Appendix 5. Heavily Indebted Poor Countries (HIPC) Initiative and Multilateral Debt Relief Initiative (MDRI)[1]

1. The objective of the Heavily Indebted Poor Countries (HIPC) Initiative of the IMF and World Bank is to reduce external debt positions of eligible low-income countries to sustainable levels and create room for increased social poverty reducing spending. In this appendix, the HIPC Initiative is described, along with Debt Relief Analysis (HIPC DRA), a building block of the HIPC Initiative. Finally, beyond HIPC assistance, the Multilateral Debt Relief Initiative (MDRI) is briefly addressed.

HIPC Initiative

Origin and Description of the HIPC Initiative

2. For a number of low-income countries, it was recognized in the second half of the 1990s, by official creditors in particular, that the external debt situation was becoming extremely difficult. For such countries, even full use of traditional mechanisms of rescheduling and debt reduction—together with continued provision of concessional financing and pursuit of sound economic policies—would not be sufficient to attain sustainable external debt levels within a reasonable period of time and without additional external support. The HIPC Initiative adopted in September 1996 is a comprehensive, integrated, and coordinated framework developed jointly by the IMF and the World Bank to address these external debt problems of the HIPCs. Following a comprehensive review launched in early 1999, the Initiative was enhanced in September 1999 to provide faster, deeper, and broader debt relief, and to strengthen the links between debt relief, poverty reduction, and social policies.

3. The Initiative is designed to enable HIPCs that have a strong track record of economic adjustment and reform to achieve a sustainable debt position over the medium term. Central to the Initiative are the country's continued efforts toward macroeconomic and structural adjustment and social reforms, with an emphasis on poverty reduction. The latter is encompassed in a Poverty Reduction Strategy Paper (PRSP) that is developed by the authorities through a broad-based participatory process. These efforts are complemented by a commitment from the international financial community to tackle the country's external debt problem in a comprehensive and coordinated fashion.

Eligibility Criteria and the Structure of the HIPC Initiative

4. A country wishing to receive debt relief under the enhanced HIPC Initiative would go through a three-stage process consisting of a preliminary stage, decision point, and completion point.

5. To receive assistance under the HIPC Initiative, a country needs to have satisfied the following set of criteria:

- Be eligible for concessional assistance from the IMF and World Bank
- Face an unsustainable debt burden as specified in the HIPC framework (see paragraph 6 below) after application of traditional debt-relief mechanisms[2]

[1] This chapter draws on work at the IMF's Strategy, Policy, and Review Department (SPR). Additional readings on the HIPC and MDRI Initiatives can be found at: www.imf.org/external/np/exr/facts/hipc.htm/.

[2] Such as a Paris Club stock-of-debt operation on a Naples terms 67 percent present value reduction with at least comparable action from bilateral creditors. Table 8.2 in Chapter 8 sets out the evolution of Paris Club rescheduling terms.

- Establish a track record of reform and sound policies through IMF and World Bank supported programs

6. The sustainability of the external debt position is determined by comparing debt burden indicators to the HIPC targets. These targets are set at 150 percent for the ratio of the present value of debt to exports under the exports window and 250 percent for the present value of the debt to government revenue under the fiscal window.

7. Exports are measured by the three-year backward-looking average of exports of goods and services converted at the average exchange rate. The three-year average is used to eliminate the effects of transitory factors. Revenues are measured by the base year central government revenues (excluding grants) converted at the end-of-period exchange rate. The net present value (NPV) amount of assistance is calculated as the reduction of the NPV of debt after traditional debt relief that is necessary to bring the NPV of debt to exports to the threshold level of 150 percent or the NPV of debt to revenue to 250 percent.[3] A country receives assistance according to whichever of these amounts is higher. To be eligible under the fiscal window, however, countries need to meet the threshold of central government revenue collection to GDP (at least 15 percent) and the openness criterion of exports-to-GDP (at least 30 percent).

Table A5.1 The HIPC Thresholds for the NPV of Debt

Ratios of NPV of Debt	Thresholds
NPV of debt to exports	150 percent
NPV of debt to fiscal revenues	250 percent
The fiscal revenue threshold only applies if	
Exports to GDP are at least	30 percent
Revenue to GDP are at least	15 percent

8. If a country satisfies all eligibility criteria and requests HIPC Initiative assistance, a preliminary HIPC Initiative document (prepared jointly by the IMF and the World Bank) will be issued to the Executive Boards of the IMF and World Bank informing them that the country meets the HIPC Initiative eligibility criteria. This document will include a discussion of the debt situation and the policy track record and a loan-by-loan HIPC DRA; provide preliminary estimates of the costs and timing of debt relief; and discuss in broad terms the conditionality envisaged for reaching the completion point. Eligibility will be confirmed at the HIPC decision point.

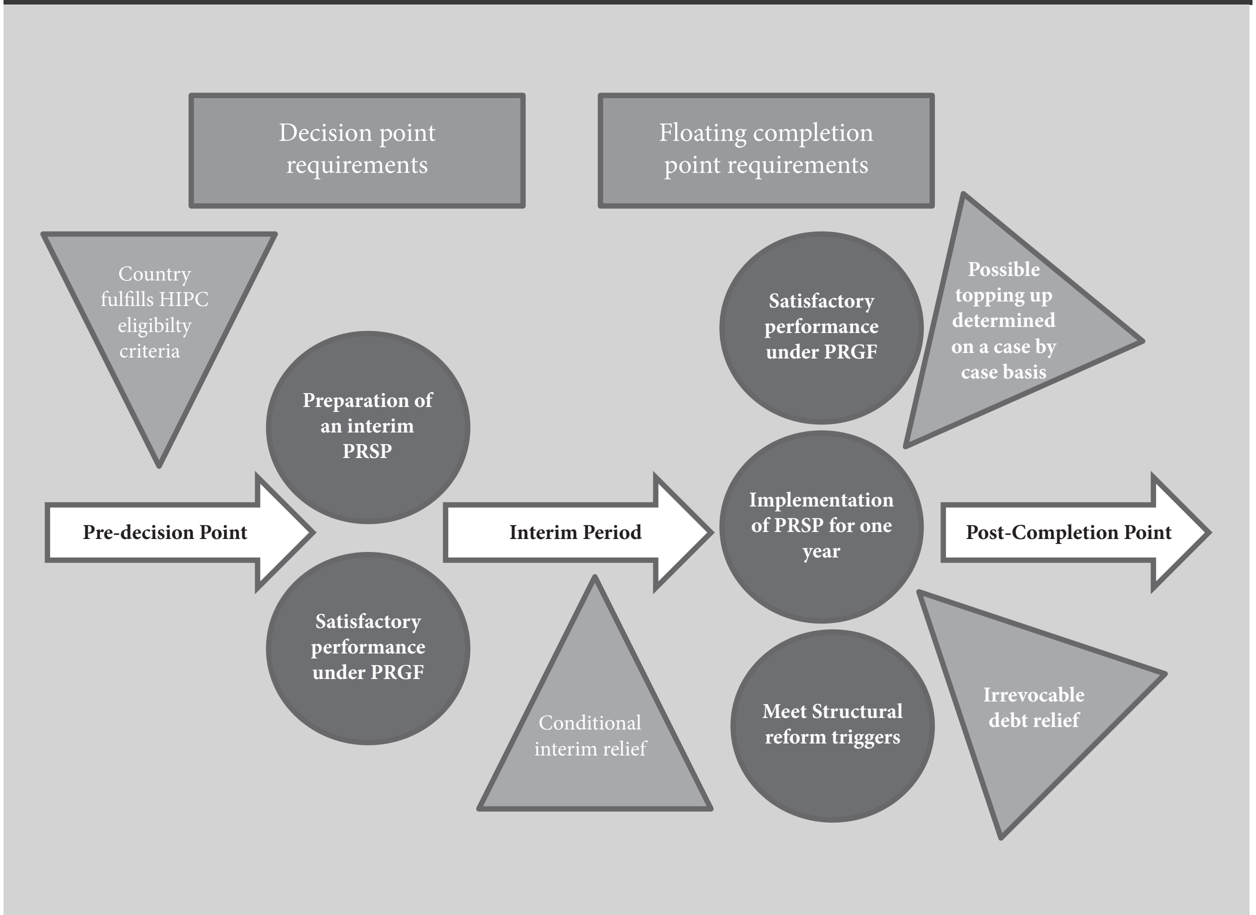
9. An eligible country qualifies for the HIPC Initiative decision point if its debt burden indicators are above the HIPC Initiative thresholds using the most recent data for the year immediately prior to the decision point, it has established a satisfactory track record of strong policy performance under respective IMF- and IDA-supported programs, and has a satisfactory poverty reduction strategy in place.

10. Once a country has met the above set of criteria, the Executive Boards of the IMF and World Bank formally decide on its eligibility for debt relief, and the international community commits to reducing debt to a level that is considered sustainable. This milestone under the HIPC Initiative is referred to as the decision point. Once a country reaches its decision point, it may immediately begin receiving interim relief on its debt service falling due.[4] The next step is the completion point when all the debt relief is expected to be delivered. In order to receive full debt relief committed at the decision point, a country must establish a further track record of good performance under programs supported by loans from the IMF and the World Bank, implement satisfactorily key reforms agreed at the decision point, and adopt and implement its PRSP for at least one year. Once a country has met these criteria, it can reach its completion point; at this stage, a completion point document is jointly issued by the Executive Boards

[3]While the term NPV is commonly used in this Appendix, frequently it would be more accurate to describe the calculation as present value—discounting future interest and principal payments by an interest rate—and this is the approach taken in the *Guide*.

[4]Bilateral and commercial creditors are generally expected to reschedule obligations coming due. There are limits to the maximum assistance that the IMF and World Bank can provide during the interim period.

Figure A5.1 Review of the HIPC Process



of the IMF and World Bank. Figure A5.1 sets out the process in diagrammatical form.

Calculations of Overall Assistance

11. Assistance under the HIPC Initiative is defined as the present value reduction required to lower external debt at the decision point to the Initiative's targets. The amount of assistance is calculated at the decision point, using the actual data on debt, fiscal revenue, exports, and the discount and exchange rates of the last (fiscal) year prior to the decision point (base year). The NPV of debt is calculated using the six-month (prior to the end of the base year) average CIRRs (commercial interest reference rates provided by the OECD), and the year-end exchange rates. The NPV amount of assistance is calculated as the reduction of the NPV-of-total-debt after full use of traditional debt relief mechanisms (i.e., a stock of debt operation on Naples terms) necessary to bring the NPV-of-debt to exports (or to central government revenue under the revenue window) to the threshold level of 150 percent (250 percent under the revenue window).[5]

12. Under exceptional circumstances, the HIPC Initiative provides the option of additional debt relief ("topping-up") at the completion point beyond the amount committed at the decision point. This topping up assistance can be provided to HIPCs whose debt

[5]See footnote 3 above regarding the use of the term NPV in this Appendix.

ratios at the completion point exceeds the HIPC Initiative's threshold due to exogenous factors that lead to a fundamental change in their economic circumstances.

Burden-Sharing Among Creditors and Delivery of Assistance

13. One of the Initiative's guiding principles is broad and equitable participation of all creditors (multilateral, official bilateral, and commercial) in providing assistance. The country is required to seek at least comparable treatment from its other official bilateral and commercial creditors.

14. Multilateral creditors take action proportional to bilateral creditors to reduce the present value of their claims on the country. Each multilateral institution chooses the vehicle to deliver its share of assistance (derived in proportion to its share in the present value of multilateral claims at the decision point). The IMF's contribution is made in the form of grants financed from PRG-HIPC Trust resources.[6] The European Union provides grants.

15. The World Bank is committed to take action after the decision point—through the selective use of IDA grants and allocations—and at the completion point. The principal vehicle for the Bank's participation, together with some other multilateral creditors, is the HIPC Trust Fund. This Trust Fund provides relief to eligible countries on debt owed to participating multilaterals and is administered by IDA, with contributions from participating multilateral creditors and bilateral donors. To provide relief on debt owed to IDA, the Bank made transfers from its IBRD net income and surplus to the HIPC Trust Fund.

Debt Eligible for HIPC Assistance

16. The debt contracted with multilateral and bilateral creditors, covered by the HIPC Initiative, is limited to public and publicly guaranteed debt, i.e., external debt liabilities of the public sector[7] and external debt liabilities of the private sector the servicing of which is contractually guaranteed by a public unit resident in the same economy as the debtor (see Chapter 5). The debt comprises:

- All medium- and long-term government and government-guaranteed external debt
- Short-term debt[8] only if it has long been in arrears
- Debt of public enterprises defined as "at least 50 percent owned by the government"
- Debt of public enterprises being privatized, if the debt remains with the government

Treatment of Arrears

17. Countries seeking assistance under the HIPC Initiative need to work toward elimination or reduction of existing arrears and the nonaccumulation of new external payments arrears. All arrears to multilateral creditors are expected to be cleared, or included in an agreement on a schedule for their clearance before the decision point is reached. However, clearance of such arrears needs to be consistent with a country's financing constraint. In addition, concessionality that is granted in arrears-clearance operations by multilateral creditors can count toward assistance required under the Initiative, on a case-by-case basis.

HIPC DRA

18. HIPC DRAs are central to the work of the HIPC Initiative. These are prepared, on a tripartite basis, jointly by the country authorities, the World Bank, and the IMF and, where appropriate, by the relevant regional development banks, such as the AfDB and the Inter-American Development Bank.

19. In preparation for the decision point discussion, a HIPC DRA is carried out to determine the current external debt situation of the country. This is essentially a medium-term balance of payments projection that assesses the debt burden of the country and its capacity to service those obligations. If external debt ratios for that country fall above applicable targets after application of traditional debt-relief mechanisms, HIPC Initiative assistance is considered.

20. The HIPC DRA is undertaken on the basis of debt stock and flow projections. All the information needs to be obtained on a loan-by-loan basis, disaggregated

[6]Trust for Special Poverty and Growth Operations for the Heavily Indebted Poor Countries and Interim Extended Credit Facility Subsidy Operations.

[7]The public sector comprises the general government, the central bank, and those units in the deposit-taking corporations, except the central bank, and other sectors that are public corporations; see Chapter 5.

[8]Debt that has an original maturity of one year or less.

by creditor and currency. The stock of debt is the amount outstanding at the end of the latest available fiscal or calendar year, depending on whether the country operates on a fiscal or calendar year basis. Projections of financial flows consist of expected amortization payments, disbursements on existing debt, and new loans.

21. Countries seeking assistance under the HIPC Initiative are expected to fully reconcile all debt data on a loan-by-loan basis with the creditor billing records before the decision point.[9] The reconciliation process refers to the position and flows. If a loan is amortized according to its original schedule (if there are no adjustments such as rescheduling, forgiveness, cancellations, supplemental commitments, arrears, or prepayments), the periodic flows depend mainly on the original terms of the loan. Any adjustments to the loan amount, such as write-offs or rescheduling, have to be taken into account, so that a reconciled debt service is agreed (and, by extension, the present value of the debt). The information needed by a HIPC country compiler is set out in Table A5.2.

22. The consistency of stock and flow data on existing debt needs to be assessed. Simple equations can help the data compiler to complete this task, such as:

- The sum of future repayments of loan principal equals the outstanding debt (assuming no accrual of interest costs)
- The sum of future disbursements of loan principal equals the undisbursed balance
- For interest projections, egregious errors could be checked by calculating the implied interest rate (interest t/stock of debt t–1) for a reference year and comparing it to the interest rate recorded in the original terms; or each loan there is a declining interest charge as the years progress and the debt stock is being reduced with each amortization

23. Regarding new loans, given certain underlying assumptions, the expected financing gap on the balance of payments is projected. This is the baseline scenario. Assumptions have to be made about how the gap is to be filled—by grants, concessional loans, or com-

Table A5.2 Data Needed by a HIPC Country Compiler

General information
—Debtor
—Debtor type (central bank, public enterprises, etc.)
—Creditor
—Creditor type (official, bilateral, commercial banks)
—Debtor loan identification
—Creditor loan identification
—Project title
—Loan type (supplier's credit, export credit, etc.)
—Date of signature
—Committed amount and currency of the loan
—Disbursed amount
—First and last date of amortization
—Grace period
—Maturity
—Interest rate and other charges (fixed or variable interest rate)
—Penalty on arrears
—Repayment schedule (equal installments, annuity, etc.)
—Cutoff date
—Grant element
—Identification of ODA loans
At the end of a period
—Stock of debt
—Arrears on principal (on a loan-by-loan basis)
—Arrears on interest
—Exchange rates at the end-of-period and average exchange rate of the year
—Average six-month CIRRs
Disbursements
—On "pipeline" debt
—New debt
Macroeconomic data
—Gross domestic product
—Balance of payments
—Government finance statistics

Note: ODA, official development assistance; CIRRs, Commercial Interest Reference Rate (OECD).

[9] The preliminary HIPC document data might be on the basis of partially reconciled data.

mercial borrowing. The terms of any gap-filling loans can be assumed to be the same as the assumptions on new disbursement terms, or they can vary according to the assessment of willingness to fill the financing gap—if this is possible to assess. For instance, new borrowing to finance the gap can be introduced into the HIPC DRA framework as two separate loans for each year. The first might be assumed to be available on IDA terms, while the remainder is secured at less concessional terms, but still at a concessional rate.

24. Interest charges on new borrowing enter the debt-service stream six months to one year after they are assumed to be committed, and the repayments of the principal become due after the grace period ended. So, for each year, the balance of payments financing gap is established, with any resultant new borrowing being fed back into HIPC DRA as a new loan. Hence, the balance of payments and the HIPC DRA data are obtained interactively over the projection period, and the new debt-service flows taken into account in calculating the present value[10] and debt-service indicators that are presented in the decision point document. This document is the basis for the Bank and IMF Boards' decisions on the eligibility and amount of assistance for the country.

25. Furthermore, sensitivity analysis is undertaken—the decision point document includes the results of alternative macroeconomic scenarios, thus providing a quantitative assessment of the impact of downside risks of the baseline balance of payments scenario. Modified assumptions are applied to external sector variables, such as international prices and trade volumes, and availability and terms of the financing items in the balance of payments. A modification to an assumption may have numerous direct and secondary effects on the balance of payments projections and the whole macro framework. In principle there are two ways for reflecting the impact of the envisaged shock. The first would be to capture only the immediate direct effect of any adverse shock on the balance of payments, which is reflected in lower credit entries or higher debit entries along with a higher additional financing gap. The additional financing gap would then be covered by new borrowing, which in turn would raise the debt ratios. This is normally the preferred approach for HIPC alternative scenarios.

[10]Debt service on new borrowing does not affect the external debt position in the reference year used for decision point calculation of assistance.

26. The alternative approach takes into account secondary effects, such as slower economic growth, which would typically dampen the initial increase in the financing gap, e.g., a significant shortfall in coffee exports would, in the first instance, cause a higher balance of payments financing gap. In addition, however, it would also lead to slower GDP growth and lower import demand, which would partially compensate for the initial increase in the financing gap. However, this approach is applied only in cases where the first approach implies highly unrealistic outcomes.

Interest rate and currency assumptions under the HIPC DRA

27. The currency-specific CIRRs used in HIPC DRAs to calculate the present value of external debt are averages over the six-month period up to the reference date. For those currencies for which no CIRRs are available but that are pegged to another currency, such as the U.S. dollar, the CIRRs for the latter is used. In the absence of an exchange rate arrangement, as well as for the units of account used by various multilateral institutions, the SDR rate should be applied.

28. The present value of external debt is converted from its currency components into U.S. dollars using the actual end-of-period exchange rates—the same date as the reference date for the gross external debt position. These rates are applied to base-year calculations, as well as to projections.

Beyond HIPC Assistance

29. In 2005, to help accelerate progress toward the United Nations Millennium Development Goals (MDGs), the HIPC Initiative was supplemented by the Multilateral Debt Relief Initiative (MDRI). The MDRI allows for 100 percent relief on eligible debts by three multilateral institutions—the IMF, the World Bank, and the AfDB—for countries completing the HIPC Initiative process. The MDRI goes further than the HIPC Initiative by providing full debt relief to free up additional resources to help these countries reach

the MDGs.[11] Unlike the HIPC Initiative, the MDRI does not propose any parallel debt relief on the part of official bilateral or private creditors, or of multilateral institutions beyond the IMF, IDA, and the AfDB.[12] However, in early 2007, the Inter-American Development Bank also decided to provide similar debt relief to the five HIPCs in the Western Hemisphere.

30. At the G-7 summit in June 1999, G-7 leaders called for additional action on a bilateral basis on top of HIPC Initiative assistance, namely to forgive all ODA debt for HIPCs qualifying for assistance under the Initiative, and to give new ODA preferably in the form of grants. Subsequently, a number of Paris Club creditors indicated their willingness to undertake such actions. These bilateral actions are outside of the scope of HIPC Initiative assistance, and are not included in the debt reduction assumed in the debt sustainability analysis under the HIPC, but are presented as an estimate of the additional NPV reduction that could be forthcoming through additional bilateral action. The impact of additional bilateral action varies greatly from country to country.

[11] All countries that reach the completion point under the HIPC Initiative, and those with per capita income below $380 and outstanding debt to the Fund at end-2004, are eligible for the MDRI. To qualify for MDRI debt relief, the IMF Executive Board also requires that these countries be current on their obligations to the IMF and demonstrate satisfactory performance in macroeconomic policies, implementation of a poverty reduction strategy, and public expenditure management.

[12] Further information on the MDRI is available in *PSDS Guide*, Chapter 4.