income countries has been relatively constant in nominal terms. The share of total ODA allocated to the LDCs grew from a low of 30 percent in 1999 to a high of 45 percent in 2003, while the share allocated to other low-income countries declined from 29.5 percent to 19 percent in 2004 (figure 3.3).[2]

From a regional perspective, donors have been reallocating development assistance to countries in Sub-Saharan Africa and the Middle East. The share of total ODA allocated to Sub-Saharan Africa increased from a low of 25 percent in 1999 to 40 percent in 2004,[3] while that allocated to Asia declined from 44 percent to 35 percent. Donors are committed to continued increases in Africa's share of ODA over the balance of the decade.

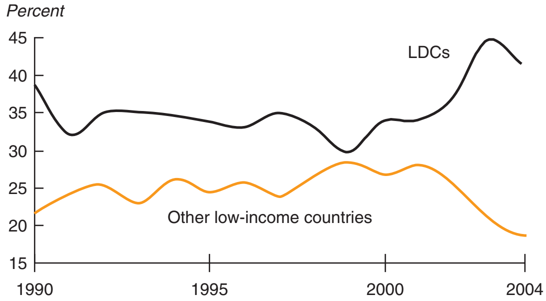
A portion of the rise in ODA over the past two years reflects increased assistance for countries affected by conflict. The share of total ODA allocated to the Middle East rose from 4.5 percent in 2002 to 11.6 percent in 2004, with most of the increase going to Iraq, Afghanistan, and Jordan (table 3.4). Aid to Iraq rose from an average of only $90 million in 2000–2 to $3.2 billion in 2003–4, making it the largest recipient of ODA. Aid to Iraq is likely to rise further, as its agreement with Paris Club creditors in November 2004 included $30 billion in debt relief that that will result in a major increase on Iraq's share of ODA beginning in 2005. Similarly, aid to Afghanistan increased from $0.5 billion to $1.4 billion over the same period. Increases in aid to Iraq, Afghanistan, and the Democratic Republic of the Congo account for over two-thirds of the increase in total ODA in 2003–4.

### *More "aid for trade" is on the way*

Donors also are focusing more aid resources to bolster the capacity of the poorest countries to participate in trade and manage the adjustment costs of liberalization. This entails providing assistance for trade policy and regulations (technical assistance for product standards, integration of trade with development plans, trade facilitation), trade development (trade promotion, market development activities) and building infrastructure (transport, energy, and telecommunications). The amount of aid devoted to trade-related assistance has risen over the past few years, increasing from 3.6 percent of total aid commitments in 2002 to 4.4 percent in 2003, with infrastructure accounting for a further 25 percent.[4]

The G-8 Summit in Gleneagles gave important high-level endorsement for "aid for trade" initiatives that aim to build the physical, human, and

**Figure 3.3 Share of total ODA allocated to LDCs and other low-income countries, 1990–2004**




*Source:* OECD Development Assistance Committee (DAC).

**Table 3.4 Net ODA disbursements to the ten largest recipient countries**

*$ billions, average over period*

| 1990–9 | | 2000–2 | | 2003–4 | |
|---|---|---|---|---|---|
| Egypt | 2.23 | Indonesia | 1.35 | Iraq | 3.24 |
| China | 1.82 | China | 1.18 | Dem. Rep. of Congo | 3.09 |
| Indonesia | 1.47 | Egypt | 1.12 | Afghanistan | 1.45 |
| Poland | 1.33 | Serbia & Montenegro | 1.05 | China | 1.36 |
| India | 1.07 | Mozambique | 1.00 | Vietnam | 1.07 |
| Philippines | 0.90 | Vietnam | 0.94 | Ethiopia | 1.03 |
| Bangladesh | 0.75 | Tanzania | 0.88 | Tanzania | 1.00 |
| Mozambique | 0.72 | India | 0.78 | Egypt | 0.98 |
| Thailand | 0.70 | Pakistan | 0.76 | Indonesia | 0.85 |
| Tanzania | 0.68 | Bangladesh | 0.57 | Jordan | 0.76 |
| *Memo items:* | | | | | |
| Iraq | 0.16 | Iraq | 0.09 | | |
| Afghanistan | 0.11 | Afghanistan | 0.47 | | |
| Dem. Rep. of Congo | 0.18 | Dem. Rep. of Congo | 0.20 | | |
| *Net offical assistance disbursements by largest recipients*[a] | | | | | |
| Russian Fed. | 1.22 | Russian Fed. | 1.12 | Russian Fed. | 1.03 |
| Israel | 1.33 | Israel | 0.57 | Israel | 0.46 |

*Source:* OECD Development Assistance Committee (DAC).
a. Included in official aid (OA), but not official development assistance (ODA).

institutional capacity of poor countries so that they can play a more prominent role in the negotiation of multilateral trade agreements and benefit more fully from the outcomes. The G-8 asked multilateral institutions to provide additional assistance to poor countries to develop their trade capacity and ease the adjustment costs arising from trade liberalization. In response, the World Bank and the International Monetary Fund (IMF) proposed to enhance the Integrated Framework for Trade-related Technical Assistance for the LDCs (box 3.1), a move endorsed at the annual meetings of the IMF and the World Bank in September and at the WTO Hong Kong Ministerial in December.

Although the Doha Development Round was not completed as planned at the WTO Ministerial Meeting in Hong Kong in December 2005, modest progress was made. In particular, participants agreed to phase out agricultural subsidies by 2013, and developed countries agreed to provide market access (free from quotas and duties) to the LDCs on 97 percent of their tariff lines.

### *Donors have enhanced their commitments to scale up aid*

At the G-8 Summit in Gleneagles, Scotland, donors announced their commitment to increase ODA by $50 billion by 2010 (in real terms) from 2004 levels. Many donor countries have made explicit commitments to scale up aid significantly over the medium term. Five of the 22 DAC member countries have already increased ODA to levels that exceed the UN target (Norway, 0.87 percent of GNI; Denmark, 0.85 percent; Luxembourg, 0.83 percent; Sweden, 0.73 percent; the Netherlands, 0.73 percent). The European Union has pledged to increase ODA provided by its member countries from 0.35 percent of GNI in 2004 to 0.7 percent by 2015, with an interim target of 0.56 percent by 2010.[5] Moreover, six EU member countries announced commitments to attain the 0.7 percent UN target prior to 2015 (Belgium and Finland by 2010; France, Ireland, and Spain by 2012; and the United Kingdom by 2013).

Other donors have made commitments that are not linked to the UN target. For example, ODA provided by the United States is projected to decline from $27.5 billion in 2005 ($23.4 billion excluding debt relief grants) to $24 billion in 2006 (in real terms) and remain at that level to 2010, based on commitments announced on the margins of the G-8 Summit.[6] At the G-8 Summit, Japan announced its intention to increase ODA by $10 billion over the next five years. Projections based on these commitments imply that the share of total ODA provided by the United States will decline from 26 percent in 2005 to 19 percent in 2010, while that provided by the EU member countries as a group will increase from 54 percent to 63 percent (table 3.5).

## Box 3.1 The Integrated Framework for Trade-Related Technical Assistance

The Integrated Framework for Trade-Related Technical Assistance (IF) brings together the International Monetary Fund, International Trade Centre, United Nations Conference on Trade and Development, United Nations Development Programme, World Trade Organization, the World Bank, and bilateral donors to: (i) integrate trade into the national development plans of LDCs; and (ii) assist in the coordinated delivery of trade-related technical assistance. The IF is built on the principles of country ownership and partnership. It consists of diagnostic studies, technical assistance projects, and capacity-building projects valued at up to $1 million per country.

By the end of 2005, diagnostics had been completed in 20 countries, with a further 17 countries in the process or applying to join. As of September 2005, 30 capacity-building projects had been approved in 12 countries, amounting to $10 million, and 17 donors, including the World Bank, had pledged a total of $34 million to the IF Trust Fund.

To date, the IF has completed several capacity-building projects; made solid progress in the difficult task of coordinating donors and international agencies; contributed to increased understanding of the constraints facing poor countries; and brought IF governments to the table on trade. Of the eight IF countries that had completed diagnostics at the time of their poverty reduction strategy, three incorporated the recommendations, and two were working to do so for their next poverty reduction strategy.

**Table 3.5 Donors' shares of ODA in 2005, projected 2010**

*Percent*

| | 2005 | 2005 (excluding debt relief) | 2010 |
|---|---|---|---|
| United States | 25.8 | 28.0 | 18.7 |
| Japan | 12.3 | 11.4 | 9.3 |
| United Kingdom | 10.1 | 8.5 | 11.4 |
| France | 9.4 | 8.2 | 11.0 |
| Germany | 9.3 | 7.6 | 12.1 |
| Netherlands | 4.8 | 5.7 | 4.0 |
| Italy | 4.7 | 4.0 | 7.2 |
| *Sum:* | 76.5 | 73.4 | 73.7 |
| *Memo item:* | | | |
| EU Members | 53.9 | 49.2 | 63.4 |

*Source:* Projections by the OECD DAC Secretariat.

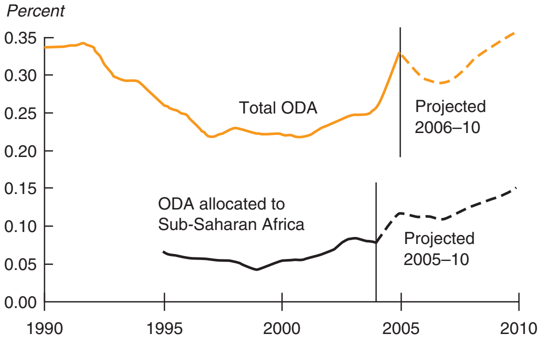
### *ODA is expected to decline as a percentage of GNI in the short run and then increase gradually over the balance of the decade*

ODA is expected to decline in 2006 as the debt relief component falls to more normal levels (figure 3.4). ODA will continue to be affected by further debt relief to be provided to Iraq and Nigeria by its Paris Club creditors over the coming few years, but in smaller amounts than in 2005. This explains the transitory nature of the ODA surge in 2005. Based on current commitments of DAC donors, the OECD DAC Secretariat is projecting that ODA will decline from 0.33 percent of GNI in 2005 to about 0.29 percent in 2006–7 and then rise gradually over the balance of the decade as a percent of their GNI, reaching 0.36 percent in 2010, just slightly above levels attained in the early 1990s.

The projections imply that ODA as a ratio to GNI in donor countries will increase by about 0.017 of a percentage point per year on average over the period 2005–10. Extrapolating this rate of increase would mean that the UN target of 0.7 percent would not be attained until 2030, 15 years after the 2015 deadline set for attaining the MDGs. The UN Millennium Project (2005) estimates that financing the MDGs requires an increase in ODA (excluding debt relief) to 0.46 percent of GNI by 2010, suggesting that current commitments fall short. There is, however, a high degree of uncertainty surrounding such estimates.[7] Moreover, the *quality* of aid, is as, or perhaps even more, important than the *quantity* of aid for supporting developing countries progress on the MDGs. For example, enriching special purpose grants rather than direct budgetary support could have quite different implications for the ability of developing countries to fund programs that are deemed to be critical for accelerating progress of the MDGs.

Commitments to increase ODA have been made despite the very high level of general government deficits in many donor countries. Fiscal deficits are expected to exceed or be close to 3 per-

**Figure 3.4 Net ODA as a percentage of GNI in DAC donor countries, 1990–2005 and projected 2006–10**




*Source:* OECD Development Assistance Committee (DAC); projections by the OECD DAC Secretariat.

**Table 3.6 General government financial balances in 2004, projected 2005–7**

*Percent of GDP*

| | 2004 | 2005[c] | 2006[c] | 2007[c] |
|---|---|---|---|---|
| United States[a] | –4.7 | –3.7 | –4.2 | –3.9 |
| Japan[a] | –6.5 | –6.5 | –6.0 | –6.0 |
| United Kingdom | –3.2 | –3.1 | –3.0 | –3.2 |
| France | –3.6 | –3.2 | –3.2 | –3.0 |
| Germany | –3.7 | –3.9 | –3.6 | –2.6 |
| Netherlands | –2.1 | –1.6 | –1.8 | –1.5 |
| Italy | –3.3 | –4.3 | –4.2 | –4.8 |
| *Weighted average:*[b] | –4.3 | –3.9 | –4.0 | –3.8 |

*Source: OECD Economic Outlook No. 78 Annex Table 27.*
a. Including social security.
b. Weighted using shares of ODA in 2005 listed in Table 3.5.
c. Projected.

cent of GDP in 2005/6 in six of the seven largest DAC donor countries, which together accounted for three-quarters of total ODA in 2004 (table 3.6). However, ODA makes up less than 1 percent of fiscal revenues and expenditures in six of the seven major donor countries (the Netherlands being the exception) (table 3.7). Donors have examined several innovative financing mechanisms that could augment aid flows, including the International Finance Facility for Immunization, advance market commitments for vaccines, and airline departure taxes.[8]

**Table 3.7 ODA as a percentage of fiscal expenditures and revenues in 2004, projected 2006**

*Percent*

| | Expenditures[a] | | Revenues[b] | |
|---|---|---|---|---|
| | 2004 | 2006[c] | 2004 | 2006[c] |
| United States | 0.46 | 0.49 | 0.53 | 0.55 |
| Japan | 0.51 | 0.55 | 0.51 | 0.55 |
| United Kingdom | 0.84 | 0.90 | 0.90 | 0.97 |
| France | 0.79 | 0.87 | 0.85 | 0.93 |
| Germany | 0.59 | 0.72 | 0.64 | 0.78 |
| Netherlands | 1.56 | 1.65 | 1.64 | 1.71 |
| Italy | 0.30 | 0.64 | 0.32 | 0.70 |

*Source: OECD Economic Outlook No. 78 Annex tables 2 and 26.*
a. General government total outlays.
b. General government total tax and nontax receipts.
c. Projected.

### *Donors have agreed to provide significant increases in aid for Africa*

With 10 years remaining for developing countries to meet the MDGs, Africa is the only continent not on track to meet any of the goals. The past year was to be the year of Africa. It began with a report issued by the Commission for Africa in March. British Prime Minister Tony Blair had launched the commission in February 2004 to take a fresh look at Africa's past and present, as well as the international community's role in its development path. The report called for a doubling of aid by 2010, while recognizing the need for African countries to improve governance and accelerate policy reforms so that higher amounts of aid could be absorbed effectively. Countries at the African Union Summit in June reaffirmed their commitment to promoting economic growth and reducing poverty. In turn, at the G-8 Summit in July, "Africa and Development" was adopted as one of two main themes. The G-8 leaders supported the recommendations of the Africa Commission (including the doubling of aid to Sub-Saharan Africa by 2010), while underlining the importance of good governance, democracy, and transparency on the continent. Building on this momentum, the World Bank presented its Africa Action Plan in September, setting out a program of concrete, results-oriented actions for the Bank and development partners to assist all African countries to meet as many MDGs as possible.

Current commitments by donors imply a significant scaling-up in aid to low-income countries in Sub-Saharan Africa. Donors have committed to increase total ODA by about $50 billion by 2010 (in real terms), at least half of which is slated for Sub-Saharan Africa. This would double the amount of aid to the region by 2010 and raise its share of total ODA from 40 percent in 2004 to almost 50 percent in 2010.

### *The new commitments have raised concerns about absorptive capacity*

The commitment by donors to double the amount of aid to Sub-Saharan Africa by 2010 raises the question of absorptive capacity. There is a concern that a substantial increase in aid flows to some countries could have unfavorable macroeconomic repercussions. Specially, there is a risk that a surge in aid flows could lead to an appreciation of the real exchange rate (either through inflation or the nominal exchange rate), which could in turn undermine competitiveness and thereby curtail exports. This so-called Dutch disease could undermine growth, particularly in countries where the export sector provides a key source of productivity growth (because of dynamic externalities such as learning by doing).

Assessing the overall consequences of a surge in aid flows requires considering the potential benefits, along with the costs. For example, investments in public infrastructure could boost productivity and thereby improve competitiveness, offsetting the impact of a real exchange rate appreciation. Moreover, higher spending on programs needed to accelerate progress on the MDGs could also enhance growth over the longer term (education and health being prime examples). The empirical evidence on the macroeconomic consequences of aid surges is inconclusive.[9] Recent aid surges in a number of African countries have coincided with a *depreciation* of the real exchange rate, contrary to theory.[10] It is unclear, however, whether that outcome reflected productivity-enhancing benefits of higher aid, or whether the higher aid was not spent or "absorbed" by recipient countries.[11] Donors and recipient countries need to pay careful attention to the macroeconomic consequences of higher aid flows for inflation, domestic interest rates, and fiscal balances, taking into account the high degree of uncertainty surrounding the effects on competitiveness and productivity.

Moreover, Bourguignon and Sundberg (2006a and 2006b) stress that absorptive capacity is a dynamic concept that depends on the composition and sequencing of aid, as well as characteristics of the local economy (labor markets, institutions, demand side constraints, etc.). And as such, a country's absorptive capacity can be enhanced by strategic planning that aims to identify key constraints to growth and expand its productive capacity through targeted and carefully sequenced investments (developing public infrastructure and labor market training initiatives being prime examples) and through improvements in governance. Current proposals under study involve scaling up aid significantly with predictable flows of grant-financed aid to selected countries that have relatively strong institutions and governance. The historical record provides few examples along these lines and, hence, it is difficult to estimate the response of key macro variables—the real exchange rate, interest rates, inflation, and output growth—under such circumstances. Researchers have developed modeling frameworks that can provide insights into the complex linkages between the sequencing and components of aid and the growth process, taking into account some of the constraints that can hinder development. As an example, model simulations reported by Sundberg and Lofgren (2006) indicate that a cost-minimizing strategy for achieving the MDGs in the case of Ethiopia entails a front-loaded expansion in infrastructure spending with constantly growing social spending.

### *Improving aid effectiveness plays a critical role in the development agenda*

In addition to their commitments to scale up the volume of aid, donors promised to improve the effectiveness of aid. Ministers of developed and developing countries responsible for promoting development, along with heads of multilateral and bilateral development institutions, together representing 90 countries and 26 multilateral organizations, participated in the OECD High-Level Forum in March. Participants at the Forum recognized that while the volumes of aid and other development resources must increase to achieve the MDGs, aid effectiveness must increase commensurately to support partner-country efforts to strengthen governance and improve development performance. To this end, the "Paris Declaration on Aid Effectiveness" committed donor countries, partner countries, and multilateral institutions to:

- Strengthen partner countries' national development strategies and associated operational frameworks
- Increase alignment of aid with partner countries' priorities, systems, and procedures, and help to strengthen their capacities

- Enhance donors' and partner countries' respective accountability to their citizens and parliaments for their development policies, strategies, and performance
- Eliminate duplication of efforts and rationalize donor activities to make them as cost-effective as possible
- Reform and simplify donor policies and procedures to encourage collaborative behavior and progressive alignment with partner countries' priorities, systems, and procedures
- Define measures and standards of performance and accountability of partner-country systems in public financial management, procurement, fiduciary safeguards, and environmental assessments, in line with broadly accepted good practices and their quick and widespread application.

Tangible indicators and targets were established so that progress toward the commitments could be tracked. To this end, donor and partner countries are working together to develop an international monitoring system that will enable them to measure progress toward the targets identified in the Paris Declaration.

## Debt relief: improving and maintaining debt sustainability

Progress continues on reducing the debt burdens of the poorest countries, particularly those in Africa. Debt relief is provided under the HIPC Initiative, through the Paris Club, and on a bilateral basis. According to the data reported by OECD DAC donors, grants provided for debt relief from all three sources have increased significantly over the past few years, reaching $23 billion in 2005, largely due to $19 billion in debt relief provided by the Paris Club to Iraq and Nigeria. In the three years prior to 2005, debt relief grants averaged $6.7 billion, well above the $3.4 billion average in 1990–2002, with most of the additional resources going to the poorest countries, particularly those in Sub-Saharan Africa (table 3.8). Of the total $20 billion in debt-relief grants provided by DAC donors over the period 2002–4, more than half was allocated to the LDCs, up from an average share of 29 percent over the period 1990–2001. Countries in Sub-Saharan Africa received almost three-quarters of debt relief provided in 2002–4, up from just over a third during the period 1990–2001.

### *The HIPC Initiative is significantly reducing the debt service burdens of some poor countries*

The HIPC Initiative has substantially eased the debt-service burden of a small group of poor countries, most of which are in Africa (box 3.2).[12] The 28 countries that reached the "decision point" for debt relief under the initiative prior to 2006 received $2.3 billion per year in debt relief from 2001 to 2005, equal to 2.2 percent of their GDP and 9.2 percent of their exports.[13] The HIPC Initiative has provided debt relief equal to about half of the debt service due from the group. Debt-service payments for the 28 countries equaled 1.8 percent of their collective GDP in 2005 (down from 3.2 percent in 2000); were it not for debt relief under HIPC, they would have been an estimated 3.8 percent of GDP in 2005 (figure 3.5).

The amount of debt relief provided has varied considerably across countries. In 4 of the 28 countries that reached the decision point prior to 2006, HIPC debt-service reduction exceeded 5 percent of GDP on average over the period 1998–2006, but

**Table 3.8 Debt-relief grants provided by DAC donor countries, by income and region of beneficiary, 1990–2005**

*$ billions*

| | 1990 | 1995 | 2000 | 2001 | 2002 | 2003 | 2004 | 2005 |
|---|---|---|---|---|---|---|---|---|
| Debt relief grants | 4.3 | 3.7 | 2.0 | 2.5 | 4.5 | 8.3 | 7.1 | 23.0 |
| *Allocation across income classifications* | | | | | | | | |
| Least-developed countries | 0.9 | 0.9 | 1.2 | 1.1 | 2.2 | 5.6 | 3.4 | — |
| Other low-income countries | 1.1 | 0.6 | 0.3 | 0.8 | 1.1 | 2.2 | 2.7 | — |
| *Allocation across regions* | | | | | | | | |
| Sub-Saharan Africa | 2.2 | 1.2 | 1.2 | 1.3 | 3.0 | 6.5 | 5.0 | — |
| Other regions | 2.2 | 2.6 | 0.8 | 1.2 | 1.6 | 1.9 | 2.1 | — |

*Source:* OECD Development Assistance Committee (DAC).

## Box 3.2 The HIPC Initiative

The HIPC Initiative was launched by the World Bank and the International Monetary Fund (IMF) in 1996, amid growing concerns that excessive debt was crippling efforts to reduce poverty in some of the poorest countries. It was based on agreement by multilateral organizations and governments to offer a fresh start to countries that were making efforts to reduce poverty by reducing their external debt burdens to sustainable levels. The HIPC Initiative was enhanced in 1999 to provide deeper and faster debt relief to a larger group of countries and to increase the links with poverty reduction efforts in those countries.

There are currently 40 countries eligible for the HIPC Initiative, 33 of which are in Sub-Saharan Africa. So far 29 countries have reached the "decision point" at which donors make a commitment to provide the debt relief necessary to meet a specified debt ratio. The Republic of Congo reached the decision point in March 2006. Of these, 19 have reached the "completion point," at which they receive irrevocable debt relief. Honduras, Rwanda, and Zambia reached the completion point in 2005, followed by Cameroon in May 2006. The debt relief accorded the remaining 10 decision-point countries will not become irrevocable until they pass the completion point. All 10 decision-point countries are expected to reach the completion point by the end of 2007. The 11 remaining countries that are already eligible for the HIPC Initiative are referred to as the "pre-decision" countries. All 11 countries are expected to reach the completion point by the end of 2010.*

The HIPC initiative is estimated to cost about $41 billion in debt relief to the 29 countries that have reached the decision point, measured in net present value terms at the end of 2004. Most of the debt relief will be provided by multilateral creditors (50 percent) and official bilateral creditors (47 percent). Commercial creditors (3 percent) have played a relatively minor role.

*See World Bank 2006b (p. 20 Annex 2.3) for a list of estimates for completion-point dates.

**Estimated costs of the HIPC Initiative**

*$ billions, net present value at end-2004*

| | Completion point (18 countries) | Decision point (11 countries) | Total (29 countries) |
|---|---|---|---|
| Multilateral creditors | 14.5 | 5.8 | 20.3 |
| *of which:* | | | |
| World Bank | 7.0 | 2.3 | 9.3 |
| IMF | 2.2 | 0.8 | 3.0 |
| AfDF/AfDB | 1.9 | 1.5 | 3.4 |
| IDB | 1.3 | 0.0 | 1.3 |
| Other | 2.1 | 0.9 | 3.0 |
| Official bilateral creditors | 12.3 | 7.0 | 19.3 |
| *of which:* | | | |
| Paris Club | 8.9 | 5.8 | 14.7 |
| Other | 3.3 | 0.3 | 3.7 |
| Commercial creditors | 0.7 | 0.8 | 1.5 |
| Total | 27.5 | 13.6 | 41.1 |

*Sources:* World Bank and IMF 2005 (table 2) and World Bank Staff estimates.

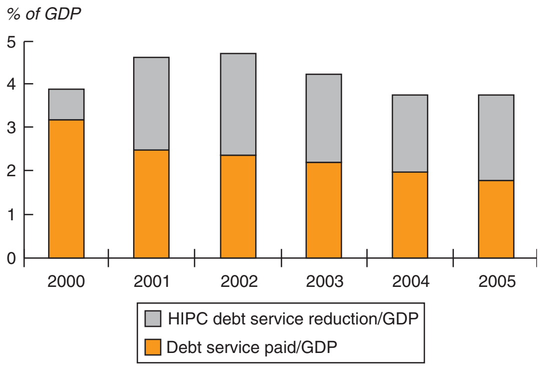
less than 1 percent in 4 other countries (figure 3.6).[14] There are also large differences between countries' debt-service burdens. In 2005, debt-service payments exceeded 5 percent of GDP in 4 countries, but was less than 1 percent in 4 other countries (figure 3.7). This reflects the fact that some countries had higher debt-service burdens prior to HIPC debt relief and that some countries received more HIPC debt relief than others.

Debt relief provided under the HIPC Initiative will free up additional resources in recipient countries only if it does not displace other components of foreign aid. As with the more general case of debt relief mentioned above, it is difficult to assess whether HIPC debt relief has been additional in the absence of an explicit counterfactual showing. The share of ODA allocated to the 29 decision-point HIPCs has increased substantially over the past few years, rising from 19 percent in 1999 to 28.5 percent in 2004. This suggests that HIPC debt relief has not displaced other components of ODA. However, the share of ODA allocated to countries in Sub-Saharan Africa and to the LDCs increased by even more during this period.

### *The Paris Club plays an important role in the HIPC Initiative*

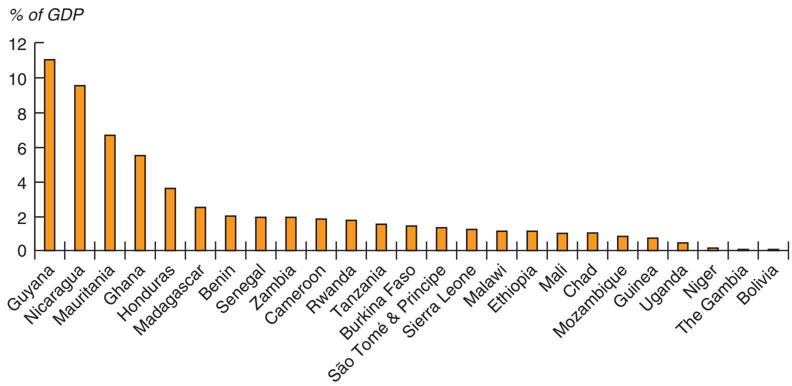
The Paris Club has made an important contribution to the debt relief provided to HIPCs. Initially, the Paris Club provided cash-flow relief to distressed debtors (debt restructuring), but no debt relief in the sense of reducing the net present value of the debt (box 3.3). However, in the mid-1980s it became apparent that debt burdens in many low-income countries were unsustainable and that debt relief was needed. Beginning in 1988, the Paris Club began providing concessional debt relief to poor countries, first under *Toronto Terms*,

**Figure 3.5 Debt-service payments and HIPC debt service reduction for 28 "decision point" HIPCs**



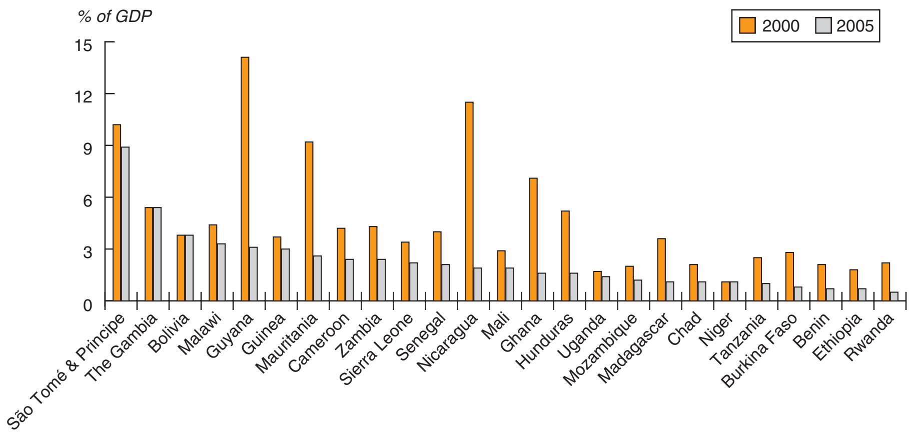

*Sources:* World Bank and IMF 2005 (table 1A) and staff estimates.

**Figure 3.6 Debt-service reduction provided by the HIPC Initiative to 25 decision-point countries**




*Source:* World Bank staff estimates.

**Figure 3.7 Debt service paid by 25 decision-point HIPCs, 2000 versus 2005**




*Source:* World Bank staff estimates.

## Box 3.3 The Paris Club

The year 2006 will mark the fiftieth anniversary of the establishment of the Paris Club of Creditors. Historically this informal body has met in Paris to: (i) review the external debt-servicing performance of debtor countries; (ii) develop rules and mechanisms that may be used to resolve debt-payment difficulties; and (iii) negotiate debt rescheduling or reduction agreements with debtor countries. Since 1956, the club's 19 creditor members (along with about a dozen invited creditor countries) have reached more than 400 agreements with debtor countries. Initially, the Paris Club provided only cash-flow relief to countries experiencing temporary balance-of-payments difficulties, while maintaining the present value of creditors' claims. In the past 15 years, however, the club has engaged increasingly in debt-reduction operations covering not only debt flows but also debt stocks.

The Paris Club took on greater importance with the onset of the 1980s debt crisis. The number of agreements concluded by the club since the early 1980s has been almost three times the number reached during the first 25 years of its existence. Since 1983, the total amount of debt covered in agreements concluded by the Paris Club or ad hoc groups of Paris Club creditors has been $504 billion.

The activities of the Paris Club have been governed by five basic principles:

1. *Creditor solidarity.* The members of the Paris Club act as a group in their dealings with a particular debtor country. For debtors this implies that any country seeking a debt rescheduling from the club must agree to treat all its members in the same way; for creditors it implies that club members will refuse to consider a request from a debtor to reschedule debt on a purely "bilateral" basis, that is, outside of the Paris Club framework.
2. *Commitment to economic reform.* Debt rescheduling requires an economic policy plan aimed at correcting deficiencies that have brought about the need for debt treatment. As a general rule, such a plan takes the form of an economic adjustment program officially supported by the International Monetary Fund (IMF) although in a few cases the Paris Club did not require an IMF program.
3. *Comparable treatment.* The debtor country must secure from all other creditors debt relief terms that involve treatment comparable to those agreed with the Paris Club. Formerly private creditors were not affected by the comparability-of-treatment clause. However, beginning in 1998 (for Pakistan) the Paris Club has asked some debtors to obtain comparable debt relief from bondholders.
4. *Agreement by consensus.* This principle requires that the Paris Club act only with the concurrence of all of its participants.
5. *Case-by-case approach.* Paris Club members reserve the right to apply the principles in a flexible manner so as to meet the particular requirements of a specific debtor.

In October 2003, the Paris Club adopted a new approach to treating debt in countries that were not eligible for the HIPC Initiative. The *Evian Approach* was designed to ensure that debt restructuring was granted only in cases of imminent default and that the debt treatment provided reflected countries' financial needs and the objective of ensuring debt sustainability. Debt sustainability therefore plays a central role in determining whether and to what extent countries receive debt relief. The adoption of the *Evian Approach* was followed by two major agreements that provided record amounts of debt relief. In November 2004, the Paris Club agreement with Iraq considered $37 billion in debt, canceling $30 billion (80 percent) and rescheduling the rest. In October 2005, the Paris Club reached an agreement with Nigeria concerning $30 billion in debt, $18 billion (60 percent) of which was canceled.

which provided for a 33 percent reduction in the net present value of the debt. It soon became evident that even more relief was required to reduce debt burdens to sustainable levels. The terms offered by the Paris Club were made more generous in a series of steps. In 1991 *London Terms* allowed for a 50-percent reduction in net present value; in 1994, *Naples Terms* allowed for debt relief of as much as 67 percent.

Since 1997, debt relief provided by the Paris Club has been an integral part of the HIPC Initiative. To be eligible for the HIPC Initiative, a country's debt must exceed certain threshold levels. Either external debt must be at least 150 percent of exports, or public debt must be at least 250 percent of revenues (in net present value terms), after receiving debt relief from the Paris Club under *Naples Terms*.[15] Under the HIPC Initiative, countries benefit from debt reduction from all creditors (which include the Paris Club and other bilateral official creditors, multilateral creditors, and commercial creditors) in an amount that reduces their debt burden to the threshold levels. In principle, the burden of debt relief is to be shared equally among all creditors. However, participation is voluntary. In practice, most commercial creditors have not participated,[16] while the Paris Club creditors have provided much more than their share of the debt relief. In most cases, Paris Club creditors have cancelled all of the debt owed to them by countries that have reached the completion point.[17] In contrast, other official bilateral creditors have committed so far to less than half of their share of debt relief.[18]

### *HIPC debt relief could lead to more litigation by commercial creditors*

Sharing the burden of debt relief equally across all creditors is complicated by the "collective action" problem. Some commercial creditors have an incentive to "hold out" of an agreement, preferring to pursue their claims through litigation in hopes of obtaining more favorable terms. In corporate bankruptcies, the legal system prevents creditors from engaging in such "free-riding" and imposes rules for collective action. But in the case of sovereign debt restructuring, there is no overriding legal system that has such jurisdiction over all creditors. Hence, collective action cannot be imposed through legal means. Some commercial creditors have prevailed in litigation against HIPCs. There are currently 24 litigation cases on record against HIPCs, 4 of which were new in 2005; court awards to creditors total $586 million, of which countries have paid only about $35 million.[19] Although the amounts paid are small relative to the total amount of debt relief committed by the HIPC Initiative ($38 billion in net present value terms), judgments in favor of creditors set a precedent that could lead to more litigation. Debt relief frees up financial resources, leading creditors to reassess their chances of obtaining a significant judgment in their favor. Thus further debt relief could make the litigation strategy even more alluring.

### *Further debt relief is envisioned under the HIPC Initiative and the Multilateral Debt Relief Initiative*

The HIPC initiative will continue to reduce debt-service burdens. In 2006/7, some $2.6 billion in relief will be provided annually to the 29 decision-point countries, up from an average of $2.3 billion provided during 2001–5. Debt service by these countries is projected to remain unchanged in 2006/7 relative to their GDP and exports, but the total amount of debt relief provided under the HIPC Initiative will increase over time as additional countries reach the decision point and completion point.

Following on the HIPC initiative, the Multilateral Debt Relief Initiative (MDRI) will achieve further, significant reductions in the debt burden of poor countries (box 3.4). The MRDI calls for complete cancellation of debt owed to the International Development Association (IDA), the IMF,

## Box 3.4 The MDRI

The Multilateral Debt Relief Initiative (MDRI) was proposed in June 2005 by the G-8 Finance Ministers as a way to free up additional resources to help poor countries with high debt levels make progress toward the Millennium Development Goals. Under the MDRI, three multilateral institutions—the International Development Association (IDA), the International Monetary Fund (IMF), and the African Development Fund (AfDF)—will cancel all claims on countries that reach the completion point under the HIPC initiative. The IMF and IDA have approved debt relief under the MDRI for 17 of the 18 HIPCs that have already reached the completion point. The exception, Mauritania, will qualify for debt relief under the MDRI after implementing key public expenditure management reforms. (Approval by the AfDF is expected to come in April 2006.)

Although the MDRI is a common initiative, the approach to coverage and implementation varies somewhat across the three institutions.* The IMF Executive Board modified the proposal to reflect the Fund's requirement that the use of IMF resources be consistent with uniformity of treatment. Thus, it was agreed that all countries with per capita income of $380 a year or less (HIPCs and non-HIPCs) would receive MDRI debt relief financed by the IMF's own resources. Two non-HIPCs—Cambodia and Tajikistan—were certified as eligible for MDRI debt relief from the IMF on this basis. HIPCs with per capita income above that threshold would receive MDRI relief from bilateral contributions administered by the IMF.

*See World Bank (2006a) for a more detailed discussion of the implementation of the MDRI.

and the African Development Fund (AfDF) by countries that reach the HIPC completion point. The process of reaching the HIPC completion point includes conditions relating to governance, accountability, and transparency.

The MDRI can be interpreted as an extension and a deepening of the HIPC Initiative. Eligibility will require meeting the HIPC completion-point criteria, which include (i) satisfactory macroeconomic performance under an IMF poverty reduction and growth facility program (PRGF) or equivalent; (ii) satisfactory performance in implementing a poverty reduction strategy; and (iii) the existence of a public expenditure management system that meets minimum standards for governance and transparency in the use of public resources.

The objective of the MDRI is to provide additional support to HIPCs to reach the MDGs, while ensuring that the financing capacity of the international financial institutions is preserved. Debt stocks in the 18 countries that reached the HIPC completion point prior to 2006 will be reduced by an estimated $17 billion (in net-present-value terms, valued at end-2004), with most of the reduction coming from cancellation of IDA credit repayments of $12 billion (table 3.9).[20] If all 11 decision-point countries were to reach the completion point by the end of 2007, the total amount of debt relief would be almost $22.4 billion, an amount equal to 56 percent of the debt relief provided under the HIPC initiative to the same set of countries ($40 billion).

For the 18 HIPCs that reached the completion point prior to 2006, the MDRI will reduce debt service payments by $0.9 billion on average in 2007–17 and then rise to a peak of $1.5 billion on average in 2022–4 (figure 3.8). The total amount of debt relief provided by the MDRI will rise over time as additional countries reach the completion point.[21] The modest increase in 2006 reflects the fact that the MDRI will not be implemented by IDA until July 2006 (the beginning of its fiscal year).

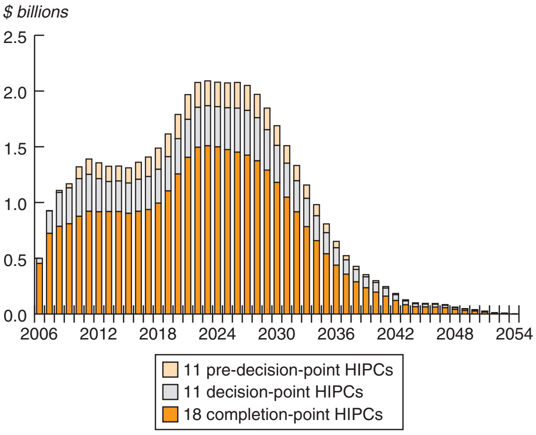
**Table 3.9 Debt-service reductions to be provided by the MDRI**

*$ billions, net present value at end-2004*

| | Completion-point countries (18) | Decision-point countries (11) | Total for 29 countries | Pre-decision point countries (9) | Total for 38 countries |
|---|---|---|---|---|---|
| IDA | 12.1 | 2.8 | 14.9 | 1.2 | 16.1 |
| IMF | 2.8 | 1.4 | 4.2 | 0.3 | 4.5 |
| AfDF | 2.3 | 1.1 | 3.4 | 0.3 | 3.6 |
| Total | 17.2 | 5.3 | 22.4 | 1.8 | 24.2 |

*Source:* World Bank staff estimates.

**Figure 3.8 Debt-service reduction to be provided by the MDRI, 2006–45**

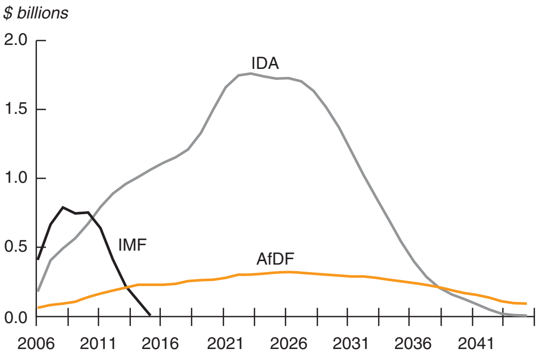



*Source:* World Bank staff estimates.

The two-humped shape of the debt-service-reduction profile is due to the fact that the bulk of outstanding IMF loans to these countries are scheduled to mature within three to six years (figure 3.9). Outstanding IDA and AfDB loans have a much longer duration (extending out to 40 years), so the debt-service-reduction profile is much more gradual once the IMF loans have disappeared from the picture.

The MDRI will affect flows of assistance from IDA and the AfDF to recipient countries in two ways. First, annual gross assistance from IDA and the AfDF to a given country will be reduced by the amount of debt relief provided that year. Second,

**Figure 3.9 Debt-service reduction to be provided to 18 completion-point HIPCs under the MDRI, 2006–45**

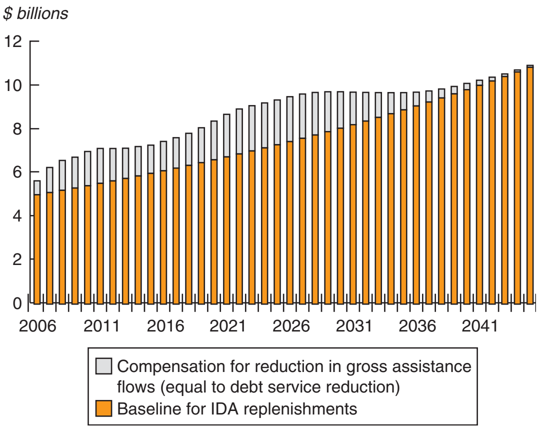



*Source:* World Bank staff estimates.

donors will make additional contributions to compensate IDA and the AfDF for the total reduction in gross assistance flows in each year. Donors have specified that the additional contributions are to be calculated relative to a baseline that maintains current contribution levels in real terms (adjusted for inflation). Under the current replenishment of IDA (IDA14) donors have agreed to make contributions of almost $15 billion between July 2006 and June 2008, or about $5 billion per year. Debt relief on IDA loans under the MDRI will be financed by donors over and above the $5 billion level, measured in real terms to compensate for the effect of inflation.[22] If the annual inflation rate were constant at 2 percent, the baseline contribution level would rise to $5.4 billion in 2010 and $8.0 billion in 2030 in nominal terms (figure 3.10 and table 3.10). Donors' commitment to compensate IDA for the total reduction in gross assistance flows is equal to the debt service reduction provided to the recipient countries (figure 3.8). Donors' total financing commitment comprised of compensation for the effect of inflation and for the reduction in gross assistance flows rises to $7.0 billion in 2010 and $9.7 billion by 2030. Donors' commitment to preserve financing of the AfDF is specified in a similar manner.

The additional resources provided to refinance IDA and the AfDF will be reallocated to recipients using each institution's existing performance-based allocation mechanism, thereby alleviating the risk of "moral hazard" associated

**Figure 3.10 Donors' commitment to refinance IDA for debt relief provided under the MDRI, 2006–45**




*Source:* World Bank staff estimates.

**Table 3.10 Donors' commitment to refinance IDA for debt relief provided under the MDRI, selected years**

*$ billions*

| | 2006 | 2007 | 2010 | 2020 | 2030 |
|---|---|---|---|---|---|
| Baseline for IDA replenishments | 5.0 | 5.1 | 5.4 | 6.6 | 8.0 |
| Compensation for reduction in gross assistance flows (equal to debt service reduction) | 0.8 | 1.2 | 1.6 | 1.7 | 1.6 |
| Total financing commitments | 5.8 | 6.3 | 7.0 | 8.3 | 9.7 |

*Source:* World Bank staff estimates.

with providing debt relief to countries with the highest debt burdens. In other words, debt relief provided under the MDRI will result in an increase in aid (above countries' initial allocation), only to the extent that the country shares in the performance-based allocation. Countries that do not qualify for debt relief under the MDRI may qualify for the reallocated resources and thereby benefit from the initiative.

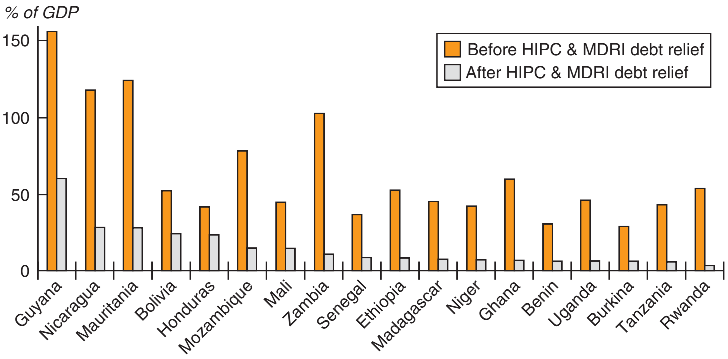
Although the amount of debt relief provided under the HIPC Initiative has been small relative to the total amount of foreign aid received by all developing countries, it is substantial for many of the individual countries that qualify. In 2004, HIPC debt-service reductions provided to the 27 countries that reached the completion point prior to 2005 totaled $2.3 billion, an amount equal to just 3 percent of total ODA ($79.6 billion), but 12 percent of ODA received by the 27 countries ($18.6 billion). Moreover, HIPC debt-service reductions exceeded 20 percent of ODA received by 8 of the 27 countries. Additional debt service reductions provided by the MDRI are expected to keep pace with the scaling up of aid to the HIPCs. In 2007, debt-service reductions provided by the HIPC Initiative and MDRI combined are projected to remain at about 12 percent of the amount of ODA received by countries that reach the completion point.

### *A gap is opening between countries that qualify for debt relief and those that do not*

Taken together, debt relief provided by the HIPC Initiative and the MDRI will substantially reduce the debt burdens of qualifying countries. For the 18 countries that reached the completion point prior to 2006, the HIPC Initiative reduces their total debt stock from 55 percent of their GDP to 30 percent; the MDRI then reduces it further to 13 percent (in net present value terms). In 4 of the 18 countries the debt-to-GDP ratio will decline by more than 90 percentage points. Debt stocks will fall below 30 percent of GDP in all countries except one (Guyana), and in 10 of the 18 countries, debt will fall below 10 percent of GDP, well below the average for developing countries ([32] percent in 2005) (figure 3.11).[23] Similar reductions would result for other countries that reached the HIPC completion point.

For the 11 HIPCs that have reached the decision point, but not the completion point, the median debt burden was 41.2 percent of GDP in 2004 (in present value terms), which is below that for middle-income countries (44.8 percent) (table 3.11). Similar results hold for the low-income countries that are not currently eligible for the HIPC Initiative (the "other low-income countries" reported in table 3.11). Relative to exports, however, the debt burden in the 11 decision-point HIPCs is significantly higher than in other low-income countries (183.7 percent compared to 99.5 percent). All 11 countries are expected to reach the completion point by the end of 2007, which will reduce their debt burdens significantly (to less than 15 percent of GDP and 50 percent of exports in most cases). For the 11 countries that are currently eligible for the HIPC Initiative but have not yet reached the decision point, the median debt burden was 67.1 percent of GDP and 150.4 percent of exports in 2004. These countries therefore have a very strong incentive to reach the decision and completion points, in order to qualify for debt relief under the HIPC Initiative and the MDRI.

**Figure 3.11 Debt burdens in 18 completion-point HIPCs, before and after the HIPC and MDRI debt relief**




*Source:* World Bank staff estimates.

**Table 3.11 Net present value of external debt relative to GNI and exports, 2004**
*Percent*

| | Number of countries | Median of present value of debt/exports | Median of present value of debt/GNI |
|---|---|---|---|
| Completion-point HIPCs | 18 | | |
| after HIPC debt relief, prior to MDRI | | 102.2 | 27.6 |
| after HIPC debt relief and MDRI | | 41.1 | 8.6 |
| Decision point HIPCs | 11 | 183.7 | 41.2 |
| Pre-decision-point HIPCs | 9 | 150.4 | 67.1 |
| Other low-income countries | 18 | 99.5 | 46.3 |
| Middle-income countries | 76 | 98.0 | 44.8 |

*Sources:* World Bank Debtor Reporting System and staff estimates.

### *Debt relief raises concerns about excessive borrowing in the future*

The low debt burdens in countries receive MDRI debt relief will improve their creditworthiness significantly, raising concerns that they might borrow excessively from nonconcessional sources. This could offset the efforts made to improve debt sustainability, leading to yet another lending-forgiveness cycle. But why would countries borrow "excessively"? And why would private creditors be willing to lend "excessively"?

Determining whether countries are borrowing excessively is not straightforward. Loans used to finance investment projects that generate revenues will not erode debt sustainability if the rates of return cover the cost of financing. From this perspective, debt sustainability is determined by the quality of the investments made, not by the quantity borrowed.

Accessing external private capital entails significant risks, but it also provides potential benefits. Financial crises have led to major setbacks in many emerging market economies over the past few decades. On the other hand, external private capital can play a valuable role in the development process, particularly for countries in which domestic savings are inadequate to finance productive investment projects with high private and social rates of return. Countries therefore face the challenge of balancing the potential risks and benefits.

Part of the concern about excessive nonconcessional borrowing stems from the incentive problems associated with providing publicly funded debt-relief initiatives. The public funding introduces an element of moral hazard into borrowing and lending decisions. If borrowers and lenders perceive publicly funded debt relief as an ongoing feature of the development agenda, countries have an incentive to increase borrowing beyond prudent levels, under the expectation that debt relief will be provided by donors if they encounter difficulties in meeting their debt-service obligations. Similarly, some investors might believe that their exposure to poor countries is reduced by an implicit guarantee of publicly funded debt relief, which would limit their downside risk, making them willing to lend at a lower rate.

Another factor underlying the concern about excessive nonconcessional borrowing stems from the inherent trade-off in scaling up the financial resources required to accelerate progress on MDGs while maintaining debt sustainability. Grants provide countries with financial resources without sacrificing debt sustainability. But the availability of grants is limited. Loans provide additional financial resources, but raise the risk of debt distress, particularly when loans are made on nonconcessional terms. Countries may be more willing to accept a higher risk of debt distress in order to gain additional resources. Official creditors may prefer a more prudent approach to borrowing; one that puts more weight on debt sustainability, with the aim of preventing a recurrence of lending-forgiveness cycles.

The Debt Sustainability Framework (DSF) for low-income countries developed jointly by the IMF and the World Bank provides a framework for managing the risks associated with additional borrowing (box 3.5). The DSF captures the distinction between concessional and nonconcessional borrowing by measuring debt in net present value terms. Nonconcessional borrowing raises the debt burden by more (in net present value terms) for the same amount of financial resources. In other words, borrowing on concessional terms improves the trade-off between debt sustainability and resource flows. More generally, it is the overall degree of concessionality in a country's loan portfolio that determines how many more resources can be provided without sacrificing debt sustainability.

The DSF can be used to assess the risks associated with additional borrowing. Assessing the risks are complicated by the high degree of uncertainty surrounding economic projections over long time horizons (measured in decades), especially when the

## Box 3.5 The DSF for low-income countries

The International Monetary Fund (IMF) and World Bank jointly assess debt sustainability in countries that receive credits and grants from the International Development Association (IDA) and that are eligible for resources under the IMF's Poverty Reduction and Growth Facility (PRGF). The DSF is used by IDA and the African Development Fund (AfDF) to allocate credits (not loans) to countries. It is also used by the Paris Club to help determine whether a country's debt is sustainable and, if it is not, how much debt relief would be required to attain debt sustainability over the long term.

The objective is to monitor the evolution of countries' debt-burden indicators and to guide future financing decisions. The DSF traces the evolution of external and public debt and debt-service indicators over the long term with reference to a baseline projection based on realistic assumptions. Stress tests are conducted to illustrate the implications of adverse shocks to key macroeconomic variables (typically lower growth, higher interest rates, and an exchange rate depreciation), along with other selected scenarios of specific interest to the country under study (for example, an increase in a contingent liability of the public sector).

The external debt burden of each country is assessed over the projection horizon with reference to threshold levels that depend on the quality of a country's policies and institutions. The World Bank's Country Policy and Institutional Assessment (CPIA) is used to classify countries into three performance categories (strong, medium, and poor). Debt thresholds for strong policy performers are highest. The risk of external debt distress is then assessed with reference to four risk classifications: low, medium, high, and "in debt distress." Empirical studies indicate that low-income countries with better policies and institutions have a lower risk of debt distress (see IMF and World Bank 2004 and the references therein).

The risk classifications do not fully capture the complexity of the assessment. For example, in cases where the various indicators give different signals, there is still a need for careful interpretation and judgment. Furthermore, vulnerabilities related to domestic public debt should also be taken into account. The past record in meeting debt-service obligations may also be a factor in determining the classification, especially for countries at high or moderate risk of debt distress.

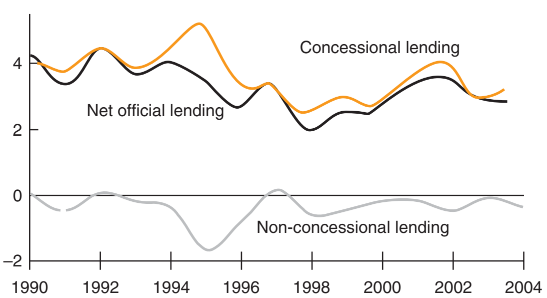
additional borrowing is used to fund projects and programs that have the potential to enhance economic growth significantly over the long term. Managing the risks by setting limits on additional borrowing would require agreement among all creditors on the assessment of debt sustainability and the degree of risk to be tolerated. In the case of the main multilateral creditors, there is typically some scope for agreement on the major issues, and moral suasion can be used to enforce limits on additional borrowing. However, reaching agreement among all prospective creditors is generally be problematic, and, under such conditions, moral suasion is likely to be ineffective in enforcing borrowing limits. For countries with IMF programs, the collective-action problem is addressed by setting limits on additional borrowing, which help ensure that additional resource flows do not endanger debt sustainability. However, for countries without an IMF program, it will be difficult to monitor and set limits on non-concessional borrowing.

What has been the experience so far for countries that have already received HIPC debt relief? Has their borrowing increased significantly?

### *Net official lending to decision-point HIPCs has been stable*

Net concessional lending from the official sector to the 27 HIPCs that reached the decision point prior to 2005 declined significantly in the mid-1990s (figure 3.12).[24] The transitory increase in 2002 was partly due to a resumption in concessionary lending to the Democratic Republic of the Congo (DRC) in 2002.[25] Non-concessional lending from the official sector to the 27 countries has been declining for several years, resulting in lower debt service costs. Since 1990, repayments on outstanding loans have exceeded disbursements of new loans by 0.4 percent of GDP on average.

**Figure 3.12 Net official lending to 27 decision-point HIPCs as a percent of GDP, 1990–2004**




*Source:* World Bank Debtor Reporting System.

Net private debt inflows to 27 HIPCs that reached the decision point before 2005 *contracted* by \$0.75 billion (0.7 percent of GDP) on average over the period 2000–3, before rebounding to \$0.5 billion in 2004 (0.4 percent of GDP).[26] The rebound in 2004 was lower than in other low-income countries, where net private debt inflows increased from an average level of \$0.4 billion (0.05 percent of GDP) in 2000–3 to \$7.2 billion (0.7 percent of GDP) in 2004. The rebound in 2004 was mainly concentrated in 4 of the 29 decision-point HIPCs: Tanzania (\$168 million, 1.5 percent of GDP), Honduras (\$151 million, 2.0 percent of GDP), Cameroon (\$133 million, 0.9 percent of GDP), and the Democratic Republic of the Congo (\$88 million, 1.3 percent of GDP). The private debt burden of the 27 countries as a group has declined significantly, falling from more than 20 percent in the early 1990s to less than 9 percent in 2004, comparable to the level in other low-income countries but well below that for middle-income countries (25 percent in 2004). Private debt exceeded 20 percent of GDP in only 2 of the 27 countries in 2004 (Nicaragua at 25 percent and Mozambique at 23.4 percent), while 13 countries recorded ratios of private debt to GDP of under 5 percent.

International credit-rating agencies have recently begun issuing sovereign debt ratings for some low-income countries. Credit ratings enhance transparency and help private investors assess the risk of holding sovereign debt. Thirteen of the 29 decision-point HIPCs are currently rated by international agencies (table 3.12). Benin, Ghana, and Senegal are rated B+ by Standard and Poor's; Ghana and Mozambique are rated B+ by Fitch. These ratings, the highest among low-income countries, are three notches below investment grade, making it difficult for countries to expand their access to international bond markets. Bank loans and short-term debt account for most of the outstanding private debt (90 percent in 2004) issued by the 29 countries. Medium- and long-term bonds account for a negligible portion, less than 0.1 percent in 2004, down from almost 4 percent in 1993. In 2004, net inflows of medium- and long-term bonds to the 29 countries totaled only \$345 million (0.3 percent of GDP), and were con-

**Table 3.12 Credit ratings for decision-point HIPCs**

*Rating of foreign currency long-term debt*[a]

| | Moody's | Standard & Poor's | Fitch |
|---|---|---|---|
| Benin | | B+ | B |
| Bolivia | B3 | B | B– |
| Burkina Faso | | B | |
| Cameroon | | CCC | B– |
| Ghana | | B+ | B+ |
| Honduras | B2 | | |
| Madagascar | | B | |
| Malawi | | | CCC |
| Mali | | B | B– |
| Mozambique | | B | B+ |
| Nicaragua | Caa1 | | |
| Senegal | | B+ | |
| Uganda | | | B |

*Sources:* Moody's, Standard & Poor's, and Fitch.
a. As of March 8, 2006.

centrated in just three countries: Honduras ($162 million, 2.2 percent of GDP), Senegal ($92 million, 1.2 percent of GDP), and Ethiopia ($71 million, 0.9 percent of GDP). The creditworthiness of HIPCs that reach the completion point will be enhanced by further debt relief under the MDRI. However, other factors such as the quality of policy and institutional frameworks, and political risk, will continue to have an important influence on credit ratings by international agencies.

### *The decline in debt service burdens is supported by stronger economic growth*

Growth has picked up over the past few years in most HIPCs, helping reduce their debt service burden, measured relative to GDP (table 3.13). Real GDP growth in the 27 HIPCs that reached the decision point before 2005 averaged 4.6 percent over the period 2000–5, up considerably from an average rate of 2.6 percent in the 1990s and just 1.8 percent in the 1980s. The pickup in growth has been broadly based across countries—real GDP growth exceeded 4 percent in 16 of 27 decision-point HIPCs in 2000–5.

It is important to recognize, however, that the range of outcomes was broad—annual per capita real GDP growth *declined* in 9 of the 27 countries. Moreover, the average increase in real GDP growth in 27 decision-point HIPCs over the sub-periods 1990–9 versus 2000–5 (1.9 percentage points) was the same as in "other low-income countries" (countries that currently are not eligible for the HIPC Initiative) and in middle-income countries. Furthermore, the increase in growth also reflects the fact that HIPCs are required to establish a track record of macroeconomic stability in order to reach the decision point. Real GDP growth increased by only half of a percentage point during this period in the 11 countries that are eligible for the HIPC Initiative but had not yet reached the decision point by the end of 2004 (these are the "pre-decision-point HIPCs" in table 3.13). Clearly, growth has been influenced by many factors beside debt relief.

According to the "debt overhang" hypothesis, excessive debt can seriously impede countries' growth potential.[27] Much of the theoretical literature has focused on the adverse incentive effects of excessive debt. Excessive debt raises concerns that the government may resort to inflationary finance or large tax increases to meet its debt-service obligations or that it may default on its obligations at some point in the future. These concerns deter private investment, which curtails growth. Moreover, in countries that are unable to meet their debt-service obligations, governments can be discouraged from carrying out structural reforms if most of the benefits were used to augment debt-service payments.

The theoretical literature suggests that external borrowing may foster growth up to some threshold level, beyond which adverse incentives begin to dominate. But empirical research on this issue has been inconclusive, on the whole. There is a high degree of uncertainty surrounding estimates of threshold levels and the effect of debt relief on growth. Recent empirical studies by Clements and others (2003) and Pattillo and others (2004) suggest that the amount of debt relief provided by the

**Table 3.13 Average annual real GDP growth, 1990–2005**

*Percent*

| | No. of countries | Average real GDP growth[a] | | |
|---|---|---|---|---|
| | | 1980–9 | 1990–9 | 2000–5 |
| Decision-point HIPCs[b] | 27 | 1.8 | 2.6 | 4.6 |
| Pre-decision-point HIPCs[c] | 11 | 2.6 | 1.7 | 2.2 |
| Other low-income countries | 19 | 4.7 | 2.7 | 4.6 |
| Middle-income countries | 77 | 3.5 | 2.8 | 4.8 |

*Source:* World Bank Debtor Reporting System and staff estimates.
a. Real GDP growth rates are first averaged over indicated sub-periods for each country and then unweighted averages are calculated across countries.
b. Burundi and Congo reached the decision point prior to 2005 and are therefore classifed as pre-decision-point HIPCs for the purpose of these calculations.
c. Real GDP data is unavailable for 2 of the 11 pre-decision-point HIPCs (Myanmar and Somalia).

HIPC Initiative should raise countries' annual per capita real GDP growth rates by about 1 percentage point.[28] That estimate is broadly consistent with recent trends—annual per capita real GDP growth increased by about 2 percentage points on average for the HIPCs over the periods just before and just after reaching their respective decision points.[29]

The "debt overhang" literature stresses that debt relief can strengthen incentives to promote domestic investment and structural reforms. Providing more aid in the form of grants in place of concessionary loans can provide the same incentive effects (because it reduces the net present value of debt), but this may not be the case for greater aid in the form of grants allocated to reduce debt-service payments. In the absence of a credible multiyear commitment, recipient countries face uncertainty about their ability to use grants to service debt. The irrevocable nature of HIPC debt relief upon reaching the completion point provides such a commitment.

Debt burdens are not the only indicator of sustainability; other factors are important, as well. Episodes of debt distress often have occurred in emerging market economies with moderate, or even low, debt.[30] Moreover, adverse shocks to economic growth and the terms of trade have had a greater influence on debt burdens in low-income countries than has the amount of borrowing undertaken (IMF 2003). Various indicators of countries' external positions can provide additional insights into debt sustainability.

### *Debt sustainability in some countries has been enhanced by reserve accumulation, higher exports, and higher inflows of FDI, remittances, and aid*

Foreign reserves enable countries to meet their debt-service obligations in the event of adverse financial or economic developments, thereby reducing of the risk of a liquidity crisis. Reserves in the 29 decision-point HIPCs as a group have increased substantially since the early 1990s, rising from 2.6 percent of GDP in 1990 to a high of 13.3 percent in 2004, before declining to 11.9 percent in 2005 (table 3.14). In 2004, reserves provided cover for more than six months of imports in one-third of the countries, whereas in 1990 none of the countries had enough reserves to cover six months of imports.

The external position of the 29 decision-point HIPCs has also been strengthened by an expansion of trade. More open economies are better able to adjust to external shocks. Exports by the 29 countries as a group have increased from 20 percent of GDP in the early 1990s to almost 30 percent in 2005, but the figure remains well below the level in middle-income countries (estimated at 40 percent in 2005).

Non-debt-creating resource flows, notably from FDI, workers' remittances, and foreign aid, can help countries meet their external financing needs by generating a relatively stable stream of foreign exchange earnings. FDI and remittance inflows to the 29 decision-point HIPCs as a group have risen considerably since the early 1990s (table 3.14). FDI and remittance inflows provide important sources of external finance to most countries, with FDI inflows exceeding 3 percent of GDP in one-half of the countries, and remittances exceeding 3 percent of GDP in about one-third. ODA has risen from a low of 12 percent of GDP in 29 decision-point HIPCs as a group to 20.5 percent in 2003–4, which is comparable to the level received in the early 1990s.

### *Sizable external and fiscal imbalances remain*

The current-account deficit for the decision-point HIPCs as a group narrowed from 8.9 percent of GDP in 1999 to 5.1 percent in 2005. But large imbalances remain in some countries: deficits exceed 10 percent of GDP in one-third of the 29 countries. Those countries still rely heavily on external financing, making them vulnerable to external shocks. In 2005, current-account deficits widened by more than 3 percent of GDP in 6 of the 29 countries, mainly due to higher oil-import bills. The value of oil imports increased from 3.5 percent of GDP in decision-point countries in 2002 to 7.6 percent in 2005.

The analysis to this point has focused mainly on external debt burdens. However, there is growing concern about fiscal imbalances and rising domestic debt burdens in some countries. Data limitations make this issue difficult to analyze. Nonetheless, the available data indicate cause for concern in some HIPCs. General government budget balances have improved over the past few years for the decision-point HIPCs as a group, reaching –3.2 percent of GDP in 2005, up from –4.3 percent in 2003. However, fiscal deficits exceed 5 percent of GDP in 8 of the 26 countries for which data are available. Gross domestic debt issued by the public sector increased by more than 5 percent of GDP over the period 1998 to 2004 in 4 of the 11 HIPCs where data are available.[31] In 2004 gross domestic debt exceeded 20 percent of GDP in 5 of the 11 HIPCs. For countries where the public debt burden is high and rising, the gains in debt sustainability provided by HIPC debt relief have been eroded by financing public debt in the domestic market.

**Table 3.14 Indicators of external position of the 29 decision-point HIPCs, 1990–2005**

*Percent*

| | 1990 | 1995 | 2000 | 2001 | 2002 | 2003 | 2004 | 2005 |
|---|---|---|---|---|---|---|---|---|
| Foreign reserves/GDP | 2.6 | 6.8 | 8.2 | 8.9 | 11.5 | 12.8 | 13.3 | 11.9 |
| Exports/GDP | 21.1 | 23.9 | 28.3 | 25.3 | 24.9 | 25.6 | 28.4 | 29.5 |
| Current account/GDP | –4.8 | –6.0 | –7.1 | –7.0 | –7.9 | –5.9 | –5.4 | –5.1 |
| FDI/GDP | 0.5 | 1.8 | 3.6 | 3.7 | 4.0 | 3.3 | 3.1 | — |
| Remittances/GDP | 1.2 | 1.4 | 2.0 | 2.3 | 2.5 | 2.7 | 2.8 | — |
| ODA/GDP | 21.2 | 18.1 | 15.3 | 17.2 | 16.0 | 20.3 | 20.7 | — |

*Sources:* World Bank Debtor Reporting System and staff estimates.

## The challenge ahead: accessing external capital, while maintaining debt sustainability

Low-income countries, HIPCs and non-HIPCs alike, face the challenge of balancing the potential risks of external borrowing against the benefits. The debt burden is an important factor in assessing those risks, but it is not the only factor. Much of the buildup in the debt burden in the HIPCs from the mid-1980s to the mid-1990s can be explained by their weak policy and institutional frameworks, low capacity for debt management, lack of export diversification, and limited fiscal revenue capacity (Sun 2004). To the extent that these factors have not improved significantly in countries that reach the HIPC completion point, debt sustainability will be an ongoing concern, despite the substantial amount of debt relief provided to the countries. Countries can enhance debt sustainability by building up foreign reserves to levels that provide adequate insurance against external shocks, and by pursuing macroeconomic policies that aim to maintain a low and stable inflation environment, along with a sound fiscal framework. Debt sustainability can also be enhanced by implementing structural reforms designed to improve institutional frameworks. This includes initiatives aimed to promote trade, FDI, and remittance inflows; advance export diversification; augment capacity for debt management; raise fiscal revenue capacity; and improve the investment climate through better governance and sound institutions. In addition to helping to maintain debt sustainability over the long term, improving policies and institutional frameworks along these lines will play a critical role in improving aid effectiveness and more generally, in helping countries attain their development objectives.

# Annex: Debt Restructuring with Official Creditors

This appendix lists official debt restructuring agreements concluded in 2005. Restructuring of intergovernmental loans and officially guaranteed private export credits take place under the aegis of the Paris Club. These agreements are concluded between the debtor government and representatives of creditor countries. The terms of Paris Club debt treatments are recorded in an agreed-upon minute. To make the terms effective, debtor countries must sign a bilateral implementing agreement with each creditor (see box 3.3).

*Burundi* On July 29, 2005, Burundi reached its decision point under the enhanced Initiative for Heavily Indebted Poor Countries (enhanced HIPC Initiative). In accordance with the agreement reached in March 2004,[32] Paris Club creditors increased debt reduction to 90 percent of the net present value of eligible external debt (Cologne terms), from 67 percent (Naples terms, or "traditional relief"), for maturities falling due between July 29, 2005, and December 31, 2006.

*Dominican Republic* In October 2005, the Paris Club creditors reached agreement with the Dominican Republic to consolidate around $137 million of debt service payments falling due in 2005, of which $50 million related to ODA loans. The rescheduling was conducted according to "classic terms," whereby claims are to be repaid progressively over 12 years, including a 5-year grace period, with 14 semi-annual repayments increasing from 5.5 percent of the amount rescheduled to 9.08 percent. ODA loans were to be rescheduled at interest rates at least as favorable as the original concessional rates and no higher than the appropriate market rate, and non-ODA loans were to be rescheduled at the appropriated market rate. Paris Club creditors also agreed to review the external financing needs of the Dominican Republic in December 2005 in connection with satisfying the conditions for the third review under the IMF Stand-by Arrangement, with a view to providing additional relief in 2006, if needed.

*Honduras* In May 2005, the Paris Club creditors reached agreement on debt reduction for Honduras, which had reached its completion point under the enhanced HIPC Initiative on April 5, 2005. Of the $1.474 billion due to the Paris Club creditors as of March 31, 2005, $1.171 billion was treated on Cologne terms (debt reduction to 90 percent of the net present value [NPV] of eligible external debt), of which $206 million was cancelled as the Paris Club share of the effort in the enhanced HIPC Initiative, $110 million was rescheduled, and $855 million was cancelled on a bilateral basis. As a result of the agreement and additional bilateral assistance, Honduras' debt to Paris Club creditors was reduced from $1,474 million to $413 million.

*Kyrgyz Republic* In March 2005, Paris Club creditors agreed with the government of the Kyrgyz Republic to a reduction of its public external debt. The comprehensive debt treatment under the Evian Approach covered $555 million of debt due to the Paris Club creditors as of March 1, 2005, of which $124 million was cancelled and $431 million rescheduled. According to the agreed rescheduling terms, non-ODA commercial credits were cancelled by 50 percent ($124 million) and the remaining 50 percent will be repaid over 23 years, with a 7-year grace period at the appropriate market rate. ODA credits ($306 million) will be repaid over 40 years with a 13-year grace period at interest rates at least as favorable as the concessional rates applying to these loans. Moratorium interest due under the agreement will be capitalized at 85 percent in 2005, 75 percent in 2006, 70 percent in 2007 and 65 percent in 2008. The capitalized interest amounts will be repaid over 23 years including a 7-year grace period.

*Nigeria* The October 2005 debt deal with Nigeria was the single largest debt relief granted to any African country, effectively providing debt cancellation estimated at $18 billion (including moratorium interest), which represents about 60 percent of its debt owed to Paris Club creditors (an overall reduction in its debt stock by an estimated $30 billion). This Paris Club agreement was made possible following the achievement by Nigeria of (1) progress in pursuing an ambitious economic reform program, which aims to accelerate growth and reduce poverty; (2) the World Bank's reclassification of the country from "blend" to "IDA only," paving the way for Paris Club creditors to grant debt relief along the Naples terms; and (3) negotiation of an agreement with the IMF for a non-lending Policy Support Instrument (PSI), which formalizes continuing IMF surveillance.

The debt relief agreement was to be implemented in two phases in consonance with the implementation of the IMF PSI approved on October 17, 2005. In the first phase, Paris Club creditors grant a 33 percent cancellation of eligible debts after payment of arrears estimated at $6.3 billion by Nigeria. In the second phase, after approval of the first review under the PSI by the IMF and repayment of post-cutoff-date debt, Paris Club creditors would grant an additional tranche of cancellation of 34 percent on eligible debts and Nigeria will buy back the remaining eligible debt. Paris Club creditors are to be paid $12.4 billion in total, with $6.3 billion to clear arrears and $6.1 billion for the buyback. Full implementation of the Paris Club deal, scheduled to be completed in April 2006 and following the IMF first review of the PSI, would reduce Nigeria's total outstanding external debt from $35 billion to $5 billion.

*Peru* In June 2005, the Paris Club creditors agreed on Peru's offer to prepay up to $2 billion of its non-ODA debt falling due between August 2005 and December 2009. Under the agreement, prepayment would be made at par and offered to all creditors. Participation by Paris Club members was voluntary, although a majority of the group's creditors agreed to accept the prepayment offer.

*Poland* In January 2005, Poland announced its intention to prepay portions of its €12.3 billion debt falling due to the Paris Club between 2005 and 2009. Although Poland had prepaid around €4.5 billion of its Paris Club debt by end-May 2005, because the prepayment was financed by sovereign bond issues, it did not contribute to any appreciable reduction of external debt. However, the deal lengthened the average maturity terms of Poland's external debt, removing the bulge in the country's debt repayments in 2005–9 and reducing refinancing risk.

*Russian Federation* In May 2005, the Paris Club creditors agreed on the Russian Federation's offer to prepay $15 billion of its debt at par. Participation by Paris Club members was voluntary, although an overwhelming majority of the group's creditors agreed to participate. This prepayment offer translates into major interest savings for Russia and is the largest such offer by a debtor country to the Paris Club creditors.

*Rwanda* The Paris Club creditors agreed on 100 percent cancellation of Rwanda's debt in May 2005, following a month after Rwanda reached its completion point under the enhanced HIPC Initiative. Around $90 million in debt due to Paris Club creditors as of March 31, 2005, was treated on Cologne terms (debt reduction to 90 percent of the NPV of eligible external debt), of which $82.7 million ($61.7 million in ODA loans and $21 million in non-ODA commercial credits) was cancelled as the Paris Club share of the effort in the enhanced HIPC Initiative. A further $7.7 million in ODA loans was to be cancelled as a result of additional debt relief granted by creditors on a bilateral basis.

*São Tomé and Principe* In September 2005, the Paris Club creditors reached agreement on the retroactive rescheduling of São Tomé and Principe's debt service payments falling due between May 01, 2001, and December 31, 2007. The treatment was on Cologne terms (cancellation of 90 percent of the NPV of eligible external debt), with ODA credits to be repaid over 40 years with a 16 year-grace period.

*Zambia* In May 2005, the Paris Club creditors agreed to reduce Zambia's debt stock under the Enhanced HIPC Initiative, a month after Zambia had reached its completion point. Of the total $1.92 billion due to the Paris Club creditors as of March 31, 2005, $1.763 billion was treated on Cologne terms (90 percent cancellation rate). Of this latter amount, $1.403 billion in pre-cut-off date debt ($461 million in ODA loans and $942 million in non-ODA commercial credits) was cancelled as the Paris Club share of the effort in the enhanced HIPC Initiative. A further $360 million ($298 million in pre- and post-cutoff-date ODA loans and $62 million in post-cutoff-date non-ODA commercial credits) was to be cancelled on a bilateral basis. As a result of the agreement and additional bilateral assistance, Zambia's debt to Paris Club creditors was reduced from $1.92 billion to $124 million. Paris Club creditors also agreed to reschedule 50 percent of the debt service payments due in 2005, 2006, and 2007 on the debt remaining due after additional bilateral cancellation.

### *Debt treatment for countries affected by the tsunami*

Following meetings in January and March 2005, Paris Club creditors reviewed the debt treatment of the tsunami-affected countries and agreed not to expect any debt payments on eligible sovereign claims from these countries until December 31, 2005. Two countries, Indonesia and Sri Lanka, took up the offer. According to the terms of treatment set in May 2005, these two countries were to repay the deferred debt over 5 years with 2-year grace periods. Under treatment were 100 percent of the amounts of principal and interest due between January 1, 2005 and December 1, 2005 on loans from Paris Club creditors having an original maturity of more than one year. For Indonesia, the total amount treated was $2.704 billion, including $2.056 billion of principal and interest on ODA loans and $648 million of non-ODA credits. For Sri Lanka, the total amount treated was around $227 million, including $213 million of principal and interest on ODA loans and 15 million of non-ODA credits.

## Notes

1. The definition of emergency and distress relief grants was modified in 2005 to included reconstruction grants. The modification was not applied to previous years. The amount of reconstruction grants reported by donors in 2005 will not be known until the OECD DAC reports the components of ODA in December 2006.

2. OECD DAC data on the allocation of ODA across income classifications and regions in 2005 will not be available until December 2006. The calculations refer to the portion of ODA that is allocated across income classifications and regions. In 2000–4, 26 percent of ODA was not allocated across income classifications and 17 percent was not allocated across regions, on average.

3. The United Nations' LDC income classification overlaps the World Bank's Sub-Saharan Africa region, but not completely—32 of the 49 LDCs are in the Sub-Saharan Africa region; 32 of the 43 low-income countries in the Sub-Saharan Africa region are LDCs.

4. As measured by the WTO/OECD-DAC Trade Capacity Building Database.

5. The *collective* interim target of 0.56 percent in 2010 entails individual targets of 0.51 percent for the 15 "original" EU countries, along with 0.17 percent targets for the 10 countries that joined the European Union in 2004.

6. Projections of ODA based on donor commitments are reported by OECD (2006, table 1.1).

7. See World Bank (2004, chapter 11) for a discussion of the difficulties entailed in estimating the amount of aid required to finance the MDGs.

8. See World Bank (2006, pp. 77–8) for a detailed discussion of innovative financing mechanisms.

9. See IMF (2005a, annex 2, and 2005b) and Isard and others (2006) for a survey of recent studies.

10. Documented in IMF (2005b).

11. See IMF (2005b) for an analysis of whether recent large aid surges in five African countries were "spent" or "absorbed."

12. All but 4 of the 29 HIPCs that have reached the decision point are in Sub-Saharan Africa.

13. The Republic of the Congo only reached the decision point in March 2006 and hence did not receive any debt service reduction from the HIPC initiative over the period 2000–5.

14. The Democratic Republic of the Congo and Gineau-Bissau are both excluded from the calculations underlying figures 3.6 and 3.7 because they did not service their debt payments in 2000–3.

15. To qualify for "traditional debt relief" provided by the Paris Club, countries must generally have a Poverty Reduction and Grant Facility (PRGF) program with the IMF.

16. Commercial creditors account for only 2 percent of debt relief due under the HIPC Initiative.

17. See IMF and World Bank (2005, section III).

18. See IEG (2006: 8–9) for a more detailed discussion of creditors' commitments to HIPC debt relief.

19. World Bank and IMF (2005: 18–20).

20. Mauritania has reached the completion point under the HIPC Initiative but has not yet qualified for debt relief under the MDRI, pending implementation of key public expenditure management reforms. The calculations reported in the text assume that Mauritania will qualify by the end of 2006.

21. The calculations underlying figure 3.8 assume that countries will reach their respective completion points on the dates listed in World Bank 2006b (annex 2.3).

22. The baseline for refinancing IDA is specified in SDRs with an inflation adjustment factor based on a three-

year moving average, so the U.S. dollar equivalent will vary over time.

23. The higher debt burdens in Guyana, Nicaragua, Bolivia, and Honduras largely represent debt owed to the Inter-American Development Bank, which is not forgiven under the MDRI.

24. Burundi and the Republic of Congo are excluded from these calculations because they reached the decision point after 2004. Net official lending in figure 3.12 includes *concessional* and *non-concessional* loans from official creditors, whereas all bilateral loans discussed in the context of ODA (figure 3.2) are *concessional* (by definition).

25. Prior to 2002, the DRC was in arrears with multilateral institutions and hence did not receive any concessional loans from official sources. In 2002 the DRC received $607 million in net concessional lending from official sources, an amount equal to 11 percent of GDP.

26. Net private debt inflows are comprised of net changes in public and publicly guaranteed debt, private nonguaranteed debt, commercial bank loans and other private credit.

27. See Clements and others (2003) and Pattillo and others (2004) for recent reviews of the theoretical and empirical literature on "debt overhang."

28. The empirical results reported by Clements and others (2003) also imply that the impact on growth could be stronger if some of the debt-service reduction were allocated to public investment. For instance, annual per capita GDP growth would be augmented by an additional 0.5 percentage point if half of HIPC debt relief were allocated to public investment.

29. This result is strongly influenced by large increases in just a few countries, notably Chad, where real GDP per capita increased from an average rate of –0.9 percent over the period 1991–2000 to 13.6 percent in 2001–04. The *median* increase is only 1.5 percentage points.

30. This is documented by Reinhart, Rogoff, and Savastano (2003), who coined the term "debt intolerance." They examined 33 debt-distress episodes in emerging market economies over the period 1970–2001. Of these, four involved countries with ratios of external debt to GDP of less than 40 percent; another seven involved ratios of less than 50 percent.

31. Calculations are based on World Bank staff estimates of gross general government debt.

32. The March 2004 agreement treated $85 million in arrears in principal and interest as of December 31, 2003 and of maturities in principal and interest falling due from January 1, 2004 to December 31, 2006. The rescheduling was on Naples terms (67 percent NPV debt reduction of eligible external debt), with non-ODA credits cancelled by 67 percent (around $4.4 billion) and the remainder rescheduled over 23 years with a 6-year grace period, at market interest rates, and ODA credits rescheduled over 40 years with a 16-year grace period.

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