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HELPDESK REQUEST

# **Is debt sustainable in the post-HIPC era? A literature review**

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# 1 Introduction

**In the 1970s and the 1980s several low-income countries progressively accumulated external debt.** Excess liquidity of international finance on the supply side, and favourable growth prospects in borrowing countries on the demand side were the key underlying factors driving this accumulation. Indeed, rapid growth in commodity prices growth in early 1970s fostered optimistic expectations for repayment capacity of low-income borrowing countries. Nevertheless, the scenario rapidly deteriorated at the end of the 1970s with the onset of the global recession. The significant drop in debtor countries' exports - combined with a strong dollar and high global interest rates - depleted foreign exchange reserves (UNECA, 2011). Debtor countries consequently began to feel the strain of having to make timely payments on their increasingly expensive foreign debt.

**Across the world public concern with excessive debt burden of these low-income countries together with their lacklustre performance in poverty reduction provided the impetus for debt relief.** With the vocal support of advocacy nongovernmental organisations (NGOs), in particular the Jubilee 2000 campaign movement, debt relief was pushed high on the agenda of Western governments. In response, the IMF and World Bank launched the Heavily Indebted Poor Countries (HIPC) Initiative in 1996, the first international response to provide comprehensive debt relief to the world's poorest, most heavily indebted countries. The HIPC Initiative was further expanded in 1999 (Enhanced HIPC Initiative) and supplemented by the Multilateral Debt Relief Initiative (MDRI) in 2005.

**To date, the HIPC Initiative and MDRI are nearly completed with the IMF and World Bank closing the scheme to new entrants in 2011.** Out of the 39 countries that have been eligible under the Initiative, to date 35 have already reached the completion point and have thus received 100% relief on eligible debt from IMF and other participating creditors. The total assistance committed under the HIPC initiative and MDRI to these 35 HIPCs amounts to US\$126bn in nominal terms as of end-August 2013 (IMF, 2013d). Moreover, debt relief under the initiatives has substantially alleviated debt burdens in recipient countries, more than halving debt service-to-GDP ratios from 2.8 percent in 2001 to 1.3 percent in 2012. The World Bank and IMF further claim that debt relief has enabled beneficiaries to increase their poverty reducing expenditure by almost three and a half percentage points of GDP, on average, between 2001 and 2012 (IMF, 2013d).

**These initiatives were intended to provide HIPCs with the opportunity for a fresh start, however the question of whether the benefits from debt relief can be preserved has become preeminent.** Last decade was also characterised by sustained growth performance in a large group of emerging and developing countries and improved macroeconomic fundamentals. Although the analysis of a country's debt sustainability is far from a homogenous concept or approach, one of the key definitions is whether a country can meet its current and future debt service obligations in full, without recourse to debt relief, rescheduling or accumulation of arrears (IDA and IMF, 2001): this is also the definition we will consider throughout this literature review. **This issue of long-term debt sustainability is critical, especially as debt relief is generally designed as a one-time intervention to minimise moral hazard issues (i.e. irresponsible lending and/or borrowing due to the expectations of regular bail-outs).**

The helpdesk request is as follows "what is currently being said on the issue of post-Heavily Indebted Poor Countries accumulating debt (since HIPC debt relief was granted) and the sustainability of that debt accumulation?" In response, this report (i) reviews the most recent literature (since 2006) analysing external and public debt dynamics for countries that have completed the HIPC initiative and MDRI, (ii) maps past trends and projections of debt ratios for

HIPC and MDRI countries – both concessional and non-concessional when applicable – analysing how much debt is being accumulated and how fast and (iii) and discusses major threats to debt sustainability in the coming years.

**A key message emerging from the literature review is that while debt burdens of post-completion point countries have declined dramatically and macroeconomic fundamentals improved for most post-completion point HIPCs, structural vulnerabilities and potentially new threats may undermine the long-term debt sustainability of newly accumulated debt in some economies.** Section 2 provides a brief overview of the salient features of the HIPC initiative as well as the MDRI. Section 3 highlights the key findings of the literature review in regards to the impact of debt relief on recipients' debt sustainability. Section 4 presents the statistical facts and figures based on trends and projections of various debt indicators from the IMF and World Bank focusing on general government debt (the public part of total external debt) due to data limitations and because historically, external public debt has been the largest component of debt in LICs and the largest source of risk, reviews studies measuring the size of the factors contributing to debt accumulation as well as assesses average terms of new borrowing and the share of concessional borrowing. Section 5 provides a few reflections on other issues pertinent to debt sustainability such as the rise in domestic public debt and external private debt as well as some of the limitations of the IMF-WB Debt Sustainability Analysis (DSA). Section 6 concludes.

## 2 Debt relief mechanisms for low-income countries: An overview of the HIPC Initiative and MDRI

Launched in 1996 by the Bretton Woods Institutions, the **Heavily Indebted Poor Countries (HIPC) Initiative** aimed (i) to reduce the overall debt stock of these countries to a sustainable level, within a reasonable period of time, in order to ensure that no country faces a debt burden that it cannot manage and (ii) to increase fiscal space to expand poverty reducing expenditure. It was the first comprehensive and coordinated programme that reduced the multilateral debt stock of the poorest countries, involving IMF, IDA, a large number of MDB (Multilateral Development Banks) and bilateral creditors under the Paris Club. According to the original framework of the initiative, a debt stock would have avoided both rescheduling and accumulation of arrears if the net present value (NPV) of debt-to-export ratio had been below a range of 200–250 per cent.

**In addition, the HIPC initiative is characterised by a two-step process.** Countries must meet certain criteria, commit to poverty reduction through policy changes and demonstrate a good track-record over time. First, low-income countries facing unsustainable external debt burdens entered the programme if they made sufficient progress implementing policies approved by the IMF and World Bank, thereby reaching the "decision point". Second, the "completion point" is achieved when a country establishes a "track record of good performance" regarding specified governmental and fiscal reforms and demonstrates that the savings from debt relief are directed significantly to programmes that benefit the poor, enabling the country to receive full and irrevocable reduction in debt available under the Initiative.

Three years later, **in 1999, the HIPC Initiative was enhanced** to provide faster, deeper and broader debt relief and to strengthen links between debt relief, poverty reduction, and social policies. This was achieved through lower sustainability targets, debt relief decided at decision point data, interim assistance and floating completion point.

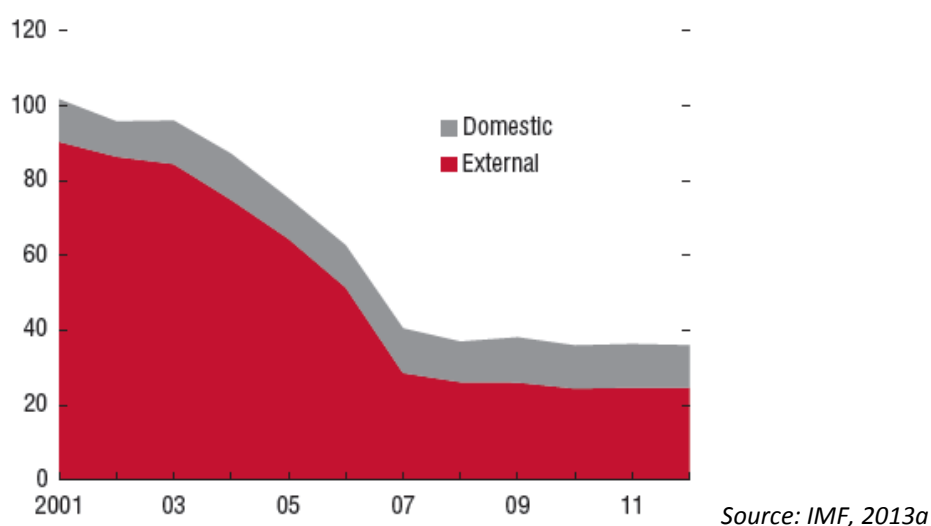
**In 2005, the HIPC Initiative was supplemented by the Multilateral Debt Relief Initiative (MDRI)** to help accelerate progress toward the United Nations Millennium Development Goals (MDGs). Under MDRI, the International Development Association (IDA), IMF, the African Development Fund (ADF) and the Inter-American Development Bank (IDB) provided 100 per cent debt relief on eligible debts. The main differences between HIPC and MDRI – country coverage, participating creditors, debt relief provided and modality of delivery – are described in detail in Table A-1 in the Annex.

**Table 1 shows that of the 39 countries eligible or potentially eligible for HIPC Initiative assistance, 35 have received full debt relief from the IMF and other creditors after reaching their completion points (as of end-September 2013).** One country, Chad, has reached its decision point and has benefited from interim debt relief. The total assistance committed under the HIPC initiative and MDRI to 35 Post-Completion-Point HIPC countries is US\$126bn in nominal terms as of end-August 2013 (IMF, 2013d). The three remaining countries, which are potentially eligible for HIPC Initiative assistance, have not yet reached their decision points. These four countries that have yet to complete the initiative share common challenges, which include preserving peace and stability, improving governance and delivering basic services (UN, 2013a).

**Table 1: List of Heavily Indebted Poor Countries (As of end-September 2013)**

<b>35 Post-Completion-Point HIPCs</b>
Afghanistan, Benin, Bolivia, Burkina Faso, Burundi, Cameroon, Central African Republic, Comoros, Congo, Dem Rep. of the, Congo, Rep. of, Cote d'Ivoire, Ethiopia, Gambia, The, Ghana, Guinea, Guinea-Bissau, Guyana, Haiti, Honduras, Liberia, Madagascar, Malawi, Mali, Mauritania, Mozambique, Nicaragua, Niger, Rwanda, Sao Tome and Principe, Senegal, Sierra Leone, Tanzania, Togo, Uganda and Zambia
<b>Interim HIPCs</b>
Chad
<b>3 Pre-Decision-Point HIPCs<sup>1</sup></b>
Eritrea, Somalia and Sudan

External debt relief under these initiatives have played a pivotal role in the reducing the public debt-to-GDP ratios of Sub-Saharan African—those involving external debt—throughout the early 2000s (Figure 1). Other factors have also contributed to this reduction and will be discussed in Section 4.2

**Figure 1: Public Debt-to-GDP Ratio in Sub-Saharan Africa (Percent of GDP)**

<sup>1</sup> Countries that are eligible or potentially eligible and may wish to avail themselves of the HIPC Initiative or MDRI.

## 3 Literature Review

This section examines the most recent reports and publications of the IMF, World Bank, leading academics as well as NGOs that have remained active in the post-HIPC/MDRI debt sustainability debate. While public debt sustainability in advanced economies is at the top of the international agenda (IMF, 2012; IMF, 2013a), external debt in HIPCs is now nearly off the radar. This is not surprising given that most commentators have deemed the HIPC Initiative and MDRI a success in terms of achieving their two original objectives, i.e. (a) lower debt stock and thus debt service, and (b) free up resources for poverty-reducing expenditure.

### 3.1 Approach to Literature Review

This literature review focuses on papers published from 2006 onwards. Papers were identified through a Google scholar search and search via Wiley and Science direct databases. The following search fields were used in combination with 'Debt Sustainability':

a. HIPC, Post-HIPC, Debt Relief, Sub-Saharan Africa and Low-Income Countries. All IMF and World Bank papers on debt analysis in developing countries published since 2006 have been reviewed for this survey.

It should be noted that most of the papers reviewed in this section are policy papers from the IMF and World Bank or NGO produced. Hence it is difficult to assess their quality in terms of level of peer review for rigor, validity and reliability. Nevertheless, given the high level of consistency in the results, derived from papers adopting a similar approach, conclusions seem robust. In particular, quantitative studies that utilised debt sustainability projections from IMF or IMF staff calculations were generally positive, while qualitative studies tended to be less optimistic and more nuanced in terms of outlook. Moreover, the conflict between the qualitative and quantitative analyses is to be expected since the former takes into account factors that cannot be readily quantified.

Table 2 provides a snapshot of this literature separating those studies either (i) arguing that debt ratios are on a sustainable track or (ii) stating and motivating threats to debt sustainability. Sections 3.2 and 3.3 will review those studies in detail.

**Table 2: A Snapshot of Debt Sustainability Literature since 2006**

Debt is sustainable	Debt is <u>NOT</u> sustainable
<p>Projected debt trajectories of HIPCs are below unsustainable debt thresholds in Debt Sustainability Analyses (DSA).</p> <p><i>IMF, 2013b</i></p>	<p>Although debt relief has given many countries a chance for a fresh start, there are persistent structural vulnerabilities of HIPCs economies that undermine the potential sustainability of their new external debt, such as a narrow export base, weak institutions and governance, poor domestic resource mobilization, and inadequate debt management capacity.</p>



	<p><i>Beddies et al, 2009; Ellmers and Hulova, 2013; UN, 2013b; Vaggi and Prizzon, 2013; and Yang and Nyberg, 2008</i></p>
<p>Although there was an adverse impact of the recent global financial and economic on debt ratios in short to medium term, projected ratios have tended to converge to pre-crisis levels, remaining on generally decreasing paths below thresholds).</p> <p><i>Baduel and Price, 2012</i></p>	<p>Several HIPC's are vulnerable to the build-up of unsustainable debt due to large current account deficits.</p> <p><i>Ellmers and Hulova, 2013; IMF, 2013c; JDC, 2012; UN, 2013a; and Vaggi and Prizzon, 2013</i></p>
<p>Non-concessional loans from non-traditional lenders such as China is not necessarily unsustainable if it contributes to better terms of trade, increased export earnings and growth figures. In fact, recipient countries may be better placed to service their loans and thus less vulnerable to a new debt crisis.</p> <p><i>Brautigam, 2011; Davies 2007; Mwase and Yang 2012; and Reisen and Ndoye 2008</i></p>	<p>While access to non-concessional debt has proven valuable to many sub-Saharan African countries, it is also exposing them to new and potentially significant risks that can undermine their debt sustainability.</p> <p><i>Ellmers and Hulova, 2013; and IMF, 2013c</i></p>
<p>The main effect of bond issuances to date has been on the composition of public debt, rather than levels. For the debt-restructuring cases, debt ratios declined significantly with the new international sovereign bonds replacing debt in default or restructured.</p> <p><i>IMF, 2013b</i></p>	<p>Continued vulnerability of HIPC's to (negative) external shocks undermines its long-term debt sustainability. The current financial turmoil and the associated reduction in trade, foreign aid and capital flows might trigger another debt crisis in low income countries. This is because increasing financing requirements, coupled with a (possible) decline in international aid is going to push developing countries to finance their deficits borrowing abroad or issuing domestic debt.</p> <p><i>Cassimon, 2013; Chauven et al., 2010; JDC, 2012; and Presbitero, 2009</i></p>
<p>Debt sustainability did not appear to be a concern for governments in the three case study countries: Cambodia, Ethiopia and Zambia. All three countries have been rated by the IMF/World Bank as being at low risk of debt sustainability problems and therefore did not show concern in relation to taking on new loans.</p>	<p>Although the HIPC/MDRI is focused on public, external debt, domestic debt and private external debt is increasing and is viewed as more expensive than concessionary external financing.</p>

<i>Greenhill et al. 2013</i>	<i>Abbas, S.M and J. Christensen, 2010; Ellmers and Hulova, 2013; IMF and World Bank, 2012; and JDC 2012.</i>
Use of borrowing- A return to pre-relief debt levels can be sustainable if new borrowing translates into productive investment and faster growth i.e. Public Investment-Growth Nexus  <i>Lewis, 2013; Ncube et al., 2013; and World Bank and IMF, 2012.</i>	Use of borrowing- A return to pre-relief debt levels can be a cause for concern if the new borrowing does not translate into productive investment and faster growth i.e. Public Investment-Growth Nexus  <i>Lewis, 2013; Ncube et al., 2013; and World Bank and IMF, 2012.</i>

## 3.2 Debt is sustainable

The two main approaches to quantitatively assess debt sustainability are: (i) the approach of the IMF and the World Bank, which looks at debt path projections and how they relate to thresholds; and (ii) the debt-stabilizing primary balance approach, which looks for the primary balances to achieve a chosen debt path, given the assumptions about the evolution of the real interest rate and growth.

Utilising the first approach, proponents of HIPC claim that debt is sustainable since projected debt of several HIPCs are below unsustainable debt thresholds in Debt Sustainability Analyses (DSA).<sup>2</sup> DSA projections suggest that the medium-term debt outlook for sub-Saharan Africa is generally favourable, given projected economic outlook for the region (IMF, 2013b). These projections indicate that average debt-to-GDP ratios are expected to edge up only marginally in the next five years relative to end-2012 levels, with limited changes in their dispersion. This reflects, for the most part, continued strong growth and favourable financing conditions: the interest rate growth differential—a key driver of debt dynamics—is negative for most sub-Saharan African countries. On the other hand, there are some important differences in projected debt dynamics across countries, with a few countries such as Ghana and Senegal experiencing a sharp rise in debt ratios in recent years. This heterogeneity will be explored in greater detail in Section 4.

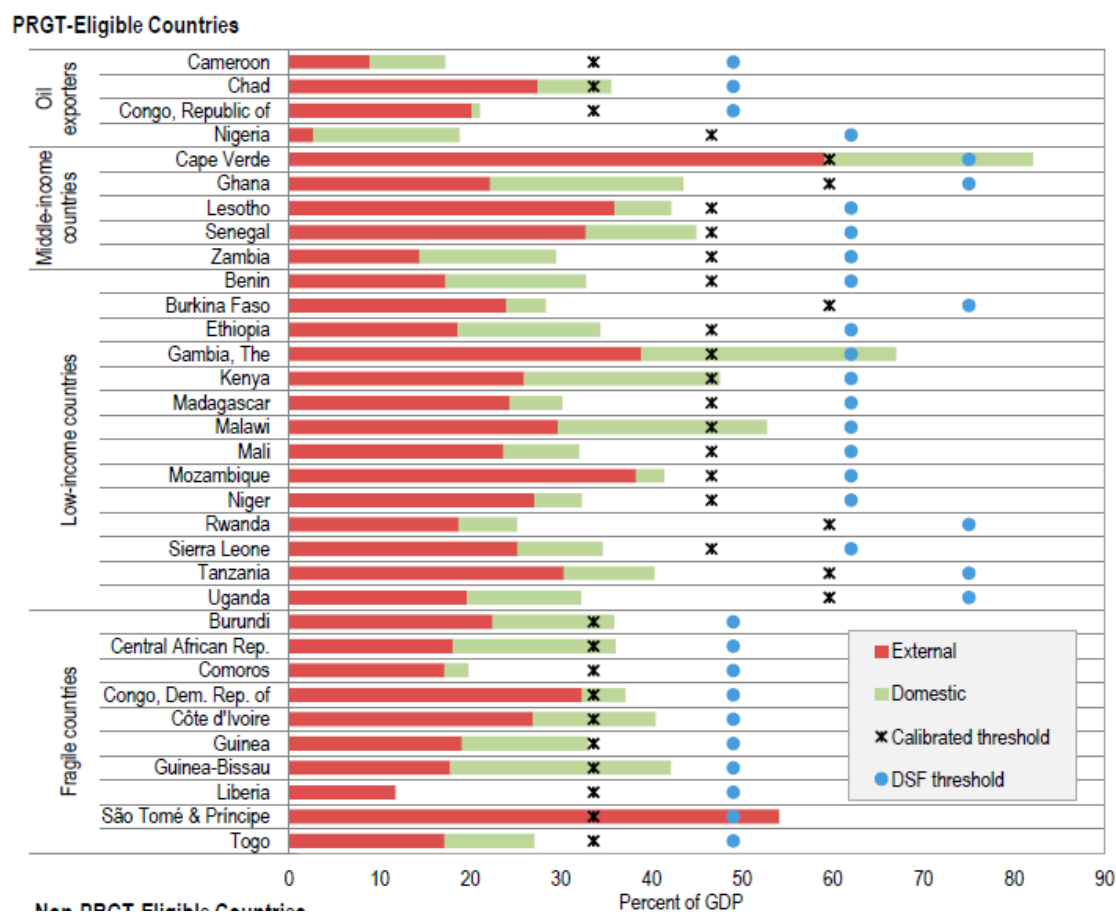
In addition, in order to assess if current and projected public debt in sub-Saharan Africa is a cause for concern, the IMF report examines whether current as well as projected public debt levels exceed the DSF threshold as well as a more conservative calibrated threshold. As shown in Figure 2, with the exception of São Tomé & Príncipe and taking into account only external debt, none of the HIPCs in SSA currently exceed either threshold.

A favourable prognosis is also given when the projected behaviour of public debt over the five years 2012-2017 is compared to sustainability thresholds (see Figure 3). In particular, among the 12 HIPCs at moderate risk of experiencing external debt distress, DSA projections for these countries indicate that public debt levels are expected to decline (or remain unchanged) over the five-year period in virtually all countries, and that the projected 2017 public debt levels lie below even the more conservative threshold levels cited. Based on these findings, the report ultimately concludes that current (or projected) debt levels do not constrain temporary financing of

<sup>2</sup> A Debt Sustainability Analysis (DSA) is a standardized analytical tool to monitor debt sustainability for a particular country. It is part of the Debt Sustainability Framework, a standardized framework introduced by the World Bank and IMF in 2005 to help guide the borrowing decisions of LICs, provide guidance for creditors' lending and grant allocation decisions, and to inform IMF and World Bank analysis and policy advice. All DSAs include an external risk rating—an explicit assessment of a country's risk of external debt distress.

expanded budget deficits in most low-income countries. Possible exceptions to this statement include the five countries that were classified at high risk of external debt distress<sup>3</sup> and, to some extent, those countries classified at moderate risk of debt distress that have experienced a sharp build-up of debt levels in recent years.<sup>4</sup>

Figure 2: Sub-Saharan Africa: Public Sector Debt in 2012 and Sustainability Thresholds (% of GDP)



Source: IMF, 2013b

This positive assessment is reinforced by the Baduel and Price (2012) study. Although there was an adverse impact of the global and financial economic crisis on debt ratios in short to medium term, this study finds that the recent global financial and economic crisis did not significantly change long-run LIC debt vulnerabilities. Analysing the evolution of debt sustainability in 29 LICs (of which 12 are HIPC countries and 9 of which had reached the completion point before April 2006) and using DSAs available for the years 2006, 2008 and 2010<sup>5</sup>, they find that projected ratios have tended to converge to pre-crisis levels, remaining on generally decreasing paths below thresholds. Furthermore, IMF (2013a) has assessed that the adjustment needed to achieve debt-stabilising primary balances would be relatively small in low-income countries. In many SSA countries, the primary balance gap, or the difference between the projected primary balance and the primary balance that would stabilise debt at its current level, is relatively small,

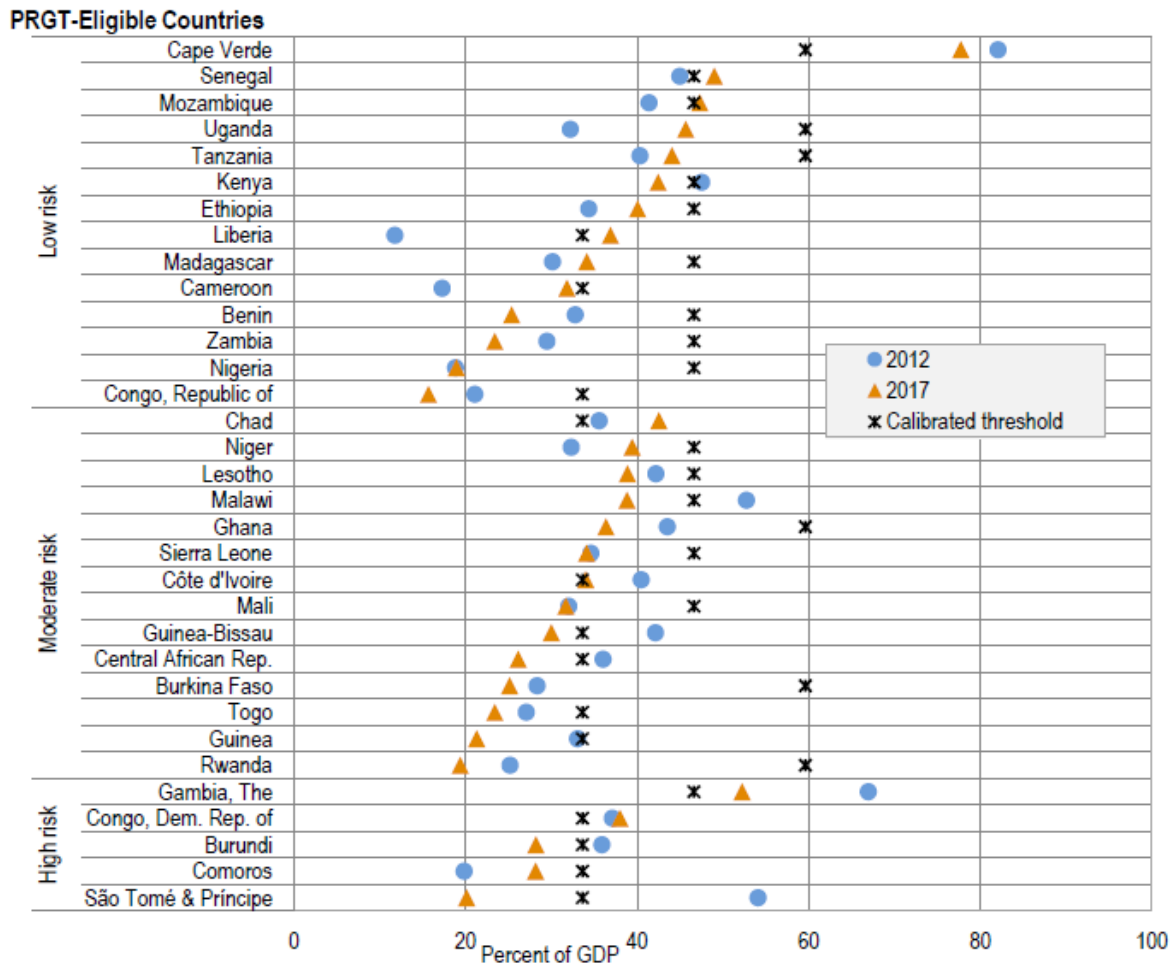
<sup>3</sup> Burundi, Comoros, Democratic Republic of Congo, The Gambia, and São Tomé and Príncipe.

<sup>4</sup> Ghana, Malawi, and Mali experienced increases in debt-to-GDP ratios of 10 points of GDP or more since end-2007.

<sup>5</sup> These years correspond to the periods before and after the peak of the global financial and economic crisis.

the major exception being in some fragile states (see Figure 4 below)<sup>6</sup>. However, this adjustment is only small given a negative interest rate–growth differential and low levels of debt. The relationship between the primary balance, interest rate, economic growth and debt-to-GDP ratio will be discussed in greater detail in Section 4 while two common critiques of DSA assumption upon which the abovementioned studies rely upon will be identified in Section 5.

Figure 3: Sub-Saharan Africa: Public Sector Debt in 2012, 2017, and Sustainability Thresholds<sup>7 8</sup>



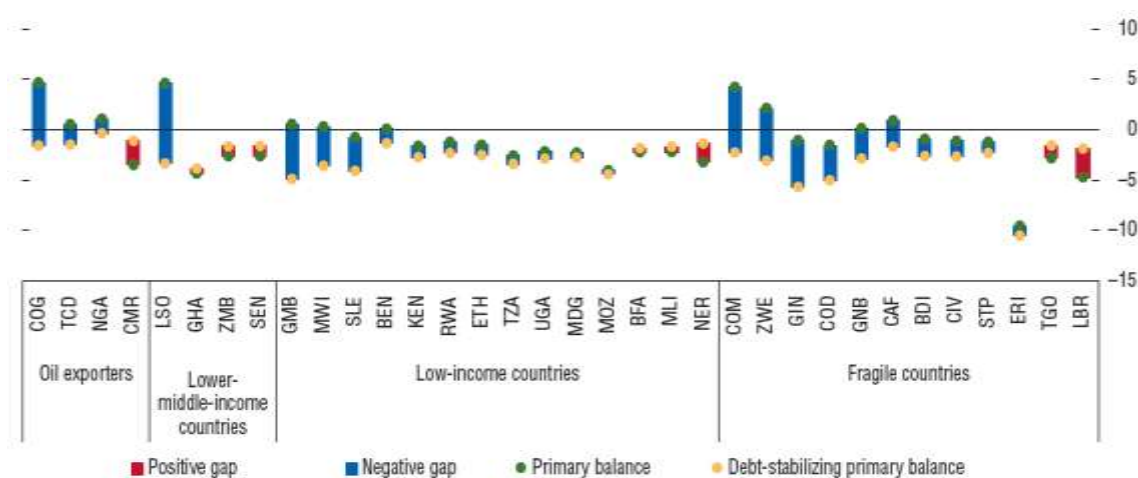
Note: Based on IMF Staff Calculations and DSA database. Source: IMF, 2013b

<sup>6</sup> A positive gap would mean that in the absence of fiscal adjustment, the debt-to-GDP ratio would rise over time.

<sup>7</sup> Public debt sustainability threshold: Despite improvements in the data, comprehensive data on domestic arrears still does not exist, which implies that the stock of domestic debt could be underestimated and debt distress events overlooked. Another reason to interpret the results with caution is the lack of homogeneity in the coverage of the public sector debt across countries. (World Bank and IMF, 2012).

<sup>8</sup> The calibrated threshold was calculated following three steps. First, episodes of debt distress were identified based on different indicators of debt-servicing, difficulties or debt-distress signals. Second, a probit model was used to estimate the incidence of debt distress, where the probability of debt distress is a function of the debt-to-GDP ratio and a set of country-specific characteristics that include the World Bank's Country Policy and Institutional Assessment (CPIA) index. Third, the debt sustainability thresholds for each CPIA rating are chosen using the probit estimation results and a specific optimality criterion (see IMF, 2013b).

Figure 4: Sub-Saharan Africa: Average Primary Balance Gap, 2012–17, (Percent of GDP)



Source: IMF, 2013a

Several studies also assess the debt sustainability of post-completion-point HIPCs in the context of new, non-concessional sources of finance such as sovereign bonds issuance and non-DAC donors such as China and India. According to several authors, **while flows of development financing from the BRICs (especially India and China) to low-income countries (LICs) have surged in recent years, it remains to be seen whether fears about the sustainability of this source of financing are borne out for three reasons:**

- i. **Both China and India not only offer a mix of concessional and non-concessional financing, but also have a long history of debt forgiveness (Brautigam, 2011; and Mwase and Yang, 2012).** China's official finance in Africa consists of grants, zero-interest loans, debt relief, and concessional loans (which would all qualify as ODA) as well as preferential export credits, market-rate export buyers' credits, and commercial loans from Chinese banks, none of which would qualify as ODA.
- ii. **Because such borrowing is not reported in a comprehensive and timely manner, it is difficult to assess the potential impact of these flows on debt sustainability (Davies, 2007).** It is worth noting that the nature of China's (and to some extent India's) cooperation with Africa does not lend itself easily to transparency, since it results from decentralised investment decisions and is often carried out in barter mode, for example, the Angola Model<sup>9</sup> (Reisen and Ndoye, 2008). **This opaqueness of China's lending operations is perhaps partly responsible for its bad press.**
- iii. **Financing from non-traditional donors could contribute to better terms of trade, increased export earnings and growth figures, and as a result recipient countries will be better placed to service their loans and thus less vulnerable to a new debt crisis.** One of the most common arguments defending the sustainability of loans from these emerging lenders is that their view of debt sustainability differs from that of traditional donors (Brautigam, 2011, Davies 2007, Mwase and Yang 2012, and Reisen and Ndoye 2008). More specifically, China and India tend to look at the potential of African countries in the

<sup>9</sup> The Angola model is where funds are not directly lent to the recipient country; instead, the Chinese government will mandate a Chinese construction company (that usually receives a support credit from the China Exim Bank) to undertake the construction works, following the approval of the recipient country. Then, in exchange for the infrastructure provision, the borrowing government will give the right to mine natural resources to a Chinese company operating in the field of natural resources (mostly oil or minerals), through the acquisition of equity stakes in a national oil company or through acquiring licences for production.

long term, rather than assessing their immediate ability to repay loans. This involves focusing on sustainability of individual projects while traditional donors pay greater attention to long-run debt sustainability by taking into account macroeconomic linkages. Using data up to 2006, Reisen and Ndoye (2008) pointed out that debt (service) ratios have been declining below the debt-distress levels set by the DSF in HIPC countries with a high China presence i.e. Ethiopia, Mozambique and Zambia. **Thus, the growth effects of new lending (that is contributing to better infrastructure), as well as terms of trade and export performance, have to be weighed against higher debt, and worsened grant elements. Overall, any alleged China-induced deterioration of debt ratios is not (yet) visible in the broad values of NPV debt to GDP or exports (Reisen and Ndoye, 2008).**

Finally, several post-completion point HIPCs (e.g. Ghana, Rwanda, Senegal, Tanzania, and Zambia) are international sovereign bond issuers.<sup>10</sup> Sovereign bond issues in SSA increased from close to US\$ 2 billion in 2001 to US\$ 7 billion in 2007, but turned negative in 2008 (World Bank data). They have since recovered to US\$ 6 billion in 2011 and experienced much dynamism into 2012 and 2013 (Hou et al., 2013; Hou et al., 2014). Although access to international bond markets brings opportunities to investors and sub-Saharan African countries, it also exposes governments to new challenges such as risks of a sudden reversal; a possibly higher debt burden; higher refinancing, currency, and interest rate risks. Foreign currency depreciations can also make repayments expensive. **Based on an analysis of 10 SSA countries<sup>11</sup>, the IMF concluded that the main effect of bond issuances to date has been on the composition of public debt, rather than levels (IMF, 2013b).** For the debt-restructuring cases, the report finds that debt ratios declined significantly with the new international sovereign bonds replacing debt in default or restructured (for example, Côte d'Ivoire). On the other hand, for the non-restructuring cases, the immediate impacts on the size of total debt were deemed modest, although Ghana and Senegal saw their debt ratios rising after their bond issuances.

### 3.3 Debt is not sustainable

**Despite the favourable projections noted above, several authors express concerns over the recent and rapid accumulation of increasingly non-concessional debt in several post-completion point HIPCs.** An IMF report notes that a number of HIPCs have taken advantage of the borrowing space created by debt relief in the past decade to finance much needed public investment. Consequently, debt ratios have been rising rapidly, with six countries in particular - The Gambia, Ghana, Malawi, São Tomé and Príncipe, Senegal, and Tanzania, at end-2012 - experiencing increases in their debt-to-GDP ratios of at least 5 percentage points since they obtained debt relief as well as having debt-to-GDP ratios of 40 percent or higher (IMF, 2013c). The authors note that while this expanded borrowing may represent good news, as stronger macro fundamentals facilitate access to global financial markets and “new sources of finance” (both in the form of bond issuance and bilateral lending), it nonetheless points to concerns over the implications of a return to pre-relief debt levels, particularly if the new borrowing does not translate into productive investment and faster growth (Lewis, 2013).

**Several authors also argue that new external debt may be unsustainable given the persistence of structural deficiencies of several HIPCs (Beddies et al., 2009; Ellmers and Hulova, 2013; UN, 2013b; Vaggi and Prizzon, 2013; and Yang and Nyberg, 2008).** In general, low- income countries have a number of macroeconomic and financial features that can complicate their capacity to generate sufficient revenues to repay the debt incurred and expose them to greater solvency and

<sup>10</sup> Sub-Saharan African governments have issued international sovereign bonds for a variety of reasons. These include deficit financing (including for increasing public infrastructure spending), benchmarking (including for expanding international market access for firms), and public debt management (including debt restructuring).

<sup>11</sup> Tanzania, Zambia, Namibia, Nigeria, Senegal, Ghana, Gabon, Republic of Congo, Seychelles and Côte d'Ivoire

liquidity risks. These features include narrow production bases and export structures, shallower financial markets, less efficient tax systems, high dependence on aid, and weaker policies and institutions, including in areas of project and debt management, complicating the implementation of sustainable macroeconomic policies and increasing the chances that scarce public resources are diverted toward unproductive uses (Beddies et al., 2009). According to Beddies et al. (2013) post-completion point HIPCs that were classified with a high risk of debt distress shared a number of vulnerabilities. These include a higher concentration of key raw commodities in total exports relative to other post-completion point countries; a poor or deteriorating quality of policies and institutions, as measured by the CPIA index; and a lower export base which renders them highly susceptible to shocks such as droughts and price volatility. Further evidence of these structural vulnerabilities is illustrated by deterioration of the debt distress risk of Ghana, a relatively strong post-completion point performer, in the second half of 2008. Ghana's reclassification from low to moderate risk of distress resulted from its rapid accumulation of external and domestic public debt contracted on commercial terms, and high current account and fiscal deficits that expose it to structural vulnerabilities in the event of a reversal of favourable terms of trade (AfDB, 2010).

**Several studies emphasise ever-present current account deficits as a significant constraint on the debt sustainability of post-completion point HIPCs.** Given that the current account measures changes in the net external position with the rest of the world, a current account deficit indicates an increase in net foreign liabilities. One study finds that for 31 HIPC completion countries for which there are data, only one had a current account surplus on average between 2001 and 2011; Bolivia (JDC, 2012). Of the other 30, 22 had a current account deficit of more than 5 per cent of their GDP over the decade. This second point is therefore an extension of the previous point that debt is less likely to be sustainable in countries with a narrow production bases and export structures. More specifically, in a low-income economy with undiversified exports, improving a negative current account might take time, implying a process of structural change in the composition of exports and possibly also of imports which is much more complicated than achieving a higher growth rate for a few years (Vaggi and Prizzon, 2013).

Based on this discussion the threats to debt sustainability of post-completion-point HIPCs can be summarised in Box 1 below.

#### Box 1: External Debt may be unsustainable because...

Structural weaknesses such as a narrow export base, weak institutions and governance, poor domestic resource mobilization, inadequate debt management capacity and irresponsible lending undermine debt sustainability. [Beddies et al. (2009); Ellmers and Hulova (2013); UN (2013b); Vaggi and Prizzon (2013); and Yang and Nyberg (2008)]

Due to the above, the sustainability of new external debt commitments remain vulnerable to external shocks such as natural disasters or volatile commodity prices (JDC, 2012).

Debt outlook is highly sensitive to the terms of new financing. Against the background of declining international aid flows, the expanding menu of new, and possibly less concessional financing options (i.e. international capital markets and re-emerging lenders like China and India) is a cause of concern [Beddies et al. 2009; IMF, 2013b; Presbitero, 2009]

**Summary of Section 3: LITERATURE REVIEW**

- While debt burdens of post-completion point countries have declined dramatically, many of the structural weaknesses that made countries vulnerable to shocks, in particular a narrow export base and/or dependence on aid, remain.
- Potentially new risks to debt sustainability have arisen in the form of new creditors and types of financing; however, a lack of the necessary information makes it difficult to fully assess these risks. Also in some cases, it may also be too soon to make a final judgment.
- Optimistic underlying assumptions of DSAs undermine the validity of their debt sustainability projections.
- It is important to assess if new borrowing will translate into productive investment and faster growth.



## 4 Trends, Projections and Decomposition of Public Debt

A key element in assessing the likelihood of achieving debt sustainability is the projection of debt indicators. Based on the relation between a measure of the debt burden – the numerator – and the capacity of repayment – the denominator, three key debt ratios are General Gross Government Debt to GDP, Debt Service to GDP and Debt Service to Exports.

Focusing on these three indicators, this section will first analyse trends and projections over the period 2006 to 2018 for the 35 Post-Completion-Point HIPCs, unless stated otherwise, based on IMF forecasts. Subsequently, the existing literature on debt decomposition is used to understand the drivers behind the changing debt ratio over the last 7 years. Finally, this section will compare the average terms of new external debt commitments across three country categories- HIPCs, Sub-Saharan Africa (SSA) and LICs.

General Gross Government Debt to GDP projections come from the IMF, World Economic Outlook (WEO) database and assume that the established policies of national authorities are maintained (IMF, 2013e). The Debt Service to GDP and Export figures are based on the DSA projections in the most recent HIPC/MDRI Statistical Update.

### 4.1 Debt Ratios- Trends and Projections

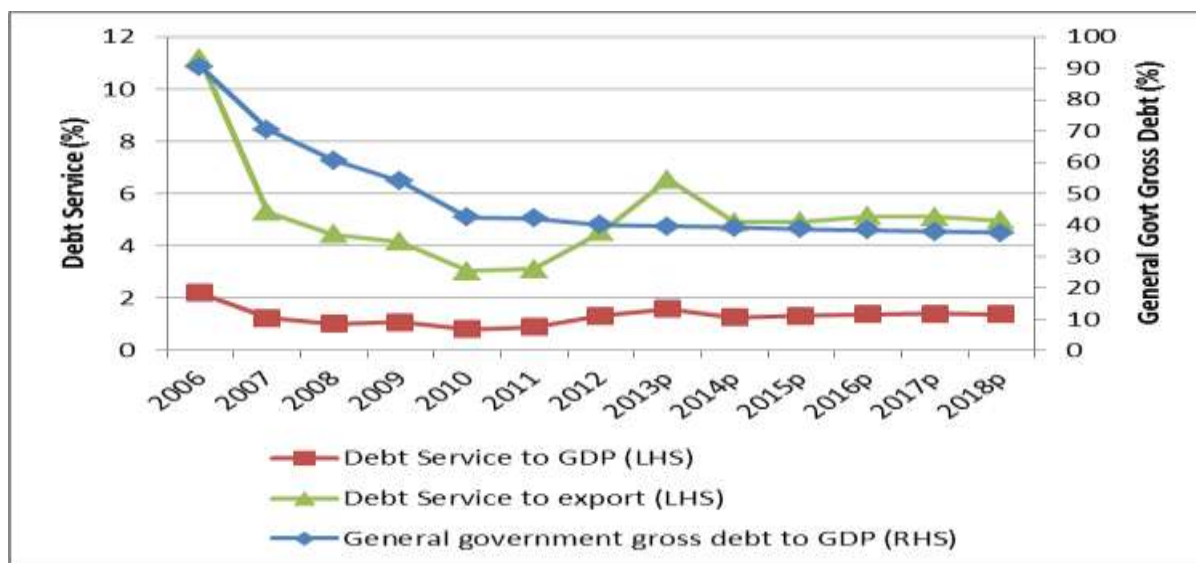
(i) **General Government Gross Debt to GDP<sup>12</sup>**- As shown in Figure 5 below, **the average public debt ratio for HIPC and MDRI countries halved between 2006 and 2010**, from 90.4 percent in 2006 to 42.5 percent in 2010. While this steady decline is estimated to persist for the next 8 years, from 40.1 percent in 2012 to 37.5 percent in 2018, it is projected to be at a much slower rate.

Moreover, public debt ratios have actually been rising in several post-HIPC/MDRI countries in recent years, and as shown in Figure 6 **they are projected to do so for 15 countries for the following five years**. The list of countries that experienced an actual percentage point increase in their debt-to-GDP ratio between 2006 and 2010 (in descending order) includes Ghana, Benin, Senegal, Mauritania, Mali Burkina Faso, and Malawi, while the rest of countries experienced a decline. Honduras, Zambia, Cameroon, Niger, Uganda, Senegal, Ghana, Haiti, Liberia and Rwanda are the 10 countries with the largest projected percentage point increase in their debt-to-GDP ratio between 2010 (actual figures) and 2018 (projected) (in descending order)

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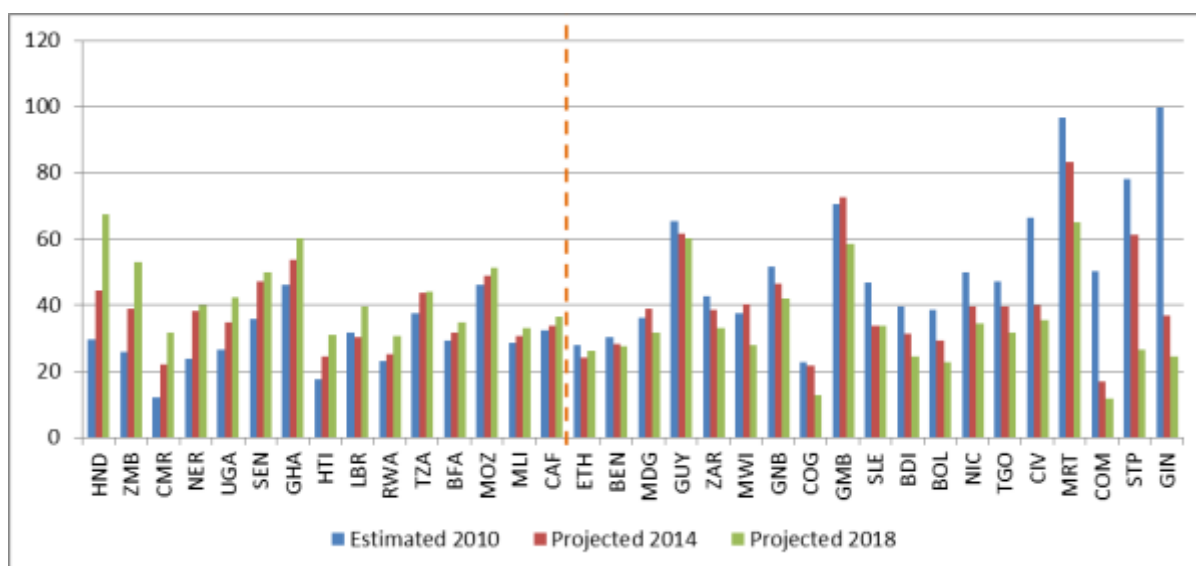
<sup>12</sup> General government gross debt consists of all liabilities that require payment or payments of interest and/or principal by the debtor to the creditor at a date or dates in the future. This includes debt liabilities in the form of SDRs, currency and deposits, debt securities, loans, insurance, pensions and standardized guarantee schemes, and other accounts payable. Thus, all liabilities in the GFSM 2001 system are debt, except for equity and investment fund shares and financial derivatives and employee stock options

Figure 5: Average Debt Service to GDP and exports; general government gross debt to GDP 2006-2018, HIPC and MDRI countries<sup>13</sup>



Source: IMF 2013d and IMF-WEO Database, October 2013 Data for 2013-2018 are projections.

Figure 6 : General Government Gross Debt (% of GDP) of 34 Post-Completion-Point HIPCs (2010, 2014, and 2018)<sup>14</sup>



Note: The red bar distinguishes HIPCs whose debt ratios are expected to rise between 2010 and 2018 (LHS) from those for which it is projected decline or unchanged (RHS).

Source: IMF-WEO Database, October 2013. Data for 2013-2018 are projections.

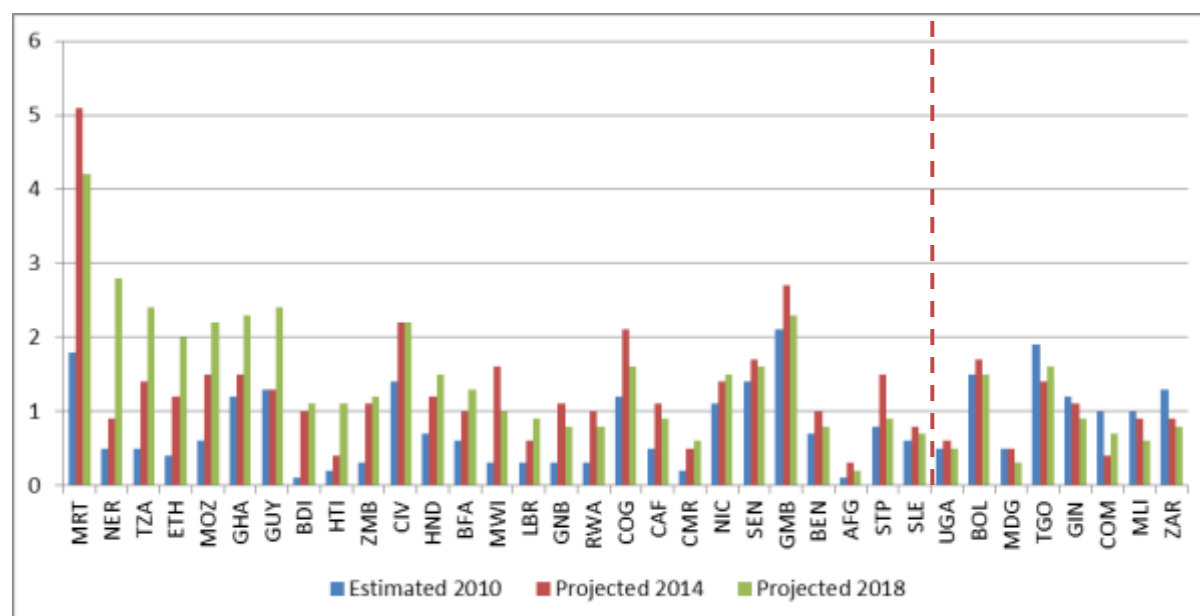
(ii) **Debt Service to GDP**- The average debt service to GDP ratio for HIPC has been relatively stable, though it also experienced a modest decline throughout most of the period, with a slight increase in the most recent years. In fact, **debt service as a percentage of GDP more than halved, from a high of 2.2 percent in 2006 to a low of 0.8 percent in 2010**. However, it is expected to increase from 1.3 percent in 2012 to 1.6 percent in 2013, remaining between 1.3-1.4 percent for the subsequent 5 years. Debt service to GDP increased in the following countries

<sup>13</sup> 'p' refers to projections.

<sup>14</sup> Afghanistan is excluded due to lack of data.

between 2006 and 2010: Togo, Côte d'Ivoire, Mauritania, Mozambique, Ethiopia, Niger, Liberia and Comoros. Out of the 27 countries and based on IMF projections the debt service ratio is projected to increase between 2010 and 2018, the top 10 countries with the largest projected increase are Mauritania, Niger, Tanzania, Ethiopia, Mozambique, Ghana, Guyana, Burundi, Haiti and Zambia (see Figure 7).

Figure 7: Debt Service (% of GDP) of 35 Post-Completion-Point HIPCs (2010, 2014, 2018)<sup>15</sup>



Note: The red bar distinguishes HIPCs whose debt ratios are expected to rise between 2010 and 2018 (LHS) from those for which it is projected decline or unchanged (RHS).

Source: IMF, 2013d Data for 2013-2018 are projections.

(iii) **Debt Service to Exports**- On average, for the 35 post-completion point HIPCs, **improvements have been made with respect to decreasing debt-service-to-export ratios, from 11.2 percent in 2006 to 4.5 percent in 2012.** However, the ratios of debt service to exports are expected to increase to 6.5 percent in 2013, and hover around 5 percent for the following five years. Moreover, while the HIPC Initiative aimed to bring the net present value of the debt/export ratio to below the 150 per cent threshold, at least 13 HIPCs had a higher ratio at completion point, with two (Gambia and Uganda) having ratios higher than at decision point (UN, 2013b). In the case of Haiti, the external debt burden has reduced, but the country's narrow export base poses a problem for debt sustainability and it remains at high risk of debt distress.

**In sum, while HIPC countries on average experienced substantial improvements in the debt ratios over the last 7 years, there is considerable variation across countries.** For example, some have seen their debt indicators deteriorate after receiving debt relief. Uganda's ratio swelled to over 300 percent within three years after reaching its HIPC Initiative completion point (UN, 2013b). According to a June 2012 debt sustainability analysis, debt relief under the initiatives reduced Tanzania's debt burden to 20.6 percent of GDP at end-June 2007 (IDA and IMF, 2012). Nevertheless, by end-June 2011, the country's external debt had risen to 34.7 percent of GDP. Moreover, fiscal balances and public debt ratios on the continent have exhibited notable heterogeneity and variations even during the aftermath of the global financial crisis. Though the region as a whole was able to finance a large increase in budget deficits during the crisis, the manner in which deficits have been financed has varied significantly across countries (IMF,

<sup>15</sup> Projections for 2018 were substituted with 2017 projections for four countries for which they were not available (Afghanistan, Benin, Mozambique, and Senegal),

2013b). Frontier markets such as Zambia experienced the largest deterioration of fiscal balances and public debt built up, as a result of the counter-cyclical measures adopted in 2009 and beyond (Ncube et al., 2013). Most of the other countries, especially some of the fragile states, could not adopt counter-cyclical measures during the crisis, due to both limited fiscal policy buffers and access to borrowing. External financing was therefore particularly strong among fragile countries (e.g., Côte d'Ivoire, São Tomé and Príncipe, and Togo), typically in the form of concessional loans from international financial institutions. **Overall, with some exceptions (for example, Cameroon and Eritrea), there was little accumulation of arrears (IMF, 2013b).**

**Additionally, although none of the 35 post-completion point HIPCs are in debt distress, as of January, 2014, 6 are classified at a high risk of debt distress per their latest IMF Debt Sustainability Analysis (DSA) and more than three quarters of the HIPC/MDRI countries that benefited from debt relief in the last decade at a low or moderate risk of debt distress (Table 3).** This is of particular concern, as it is accompanied by a decrease in ODA flows over the past two years, at a time when low-income countries need highly concessional financing to maintain debt sustainability, a point that was raised in the literature review. At the same time, it is important to bear in mind that new borrowing does not automatically erode debt sustainability due to the public investment-growth nexus (Lewis, 2013). Recognition of this basic fact has led the DSF to be modified in 2009 to include greater recognition of the impact of public investment on growth (UNECA, 2011). Prior to this the financial programming model of the Fund did not factor in the impact of public investment on growth but rather the impact of such investment on budget deficits, thereby constraining the capacity of countries to borrow to the detriment of their economic development.

As expected, a vast number of countries saw their risk of debt distress improve since 2006:

- Côte d'Ivoire has fluctuated from being in debt distress to having a high risk of debt distress between 2007 and 2011. However, according to its 2013 DSA, its rating has improved to a moderate risk of debt distress.
- Central African Republic shifted from high risk to moderate risk between 2009 and 2010.
- Comoros went from in debt distress in 2006 to high risk most recently.
- Congo, Rep. rating fell from high risk in 2007 to moderate in 2010 and further to low risk in 2011.
- Democratic Republic of Congo moved in debt distress in 2007 to high as of 2010.
- Ethiopia has improved from moderate to low risk between 2008 and 2010.
- Gambia improved from high risk in 2007 to most recently moderate.
- Guinea rating fell from in debt distress in 2006 to modest in its most recent DSA.
- Guinea-Bissau was in debt distress in 2009, but became moderate in 2011.
- Honduras went from moderate to low between 2006 and 2008.
- Liberia went from in debt distress in 2009 to low in 2010.
- Madagascar has shifted from moderate to low between 2006 and 2008.
- Niger moved from high in 2006 to moderate in 2007. Subsequently it fell to low in 2010, but has returned to moderate since 2011.
- Rwanda fell from high in 2006 to moderate in 2010 and most recently to low.
- Togo went from in debt distress in 2008 to moderate risk of distress in 2011.
- Uganda rating shifted from moderate to low between 2006 and 2007

The following countries have seen their risk of debt distress worsening since 2006:

- Burundi went from a high risk of debt distress in 2006 to in debt distress in 2007. While its rating has improved since then, it remains constant at a high risk of debt distress.

- Ghana’s reclassification from low to moderate risk of distress between 2007 and 2008.
- Mali’s risk of debt distress increased from a low risk between 2007-2009 to a moderate risk in 2011 and 2013.
- Mozambique’s rating has increased from low in 2006 to most recently moderate.

**Table 3: Risk of debt distress per latest DSA publications**

Risk of Default on Debts	Countries
In Debt Distress	None
High (6)	Afghanistan, Burundi, Comoros, Democratic Republic of Congo, Haiti and São Tomé and Príncipe
Moderate (16)	Burkina Faso, Central African Republic, Côte d'Ivoire, The Gambia, Ghana, Guinea, Guinea-Bissau, Guyana, Malawi, Mali, Mauritania, Mozambique, Nicaragua, Niger, Sierra Leone and Togo
Low (13)	Benin, Bolivia, Cameroon, Republic of Congo, Ethiopia, Honduras, Liberia, Madagascar, Rwanda, Senegal, Tanzania, Uganda and Zambia

Source: Adapted from List of LIC DSAs for PRGT-Eligible Countries As of January 02, 2014<sup>16</sup>

## 4.2 Decomposition of changes in the debt ratio

A key finding of the previous analysis is that the enhanced HIPC initiative and the MDRI led to a substantial debt-stock reduction in post-completion point countries. Debt dynamics, however, are driven by more than just the stock of debt. Critical variables include growth, the interest rate on new debt, changes in the real exchange rate over time, the level of primary surplus<sup>17</sup> and a variety of contingent liabilities<sup>18</sup>. In essence, the change in the debt ratio equals the impact of interest (positive) and nominal growth (negative) on the debt ratio, minus the primary surplus plus any contingent liabilities. Moreover, given that the debt for most low-income countries is denominated in foreign currency whereas GDP is in local currency, when the real exchange rate depreciates, the debt-to-GDP ratio tends to rise. **Ultimately, if these fundamentals driving debt are not fixed, then reduced debt levels will not be sustainable and debt will start to rise again (Dömeland and Kharas, 2009).**

In most low-income countries in sub-Saharan Africa, public debt-to-GDP ratios—particularly those involving external debt—declined significantly throughout the early 2000s. **Although external debt relief under the HIPC and the MDRI played a key role in the reduction, additional factors such as faster output growth and exchange rate appreciation also helped (Figure 8).** For low-income countries, apart from debt relief (reported as part of “Other contributions” in Figure 8), the most crucial factor was GDP growth, with no significant impact from real exchange rate

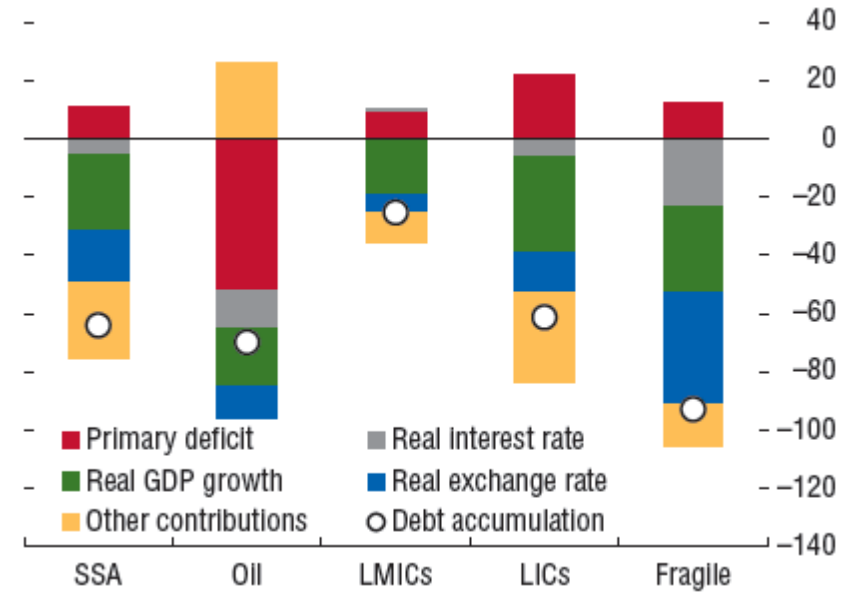
<sup>16</sup> <http://www.imf.org/external/Pubs/ft/dsa/DSAlist.pdf>

<sup>17</sup> The primary balance is government’s fiscal balance excluding interest payments from expenditure.

<sup>18</sup> Contingent liabilities are typically off-budget items and in some cases, they represent bailouts of the financial system to protect bank deposits. In other instances, they include payments by governments to companies that are too big to fail or payments tied to a previously guaranteed level of activity.

appreciation. Among fragile states, a few still exhibit high debt-to-GDP ratios, but most have experienced sharp declines (e.g., Burundi, the Central African Republic, the Democratic Republic of the Congo, and Liberia).

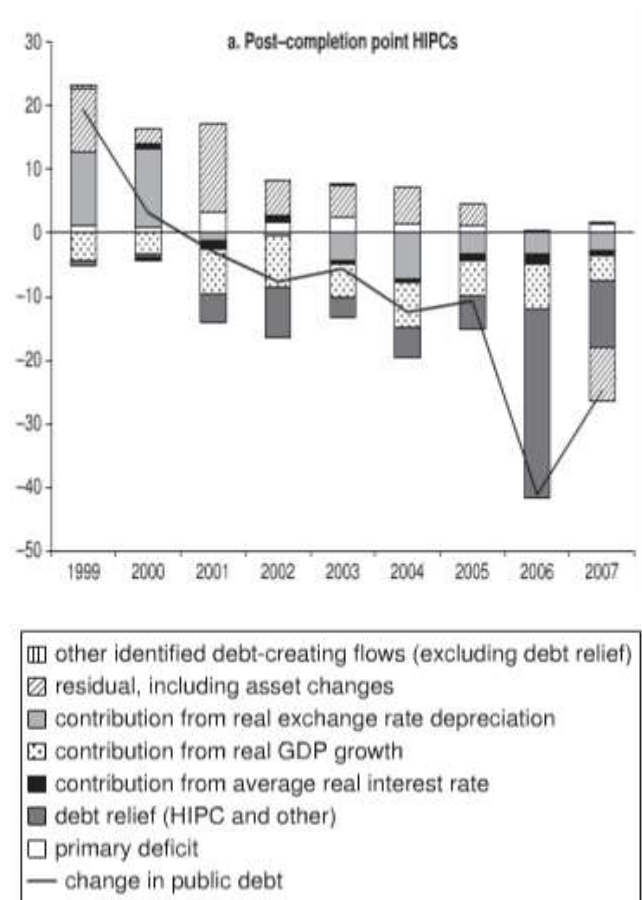
**Figure 8: Sub-Saharan Africa: Debt Accumulation Decomposition (median), 2002-12**



Source: IMF. 2013a.

Improved macroeconomic policies and generally strong growth have kept debt ratios stable on average since debt relief (IMF, 2013a). However, a few countries (like Ghana and Senegal) have registered sizable increases, largely on account of rapid growth in spending, including for infrastructure. In addition, fiscal deficits widened in most countries in the aftermath of the Great Recession, and have narrowed little since then.

Figure 9: Debt Decomposition in 24 Post-Completion Point HIPC<sup>19</sup>, 1999-2007 (Percentage of GDP)



Source: Dömeland, D. and Kharas, H. 2009. *Debt Relief and Sustainable Financing to Meet the MDGs*. In Primo Braga, C.A. and Dömeland, D. eds. *Debt Relief and Beyond: Lessons Learned and Challenges Ahead*. World Bank: Washington, D.C. pp. 117-140.

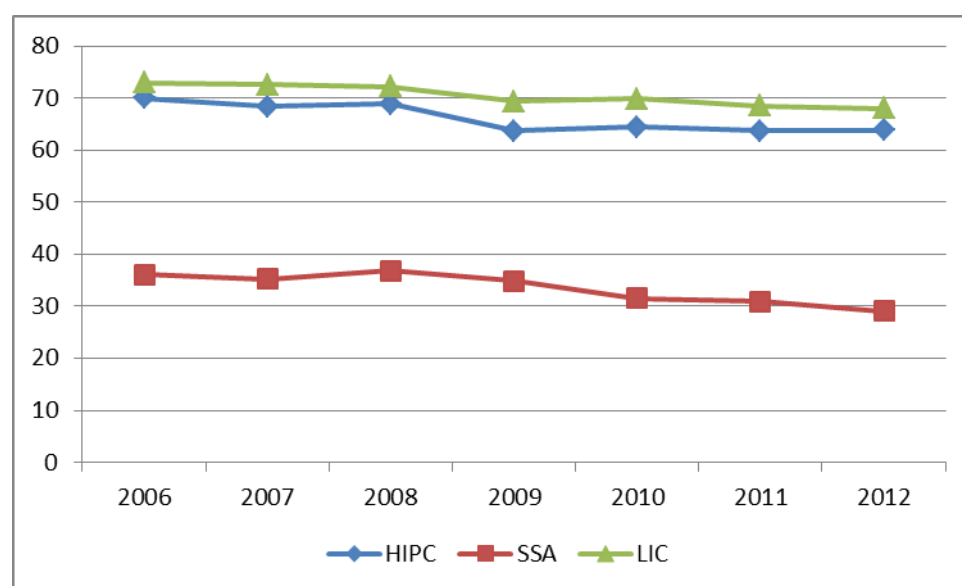
Figure 9 above provides the decomposition of debt dynamics for 24 post-completion point HIPC countries as of April 2009 and it largely confirms the findings of above analysis. The overall decline in the debt ratio in post-completion point countries is much higher than the decline attributable to debt cancellation, suggesting that these countries would have shown a market reduction in their debt ratios even in the absence of debt relief (assuming that debt relief does not affect growth). The main additional factors contributing to the decline in debt in post-completion point countries over the period 2001-2007 are higher growth and the real appreciation of the currency, caused in part by strong commodity prices in recent years. These factors reduced the debt-to-GDP ratio by about 10 percentage points each year between 2001 and 2007 (Dömeland and Kharas, 2009).

<sup>19</sup> 24 Post-Completion Point countries: Benin, Bolivia, Burkina Faso, Burundi, Cameroon, Ethiopia, The Gambia, Ghana, Guyana, Honduras, Madagascar, Malawi, Mali, Mauritania, Mozambique, Nicaragua, Niger, Rwanda, São Tomé and Príncipe, Senegal, Sierra Leone, Tanzania, Uganda and Zambia.

### 4.3 Terms of New External Debt Commitments

Understanding the financing terms that characterise new external debt commitments can have significant implications for the debt sustainability of post-completion point HIPCs. This is because debt relief has created new borrowing space, and as a result the menu of financing options to low-income countries has expanded. In fact, while external debt to GDP ratios have declined on average for post-completion point HIPCs, Figure 10 below shows that the concessional share of their external debt has also steadily declined from 70 percent in 2006 to approximately 63.8 percent in 2012. Moreover, this was slightly lower than the average of LICs throughout the entire period, but significantly higher than the SSA average. Nonetheless, all three categories experienced a slight, but steady decline in their concessional share of external debt between 2006 and 2012.

**Figure 10: Concessional debt (% of total external debt), 2006-2012**



Source: World Bank (*International Debt Statistics*)

Table 4 examines the average maturity and interest on new external debt commitments (official and private) of post-completion point HIPCs, SSA and LICs. HIPCs generally have more favourable financing terms in regards to lower interest rates than the average for SSA and LICs. In contrast, average maturity tends to be shorter for HIPCs compared to the average for SSA and LICs. Additionally, the changes in these four variables have generally been modest for HIPCs compared to SSA and LICs (see Figures A-1 to A-5 in Annex).



Table 4: Comparison of terms of financing new external debt commitments, 2006-2012

	Average 2006-2012	Change 2006-2012	Min	Max
<b>Average interest on new external debt commitments, official (%)</b>				
HIPC	1.23	-0.05	1.00	1.52
SSA	1.84	-0.22	1.37	3.29
LIC	1.30	-0.39	1.13	1.56
<b>Average interest on new external debt commitments, private (%)</b>				
HIPC	0.66	-0.16	0.29	0.97
SSA	5.14	-2.09	3.02	6.81
LIC	3.85	-1.96	1.76	6.34
<b>Average maturity on new external debt commitments, official (years)</b>				
HIPC	25.78	-6%	24.53	26.67
SSA	27.32	1%	22.00	31.31
LIC	32.69	-16%	29.35	35.30

Source: World Bank (*International Debt Statistics*)

To further assess the significance of the implications of less concessional source of finance, three country examples are examined more closely in Box 2. They suggest that while access to non-concessional debt has proven valuable to many sub-Saharan African countries, it has also exposed them to new and potentially significant risks such as high global interest rates and rollover risks.

#### Box 2: New and Old Risks to Debt Sustainability

“Côte d’Ivoire’s debt profile has improved significantly through the debt restructurings, including the bond issuance. External public debt outstanding has declined, particularly after reaching the enhanced HIPC Initiative completion point at end-June 2012, from 56.8 percent of GDP (US\$13.3 billion) at end-2008 to 34.3 percent of GDP (US\$8.4 billion) at end-2012. The bond exchange operation led to a reduction in commercial external debt outstanding, from 13.2 percent of GDP (US\$3.1 billion) at end-2008 to 10.7 percent of GDP (US\$2.6 billion) at end-2012. External arrears were completely eliminated, including those to commercial creditors. This positive evolution in debt sustainability created space for some non-concessional borrowing for infrastructure and energy sector development under the current IMF-supported program.” – (IMF, 2013b).

In Senegal, recent debt dynamics have been driven by a rising fiscal deficit, reflecting a combination of a trend increase in investment in infrastructure and a countercyclical policy response to the 2008–09 financial crisis. An IMF scenario analysis suggests that growth and fiscal performance remain the key factors affecting debt sustainability. Significantly lower growth than currently projected or absence of fiscal

consolidation, would lead to unsustainable debt dynamics. New risk factors (higher global interest rates and rollover risks) also have a destabilizing impact, but to a lesser degree because Senegal's reliance on external non-concessional financing has been limited so far. These risks, however, could increase in the medium term because Senegal's recourse to market financing is likely to increase. From this perspective, prudent fiscal management and a further strengthening of debt management capacity remain highly desirable. – (IMF, 2012c).

Ghana's debt dynamics were also related to a rising fiscal deficit. The scenario analysis suggests that fiscal consolidation during the next several years is required; without it, public sector debt could move onto an unsustainable path. In addition, higher global interest rates would increase the debt-servicing burden, while a longer-lasting loss of global appetite for "frontier market" debt could create significant challenges (IMF, 2013c). In fact, Ghana cancelled plans for a US\$300 million debt issue owing to poor global market conditions during the global financial crisis in 2008 (Hou et al., 2013).

#### **Summary of Section 4 : Trends, Projections and Decomposition of Public Debt**

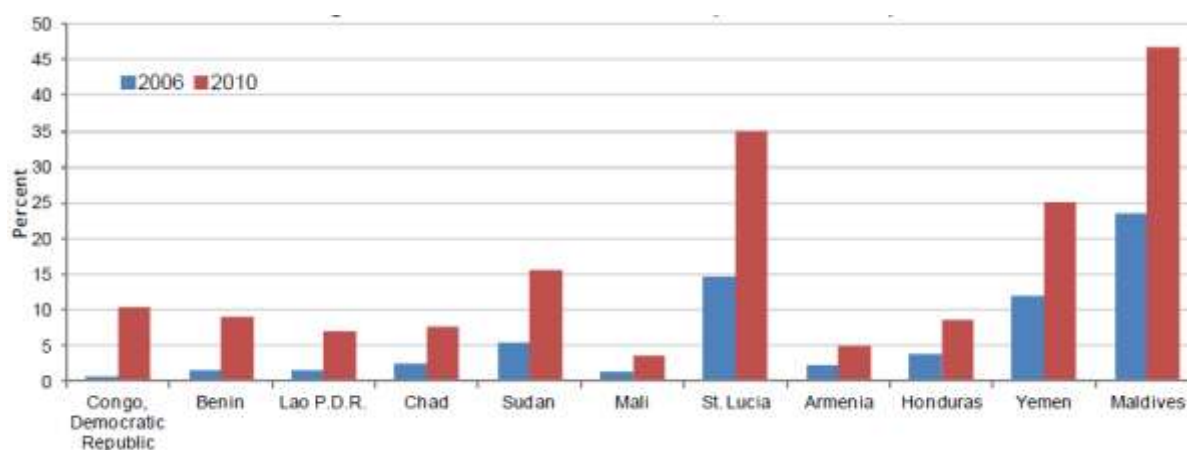
- General government gross debt ratio fell sharply between 2006 and 2010. However, this public debt ratio has actually been rising in several post-HIPC/Multilateral Debt Relief Initiatives countries in recent years and is projected to do so for the next 5 years.
- Although external debt relief under the HIPC and the MDRI played a key role in the debt reduction, additional factors such as faster output growth and exchange rate appreciation also helped.
- Although none of the 35 post-completion point HIPCs are in debt distress, 6 are classified at a high risk of debt distress as of January, 2014.
- Share of external debt as concessional debt has declined from 70 percent in 2006 to approximately 63.8 percent in 2012.
- Interest rate on external debt commitments are generally below SSA and LICs averages, and has marginally decreased.
- However, HIPCs have shorter maturity on new external debt commitments relative to that of SSA and LICs.

## 5 Other Issues relating to Debt Sustainability and Debt Relief

Another factor motivating fears of another debt crisis relates to two types of debt which are burgeoning in some low-income countries – **domestic debt and private external sector debt**.<sup>20</sup> External public debt, though still the main component of overall public debt, is not as dominant as it once was, mainly as a result of debt relief (IMF and World Bank, 2012). The analysis of total public debt has tended to be less thorough compared to the analysis of external public debt. The disparity in the analysis is most common—and to be expected—in countries where domestic public debt is negligible, or where data is unavailable. In countries where domestic public debt is relatively important and data is available, understanding the relationship between these types of debt and debt sustainability can be important.

Figure 11 below shows that **domestic debt as a percentage of GDP has increased in four post-completion point HIPC between 2006 and 2010**. Domestic debt is likely to grow in importance as domestic savings increase and governments seek to develop domestic debt markets (IMF and World Bank, 2012). Benefits associated with domestic debt include the development of local financial markets and no exchange rate risks). Nonetheless, LICs will face new risks as the universe of creditors and debt instruments continues to expand. In particular, domestic debt is viewed as more expensive than concessionary external financing and have shorter maturities (IMF and World Bank, 2012). Consequently, governments also face a significant liquidity risk from having to constantly roll-over large amounts of debt.

Figure 11. Domestic Debt to GDP (2006 vs. 2010)



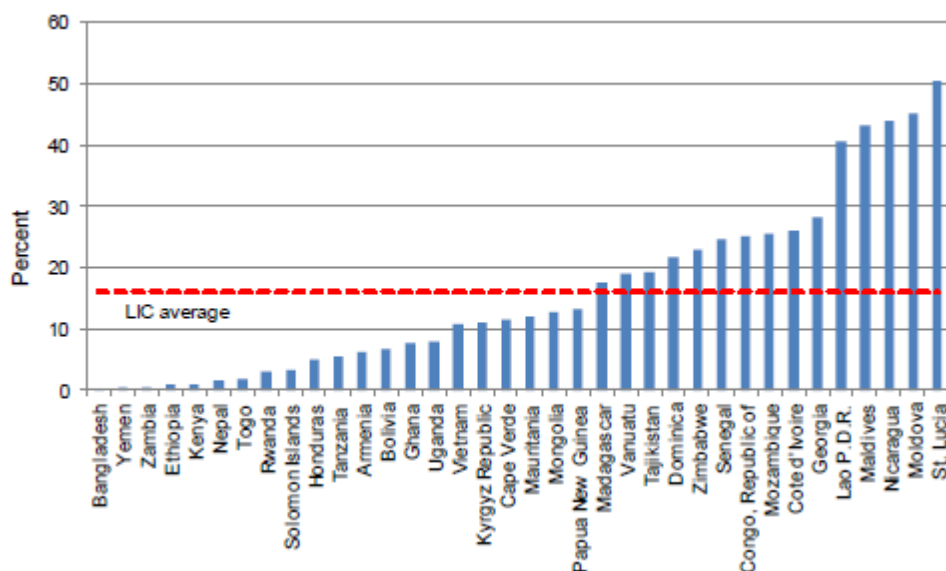
Source: IMF and World Bank, 2012

Furthermore, **increasing levels of private sector external debt from a low base could create balance of payments pressures by competing with the public sector for foreign exchange and could also increase exposure to risks stemming from the accumulation of contingent liabilities**. Although the World Bank and IMF state that private external debt is unlikely to pose an immediate concern in most LICs, they also explicitly note that some exceptions apply (IMF and

<sup>20</sup> For countries with significant vulnerabilities related to domestic public debt or private external debt, an additional risk rating would inform the macroeconomic and structural policy dialogue with country authorities. The additional risk rating would provide an overall assessment of vulnerability and would complement the existing assessment of external public debt.

World Bank, 2012). Figure 12 shows that in several countries private external debt is already substantial in relation to GDP (for example, Nicaragua, Cote d'Ivoire, Mozambique, Congo. Rep of, Senegal and Madagascar were above the LIC average in 2010). Ultimately, the type of debt which is included may potentially alter the assessment of a country's overall debt sustainability.

Figure 12: Private External Debt to GDP at end-2010



Source: IMF and World Bank, 2012

It is also worth noting that the reliability of the IMF and World Banks' DSAs projections, have been criticised on the grounds that its economic assumptions are overly optimistic (Beddies et al., 2009; JDC, 2012; and UN, 2013b). The Jubilee Debt Campaign report cites Ethiopia as an example of this excessive optimism since through its own analysis it concludes that it could be spending as much on foreign debt payments in a few years as it was before debt relief though it is currently characterised at a low risk of debt distress by the IMF (see Box 3). A similar assessment was made for Mozambique and Niger. Understanding if and how new projections have been adjusted to take into account past forecasting errors is therefore critical to increase confidence in the DSAs.

### Box 3: Ethiopia

Since the financial crisis began the government's foreign owed debt has shot-up from \$3 billion to \$7 billion, and is predicted to reach \$10 billion by 2014.

In 2010 the IMF predicted that by 2014 the country would be back to spending 10 percent of government revenue a year on debt payments. This assumes Ethiopia's economy grows by 7-8 percent a year, and exports by 17-20 percent a year.

The 2010 assessment said Ethiopia's debt payments would reach 15 percent of government revenue by 2015 in the case of one economic shock. Ethiopia has arguably already suffered this shock with the drought, and the knock-on effects of the European debt crisis may be another. Thus, while the IMF and World Bank identify Ethiopia at low risk of debt distress, the debt created in recent years may lead to as much of a debt burden for the Ethiopian people as existed before debt cancellation.

Source: Adapted from JDC, 2012

**Another contentious matter pertaining to the macroeconomic assumptions used in DSAs relates to the link between debt-financed investment and growth.** The DSF has been criticised by some observers for being overly conservative in its assessment of the risk of debt distress, thereby constraining LICs from undertaking the borrowing necessary to finance growth-enhancing investments (IMF and World Bank, 2012). This criticism is not new, but with the newly gained borrowing space after debt relief, the stakes appear to have increased as LICs seek to finance infrastructure projects critical for achieving development goals.

**Thus, while IMF and World Bank projections regarding the debt sustainability of post-completion-point countries have been generally positive (as discussed in Section 3.1), one needs to be cognisant of the realism of the underlying assumptions.** In particular, a strongly negative interest rate-growth differential (IRGD) has been a key benign force for debt sustainability in LICs. Given the sensitivity of debt dynamics to interest rate and growth assumptions, the robustness of these assumptions should be systematically assessed, especially since the IRGDs are likely to narrow over the longer term (Ncube et al., 2013). Furthermore, growth projections should try to capture the impact of public investment on growth while being mindful of historical trends (IMF and World Bank, 2012). Assessing the impact of public investment on growth, however, is not a straightforward task though modifications have been made to DSA to facilitate this to some extent

## 6 Conclusion

According to the IMF and World Bank, the HIPC Initiative and MDRI have largely succeeded in reducing the debt burdens of heavily indebted poor countries and have enabled these countries to increase their poverty-reducing expenditure (IMF, 2013d). However, debt relief does not guarantee sustainability, with less than 40 percent of the post-completion point HIPCs having a low risk of debt distress, according to the most recent DSAs. This is largely because the existing international debt relief initiatives were not designed to address the underlying causes of unsustainable debt in low-income countries, including unfair global trade terms, narrow production and export bases, vulnerability to exogenous shocks (including drops in international finance) and irresponsible lending. Instead, the initiatives have focused on reducing debts to a level deemed “sustainable” by creditors, defined in balance of payments terms: a PV of debt to exports threshold or in fiscal terms: a PV of debt to fiscal revenue threshold (Cassimon, 2013). This implies that the problem lies with imprudent debt management and poor governance on the part of the countries receiving debt relief (UN, 2013b).

In the light of these challenges, it is unlikely that in their current form, the international debt relief mechanisms can provide a lasting solution to the debt crisis. Reflecting on policy considerations for maintaining debt sustainability is therefore of great importance, particularly with regard to: (a) first and foremost use of borrowed funds - a return to pre-relief debt levels can be sustainable if new borrowing translates into productive investment and faster growth; (b) implementation of prudent and sound debt management; (c) choice of financing sources; (d) design of an effective debt strategy; (e) engagement in responsible sovereign lending and borrowing; and (f) formulation of an international debt workout mechanism.

To summarise what is currently being said on the issue of post-HIPC countries accumulating debt (since HIPC debt relief was granted) and the sustainability of that debt accumulation we identified the following key messages:

- General government gross debt ratio fell sharply between 2006 and 2010. However, this public debt ratio has actually been rising in several post-HIPC/Multilateral Debt Relief Initiatives countries in recent years and is projected to do so for the next 5 years.
- Although none of the 35 post-completion point HIPCs are in debt distress, 6 are classified at a high risk of debt distress as of January, 2014.
- Although external debt relief under the HIPC and the MDRI played a key role in the debt reduction, additional factors such as faster output growth and exchange rate appreciation also helped.
- While debt burdens of post-completion point countries have declined dramatically, many of the structural weaknesses that made countries vulnerable to shocks, in particular a narrow export base and/or dependence on aid remain.
- Potentially new risks to debt sustainability have arisen in the form of new creditors and types of financing; however, a lack of the necessary information makes it difficult to fully assess these risks. Also in some cases, it may also be too soon to make a final judgment.
- Optimistic underlying assumptions of DSAs undermine the validity of their debt sustainability projections.
- The use of borrowing, and in particular the nexus between public investment and growth must be taken into account when considering the implications for debt sustainability of new borrowing.

- Share of external debt as concessional debt has declined from 70 percent in 2006 to approximately 63.8 percent in 2012.
- Interest rate on external debt commitments are generally below SSA and LICs averages, and has marginally decreased. However, HIPCs have shorter maturity on new external debt commitments relative to that of SSA and LICs.

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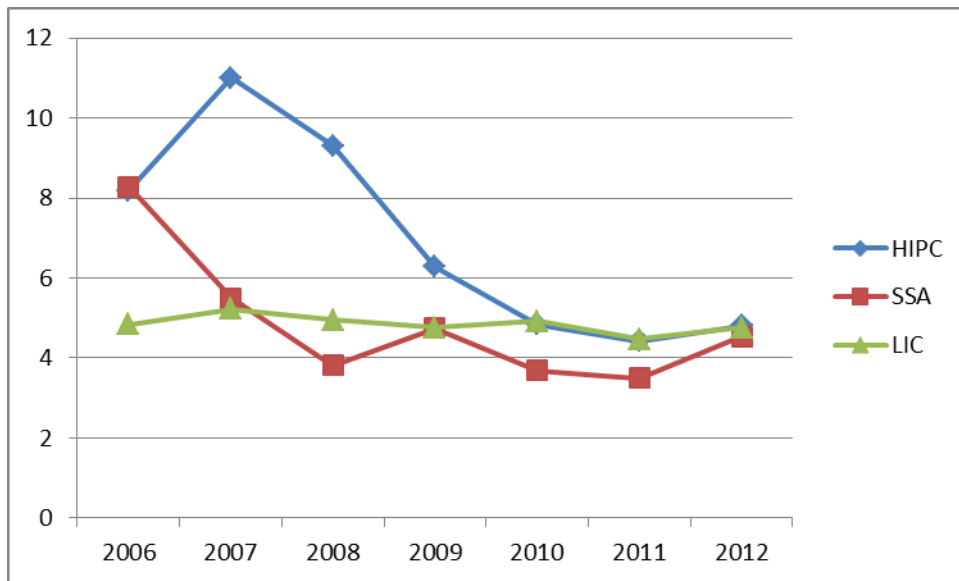
## Annex

**Table A-1: HIPC vis-à-vis MDRI**

	<b>HIPC</b>	<b>MDRI</b>
<b>Country coverage</b>	IDA-only, PRGF-eligible countries with debt indicators above the HIPC Initiative thresholds which have been engaged in qualifying IMF and IDA-supported programs	Completion point
<b>Participating Creditors</b>	All multilateral, official bilateral and commercial creditors of external public and publicly guaranteed debt to HIPC	IDA, IMF and AfDF only
<b>Debt relief provided</b>	External public and publicly guaranteed debt is reduced to the HIPC Initiative thresholds as calculated at the time of the decision point	Debt disbursed before end-December 2004 (IMF and AfDF) and end-December 2003 (IDA) and still outstanding at the time of qualification (after the provision of debt relief) is reduced to zero
<b>Modality of delivery</b>	Most multilateral and Paris Club creditors also provide interim debt relief	Stock-of-debt operation at or shortly after the completion point
<b>Total costs of committed debt relief</b>	41.3 USD billion end-2005 NPV terms	18.3 USD billion end-2005 NPV terms

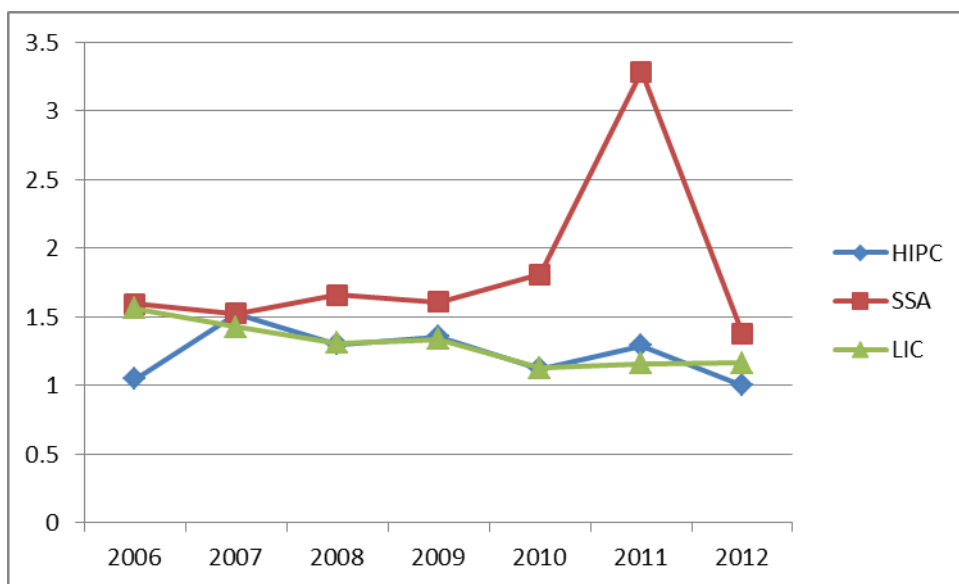
Source: IDA and IMF, 2006

Figure A-1: Total debt service (% of exports of goods, services and primary income)



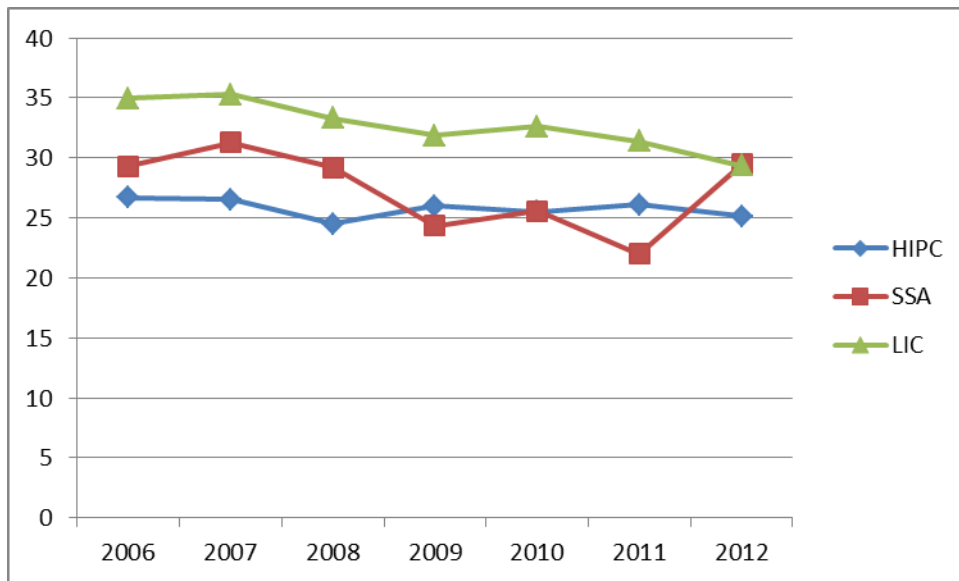
Source: World Bank (International Debt Statistics)

Figure A-2: Average interest on new external debt commitments, official (%)



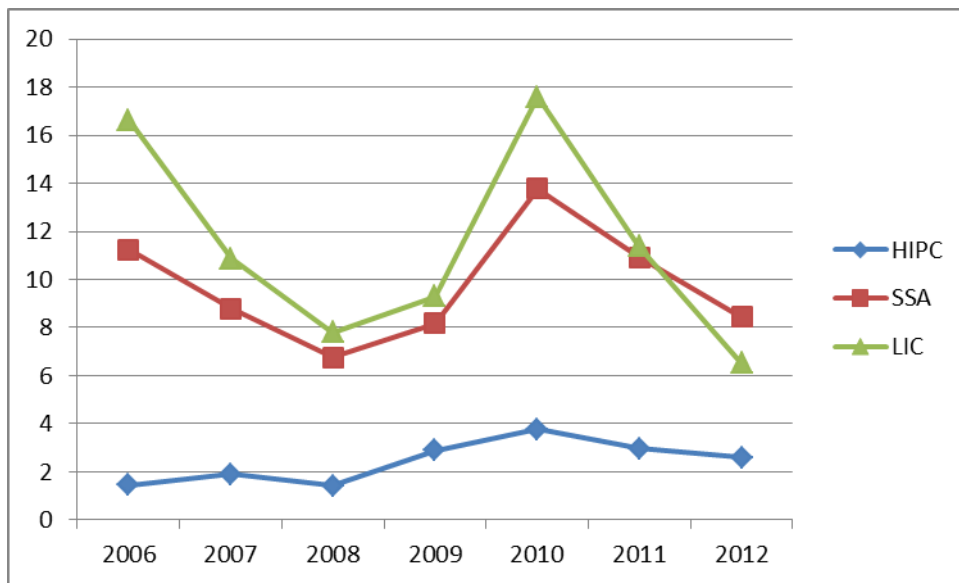
Source: World Bank (International Debt Statistics)

Figure A-3: Average maturity on new external debt commitments, official (years)



Source: World Bank (International Debt Statistics)

Figure A-4: Average maturity on new external debt commitments, private (years)



Source: World Bank (International Debt Statistics)