



Debt sustainability in HIPCs in a new age of choice

Taking stock of the debt relief initiatives and implications of the new development finance landscape for public debt sustainability

Annalisa Prizzon and Shakira Mustapha

Abstract

External debt in developing countries has nearly fallen off development practitioners and analysts' radar, especially in those developing countries that benefited from debt relief in the past decade.

This paper takes stock of some of the achievements of the Heavily Indebted Poor Countries (HIPC) initiative and Multilateral Debt Relief Initiative (MDRI) to date and reflects on the extent to which the 'new' debt-creating development finance flows may jeopardise debt sustainability and the results achieved so far.

While we found that debt ratios have declined in HIPCs -- having been quite resilient to the financial crisis shocks and having more fiscal space for social spending -- we identified four elements of the changing landscape of development finance which poses a threat for debt sustainability in HIPCs. First, graduation into middle-income country status and from International Development Association and soft windows implies a rising share of non-concessional sources of financing. Second, financing infrastructure via international capital markets, public-private partnerships and blended finance brings new opportunities, but also threats. Third, (re-)emerging sovereign donors can boost growth, but financial terms are harder. Finally, domestic debt is rising; being more expensive, its impact on debt service will be larger than that of external debt.

Acknowledgements

This study was generously supported by the Australian Department of Foreign Affairs and Trade. The authors would like to thank Danny Cassimon and Dennis Essers (both from the University of Antwerp), Aldo Caliarì (Rethinking Bretton Woods Project Center of Concern), Jonathan Glennie (ODI), Martine Guerguil (IMF) and Philipp Krause (ODI) who acted as peer reviewers on this paper. We would also like to acknowledge comments received from Tim Jones (Jubilee Debt Campaign) and Gianni Vaggi (University of Pavia). The authors would also like to thank Aldo Caliarì, Danny Cassimon, Ugo Panizza (IHEID), Matthew Martin (DRI) and Tim Jones (Jubilee Debt Campaign) who generously gave up their time to contribute to the telephonic interviews informing this report. Roo Griffiths edited this working paper. The usual disclaimers apply.

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Abbreviations

| | |
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| ADB | Asian Development Bank |
| ADF | African Development Fund |
| AfDB | African Development Bank |
| AIDS | Acquired Immune Deficiency Syndrome |
| CPI | Climate Policy Initiative |
| DAC | Development Assistance Committee |
| DRC | Democratic Republic of the Congo |
| DSA | Debt Sustainability Analysis |
| DSF | Debt Sustainability Framework |
| EU | European Union |
| GDP | Gross Domestic Product |
| GNI | Gross National Income |
| HIPC | Heavily Indebted Poor Country |
| HIV | Human Immunodeficiency Virus |
| IADB | Inter-American Development Bank |
| IBRD | International Bank for Reconstruction and Development |
| IDA | International Development Association |
| IMF | International Monetary Fund |
| ITF | EU–Africa Infrastructure Trust Fund |
| JDC | Jubilee Debt Campaign |
| LIBOR | London Interbank Offered Rate |
| LIC | Low-Income Country |
| LMIC | Lower-Middle-Income Country |
| MDB | Multilateral Development Bank |
| MDG | Millennium Development Goal |

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| MDRI | Multilateral Debt Relief Initiative |
| MIC | Middle-Income Country |
| MTDS | Medium-Term Debt Management Strategy |
| NPV | Net Present Value |
| ODA | Official Development Assistance |
| OECD | Organisation for Economic Co-operation and Development |
| OOF | Other Official Flow |
| PFI | Private Finance Initiative |
| PPP | Public–Private Partnership |
| SDR | Special Drawing Right |
| UK | United Kingdom |
| UMIC | Upper-Middle-Income Country |
| UN | United Nations |
| UNCTAD | UN Conference on Trade and Development |
| UNDESA | UN Department for Economic and Social Affairs |
| UNECA | UN Economic Commission for Africa |
| US | United States |

Executive summary

In the wake of the economic downturn and financial crisis, public debt sustainability in advanced economies is at the top of the international agenda (IMF, 2012; 2013a). Meanwhile, external debt in developing countries has fallen off the radar of development practitioners and analysts.

Debt relief initiatives have been effective in achieving some of their goals (e.g. debt reduction, fiscal space for poverty-reducing expenditure, but also poverty reduction, growth restoration and expansion of exports). Recent International Monetary Fund (IMF)/World Bank Debt Sustainability Analyses (DSAs) classified three quarters of the Heavily Indebted Poor Countries (HIPCs)/Multilateral Debt Relief Initiative (MDRI) countries that benefited from debt relief in the previous decade as being at a low or moderate risk of debt distress (IDA and IMF, 2012).

However, is a low or moderate risk of debt distress for most developing countries that benefited from HIPC/MDRI debt relief in the past decade good enough news that we really can claim the mission of debt relief initiatives has been accomplished? Several factors point to the need for further scrutiny of the situation.

First, in several developing countries, including HIPCs, current macroeconomic conditions resemble in some ways the positive conditions prevailing in some developing countries before the debt crises of the 1980s, with optimistic expectations with regard to repayment capacity. Second, several countries are graduating into middle-income country (MIC) status, including HIPCs, meaning they will soon no longer be eligible for soft-window funds from multilateral development banks (MDBs). Third, the supply side of the development finance landscape has changed visibly since the HIPC Initiative and the MDRI were launched. Greater resources from a more diversified pool of providers are now available (Greenhill et al., 2013) – some of which are debt-creating. There is a growing role for the private sector in the implementation of infrastructure projects, such as in the case of public–private partnership (PPP) agreements. Several HIPCs (Ghana, Mozambique, Rwanda, Senegal, Tanzania and Zambia) have issued sovereign bonds in international markets in the past few years, especially to promote large infrastructure projects. Others are planning to do so (such as Ethiopia (Blair and Maasho, 2013) and Uganda). Finally, while public external debt has been on a declining path in low-income countries (LICs), domestic debt is increasing (Bua et al., 2014).

More analytical work is needed to reflect on the potential threats to the results achieved so far. This paper aims to review some of the aspects of the debt sustainability debate, and is a first step in identifying areas deserving of further scrutiny. It will contribute to the debate by reflecting on the following questions:

- What are the trends in external debt ratios (stock and service ratios on GDP) in HIPC/MDRI countries since the early 2000s, and are any HIPCs seeing their debt ratios rising?
- What are the risks and opportunities for debt sustainability in HIPC/MDRI countries associated with less traditional flows of development finance?
- How might public debt and debt service ratios evolve in the medium term?

This paper reviews these issues by taking stock of some of the achievements of the HIPC Initiative and the MDRI to date and by reflecting on the extent to which the ‘new’ debt-creating development finance flows – emerging lenders, Eurobonds, PPPs, climate finance, blended and climate-related finance and domestic debt – may jeopardise debt sustainability and results achieved so far.

Three key messages emerge from this study. First, the HIPC Initiative and MDRI have been effective in achieving their goals and objectives. Debt ratios have declined in HIPCs, and are much lower than in advanced countries, having been quite resilient to the financial crisis shocks. Debt ratios in 2011 were on average a quarter of those prevailing in 2000, from 145% of GNI in 2000 to 35% in 2011. There is also more fiscal space for social spending: HIPC/MDRI countries spent 64% less on debt service in 2011 than they did in 2000 (1.4% of GDP in 2011 compared with 3.9% in 2000). Second, while it has contributed to remarkable progress, as outlined above, debt relief does not guarantee future debt sustainability: some HIPC/MDRI countries, such as Ghana and Senegal, have seen their debt ratios rising. Third, the changing landscape of development finance may pose a threat for debt sustainability in HIPCs, notably: graduation into MIC status, and from International Development Association (IDA) and soft windows, implies a rising share of non-concessional sources of financing; financing infrastructure via international capital markets, PPPs and blended finance brings opportunities but also threats; (re-)emerging sovereign donors can boost growth, but financial terms are harder and domestic debt is rising and its impact on debt service will be larger than that of external debt, being more expensive.

While discussions are ongoing regarding the principles of Responsible Sovereign Lending and Borrowing (within the UN Conference on Trade and Development (UNCTAD)) -- as is a review of the IMF’s policy on debt limits -- there are still some areas (such as the definition of debt workout mechanisms) that deserve further consideration. Based on this paper’s review and, more broadly, the literature on debt sustainability in the context of low-income countries, we make the following recommendations for borrowing countries, sovereign lenders and international bodies managing part of the debt agenda at international level, such as the UN Department for Economic and Social Affairs (UNDESA) and UNCTAD:

- Foster transparency of contract negotiations, debt management and public expenditure.
- Continue improving debt management and coordination (whole-of-government approach) and consider developing a development finance strategy.
- Account for risks associated with contingent liabilities.
- Develop a debt work-out mechanism.
- Continue strengthening macroeconomic fundamentals and achieving export diversification.

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- Undertake more analytical work to provide greater insight into the implications of the new sources of development finance for debt sustainability.

1 Introduction

In the wake of the economic downturn and financial crisis, public debt sustainability in advanced economies is at the top of the international agenda (IMF, 2012; 2013a). Meanwhile, external debt in developing countries has nearly fallen off development practitioners and analysts' radar.

Debt relief initiatives have been effective in achieving some of their goals (e.g. debt reduction, fiscal space for poverty-reducing expenditure, but also poverty reduction, growth restoration and expansion of exports) (IDA and IMF, 2001). Recent International Monetary Fund (IMF)/World Bank Debt Sustainability Analyses (DSAs) classified three quarters of the Heavily Indebted Poor Countries (HIPC)/Multilateral Debt Relief Initiative (MDRI) countries that benefited from debt relief in the previous decade as being at a low or moderate risk of debt distress (IDA and IMF, 2012). Furthermore, it has been found that the HIPC Initiative and the MDRI have achieved their objectives, which is, (i) lower debt stock and thus debt service (possibly removing debt overhang and (re-)gaining and/or expanding access to international capital markets); and (ii) freeing up resources for poverty-reducing expenditure (IDA and IMF, 2012; JDC, 2012). Also, most of the warnings (see Prizzon, 2008 for a review) regarding the potentially grim outlook for debt sustainability in the aftermath of the financial and economic crisis did not fully materialise; HIPC economies were largely resilient, at least in the medium term.

This success may suggest there should be no surprise that the issue of debt sustainability is off the agenda right now for the countries that have completed these schemes. In stark contrast, Europe and the US are struggling with their own debt challenges, amid speculation about their long-term fiscal capacity to repay. Meanwhile, developing countries that were excluded from these schemes, such as Jamaica, Pakistan, the Philippines and El Salvador, continue to pay considerable amounts in debt payments each year (JDC, 2012; Dear et al. 2013).

However, is a low or moderate risk of debt distress for most developing countries that benefited from HIPC/MDRI debt relief in the past decade good enough news that we really can claim the mission of debt relief initiatives has been accomplished? Several factors point to the need for further scrutiny of the situation.

1. In several developing countries, including HIPCs, current macroeconomic conditions resemble in some ways the positive conditions prevailing in some developing countries before the debt crises of the 1980s, with optimistic expectations with regard to repayment capacity. Then, we saw a combination of sound economic performance, high commodity prices, optimistic growth forecasts in resource-rich countries and low interest rates. For example, for some non-HIPCs, the rise in oil prices in the 1970s was such that several oil-exporting countries (notably Algeria, Ecuador, Indonesia, Nigeria and Venezuela) embarked on ambitious investment projects financed by oil revenues and external borrowing, with natural resources providing the collateral (Melina et al., 2014). When prices plummeted in the 1980s, the debt crisis was 'inevitable' (Manzano and Rigobon, 2007). These positive

macroeconomic conditions should not deflect attention from monitoring debt ratios.

2. Several countries are graduating into middle-income country (MIC) status, including HIPCs, meaning they will soon no longer be eligible for soft-window funds from multilateral development banks (MDBs) (the concessional share of their external debt in HIPCs has also steadily declined, from 70% in 2006 to approximately 63.8% in 2012). Furthermore, several donors are redefining their country strategies, either shifting their focus towards low-income countries (LICs) or fragile countries, planning their phasing-out from countries graduating into MIC status; changing their type of programme instrument from grants to (concessional or less concessional) loans; and/or downsizing their total envelope for development assistance.¹
3. The supply side of the development finance landscape has changed notably since the HIPC Initiative and the MDRI were launched. Greater resources from a more diversified pool of providers are now available. The growth of other forms of development assistance has greatly outpaced that of traditional aid, including funding from non-Development Assistance Committee (DAC) donors (such as China and India), climate finance funds, social impact investors (e.g. the Acumen Fund), philanthropists (e.g. the Bill and Melinda Gates Foundation) and global vertical funds (such as the Global Fund to Fight AIDS, Malaria and Tuberculosis) (Greenhill et al., 2013) – some of which are debt-creating. National development strategies in partner countries tend to focus heavily on infrastructure development to boost growth and to accelerate poverty reduction. Unsurprisingly, more and more attention is being placed on the financial resources and mechanisms targeting infrastructure development. There is a growing role for the private sector in the implementation of infrastructure projects, such as in the case of public–private partnership (PPP) agreements. Several HIPCs (Ghana, Mozambique, Rwanda, Senegal, Tanzania and Zambia) have issued sovereign bonds in international markets in the past few years, especially to promote large infrastructure projects. Others are planning to do so (such as Ethiopia (Blair and Maasho, 2013) and Uganda). Finally, while public external debt has been on a declining path in LICs until now – from 72% of gross domestic product (GDP) in 1996 to 23% in 2011 – domestic debt is on the rise – from 12.3% in 1996 to 16.2% in 2011 (Bua et al., 2014). Domestic debt obligations do not entail exchange rate risks, but shorter maturities and a steeper yield curve make their financial terms more expensive than those on external debt.

More analytical work is needed to reflect on the potential threats to the results achieved so far. This paper aims to review some of the aspects of the debt sustainability debate, and is a first step in identifying areas deserving of further scrutiny. It will contribute to the debate by reflecting on the following questions:

- What are the trends in external debt ratios (stock and service ratios on GDP) in HIPC/MDRI countries since the early 2000s, and are any HIPCs seeing their debt ratios rising?
- What are the risks and opportunities for debt sustainability in HIPC/MDRI countries associated with less traditional flows of development finance?

¹ In aggregate terms, in 2013 official development assistance (ODA) flows achieved their highest level ever. However, this trend was driven largely by the increase in ODA contributions by the UK (28% annual increase) and Japan (37%).

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- How might public debt and debt service ratios evolve in the medium term?

To do so, we have reviewed the existing literature, analysed trends based on World Bank and IMF data and interviewed experts on debt issues. With this paper, we aim to spur debate on these issues by reviewing key issues at stake and their inter-linkages, rather than ‘deep diving’ on any of these issues. The concluding section also frames questions for further research.

This paper focuses on liabilities that are a competence of the public sector – that is, public or publicly guaranteed debt – but not on private debt, either domestic or external. This is not to say that private debt may be less important. On the contrary, increasing levels of private sector external debt from a low base could create balance of payment pressures by competing with the public sector for foreign exchange, and could also increase exposure to risks stemming from the accumulation of contingent liabilities. In several countries, private external debt is already substantial in relation to GDP (e.g. Côte d’Ivoire, the Democratic Republic of the Congo (DRC), Madagascar, Mozambique, Nicaragua and Senegal were above the LIC average in 2010). We opted to investigate only external sovereign debt, and not private debt, simply because our focus of analysis is debt that benefited from the HIPC Initiative and MDRI in the 1990s and 2000s. We are explicit about which type of debt we refer to when we divert our focus on external debt.

This analysis also concentrates on HIPCs. Analytical pieces often focus on LICs, and there is a high degree of overlap between the two categories (even though there are some HIPCs that are not LICs at the moment,² and some LICs did not qualify for HIPC/MDRI assistance). We specify when we are referring to LICs in the different sections of this paper.³

Borrowing is a prerequisite for investment where there is a clear financing gap and is a sign of both creditworthiness and state capacity (see Krause, 2013). However, debt management issues materialise when liabilities are not well administered in terms of implementing the project, and the project itself (or the government) fails to generate sufficient revenues to repay loans. New borrowing does not automatically erode debt sustainability, particularly if it translates into productive investment and faster growth (Lewis, 2013). At the same time, persistent vulnerabilities to external shocks could result in significant deterioration in the debt outlook regardless of the growth dividend of debt-financed public investments.

This Working Paper is structured as follows. In Section 2, we take stock of some of the achievements of the HIPC Initiative and the MDRI to date – e.g., the sharp decline in debt ratios in HIPCs and greater fiscal space created to allow for increased social spending. We reflect on direct outcomes of the initiatives rather than reviewing and analysing impacts on growth performance, exports and poverty reduction. We end Section 2 by examining whether any setbacks are looming. Section 3 reviews the risks and opportunities for debt sustainability in HIPCs, in particular, different positions on whether and why current debt liabilities are sustainable or not. Considering the scarcity of relevant data so far, Section 3 also speculates on the extent to which the ‘new’ debt-creating development finance

² A total of 23 of the 35 post-completion point HIPCs (as of December 2013) are classified as LICs, and 12 are classified as lower-middle-income countries (LMICs).

³ Furthermore, there are LICs that have not benefited from the debt relief initiatives of the 2000s, such as Kenya, that are seeing their debt ratios rising. The analysis has also intentionally focused on HIPCs and not considered the case of Caribbean MICs and other MICs, such as Nigeria, that did benefit from debt relief but not within the HIPC/MDRI framework.

flows – emerging lenders, Eurobonds, PPPs, climate finance, blended and climate-related finance and domestic debt – may jeopardise debt sustainability and results achieved so far. Building on IMF analysis, Section 4 reviews forecasts for debt stock and debt service ratios up to 2018 and reflects on the potential impact on, for instance, fiscal space and the expansion of public spending on social services. Section 5 concludes by outlining recommendations for the international community and for borrowing countries to prevent another debt crisis, as well as areas for further analyses.

2 Taking stock of the debt relief initiatives

The Bretton Woods institutions jointly launched the HIPC Initiative in 1996 to guarantee a permanent exit from debt rescheduling in favour of LICs that were not eligible under the Brady Plan.⁴ It was intended to reduce the overall debt stock to a sustainable level within a reasonable period of time in a coordinated effort of multilateral, bilateral and commercial creditors, including also non-Paris Club members, with the ultimate goal of eliminating the debt overhang as a constraint to economic growth and poverty reduction.⁵ The Initiative, enhanced in 1999⁶ and supplemented by the MDRI in 2005,⁷ is now nearly completed, and the IMF and the World Bank closed the scheme to new entrants in 2011. Out of the 39 countries that were eligible under the Initiative, 35 have already reached the completion point and have thus received 100% relief on eligible debt from the IMF and other participating creditors. Total assistance committed to these 35 HIPCs under the HIPC Initiative and the MDRI amounted to \$126 billion in nominal terms as of end-August 2013 (IMF, 2013a) – which is similar to recent annual official development assistance (ODA) flows, at least on average.

This section briefly reviews two major results and achievements of the HIPC/MDRI initiatives, among others, notably the reduction in debt ratios and greater fiscal space – resulting from the lower debt service burden – which has also allowed for higher social spending.

⁴ The goal of the Brady Plan was to restructure the public and publicly guaranteed debt claims of the commercial banks in such a way that interest payments would be reduced, principal forgiven and maturities lengthened. Countries that received a Brady Plan between 1989 and 1995 were Argentina, Bolivia, Brazil, Bulgaria, Costa Rica, the Dominican Republic, Ecuador, Jordan, Mexico, Nigeria, Panama, Peru, the Philippines, Poland, Uruguay and Venezuela.

⁵ Krugman (1988) and Sachs (1989) define as ‘debt overhang’ the adverse effect of a high debt stock on investment incentives owing to medium-term uncertainty: a higher output resulting from greater capital formation can be taxed away because of creditors’ claims – or, in other words, the debt burden distorts the country’s incentives, since the benefits of good performance go largely to creditors rather than to the country itself. According to Krugman, the debt overhang effect manifests when the expected repayments on foreign debt are lower than the contractual value.

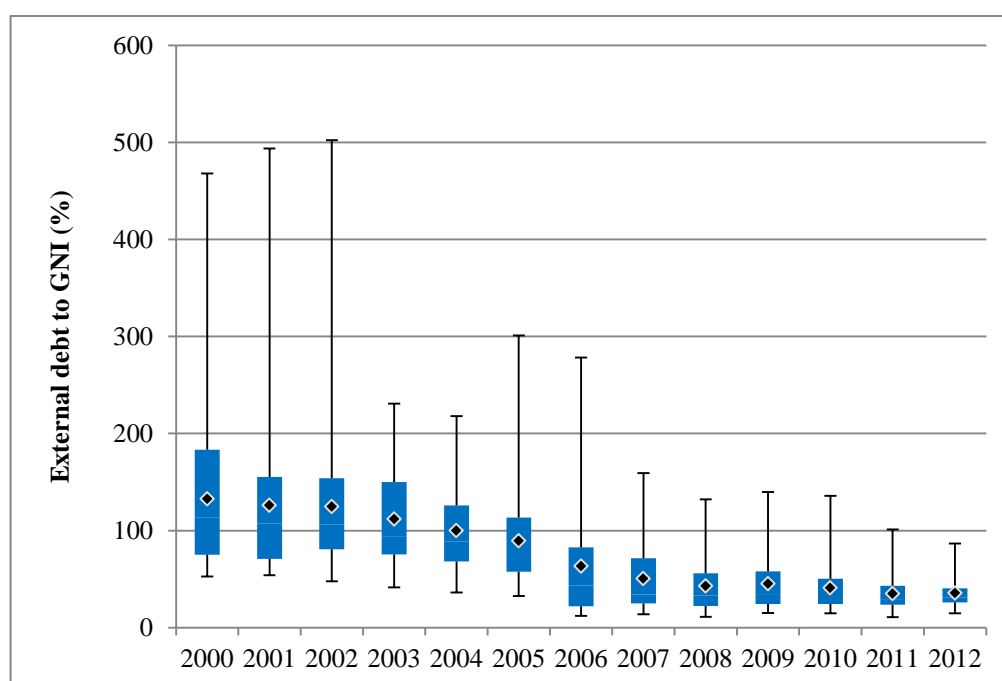
⁶ Three years later, in 1999, the HIPC Initiative was enhanced to provide faster, deeper and broader debt relief and to strengthen links between debt relief, poverty reduction and social policies. It was achieved through lower sustainability targets, debt relief decided at decision point, interim assistance provided and a floating rather than fixed completion point.

⁷ In 2005, the HIPC Initiative was supplemented by the MDRI to help accelerate progress toward the Millennium Development Goals (MDGs). Under the MDRI, the International Development Association (IDA), the IMF, the African Development Fund (ADF) and the Inter-American Development Bank (IADB) provided 100% debt relief on eligible debts.

2.1 Debt ratios have declined in HIPCs and are much lower than in advanced countries, being – all-in-all – more resilient to the financial crisis shocks

Debt ratios have declined substantially among HIPCs over the past decade. From an average of 145% of gross national income (GNI) in 2000, the average debt ratio fell to 35% in 2011 (Figure 1) and inevitably, given the mechanisms of how debt relief is granted,⁸ debt ratios have converged among HIPC countries (see upper and lower values in Figure 1). The sharpest decline took place in 2003 and 2004, when most HIPCs reached their completion point and then benefited from most of the debt relief.⁹ This trend does hold for both natural resource-rich and natural resource-poor countries (Thomas et al., 2012).

Figure 1: Declining and converging debt ratios, all HIPCs, since mid-2000s



Note: The black diamond indicates the mean value and the whiskers represent the maximum and minimum values of external debt/GNI (%) among HIPCs.

Source: World Bank International Debt Statistics.

In the introduction, we stressed how most media attention nowadays is devoted to debt issues in advanced economies, and no longer to developing countries. And there is a reason for this. HIPC countries were on average two and half times more indebted than advanced economies in 1990; by 2012, the picture had reversed. While, as Reinhart et al. (2003) show, ‘debt tolerance’ is higher in advanced economies than in emerging ones, advanced economies are now at least two and a half times more indebted than HIPC countries (Figure 2).¹⁰ While all developing

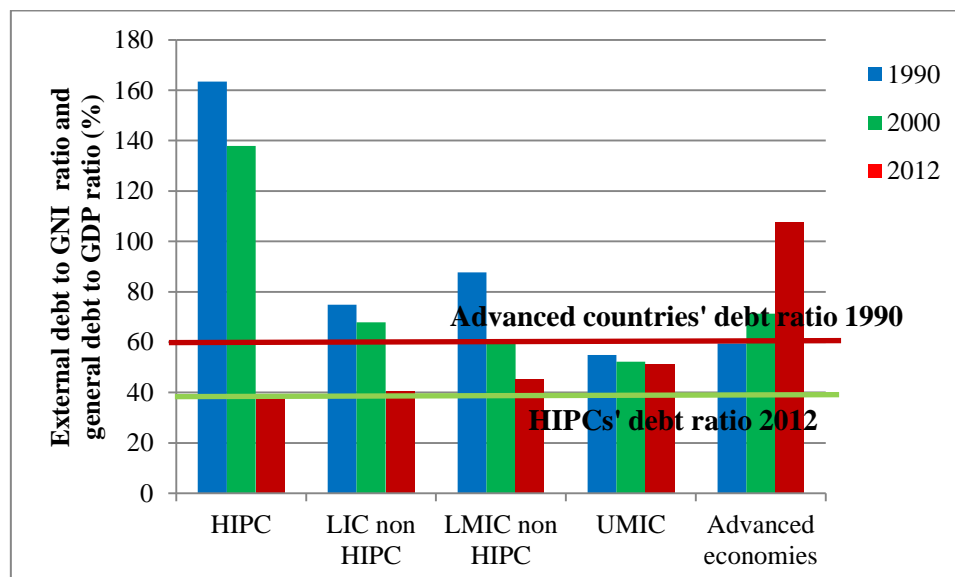
⁸ With the enhanced HIPC Initiative, the debt sustainability threshold was lowered to 150% net present value (NPV) of debt as a ratio of exports.

⁹ When beneficiary countries receive 100% relief on eligible debt from the IMF and other participating creditors. In the enhanced HIPC Initiative, countries were eligible for part of debt relief after having reached completion point.

¹⁰ In Figure 2, we compare external public and publicly guaranteed debt in HIPCs and other developing countries and general government debt for advanced economies, given the lack of comparable annual measures for both groups (World Bank external debt statistics are available for advanced countries as well but data are presented in a quarterly format only). In other words, figures reported in Figure 2 for advanced economies capture both domestic and external debt; developing country data are restricted to external debt.

countries have seen their average debt ratio fall across income levels, again unsurprisingly, the sharpest (average) decline took place in those countries that had benefited from debt relief initiatives.

Figure 2: HIPCs were more indebted than advanced countries in 1990; the picture had reversed in 2012



Note: External debt to GNI ratio except for advanced economies (general debt to GDP ratio, %).

Source: World Bank World Development Indicators 2014 and IMF World Economic Outlook April 2014.

Plummeting debt ratios saw only a temporary halt in the wake of the 2008/09 financial and economic crisis. At the start of the financial crisis, several authors pointed out that HIPCs were vulnerable, and that gains occurred until that time would be jeopardised by fiscal deterioration in recipient countries, declining donor commitments and frozen access to international financial markets (see Prizzon, 2008). These predictions turned out to be wrong: most of the economies proved resilient and recovered at the beginning of this decade. First, most of the LICs had sufficiently large fiscal buffers, with macroeconomic fundamentals visibly stronger than at the outset of any other crisis. And the trough in commodity prices, starting from the end of the commodity super-cycle, recovered entirely in 2010. Second, donors disbursed their highest-ever level of ODA in 2010 (OECD, 2011a) (after two years of ODA falling, it reached its all-time high in 2013; see OECD, 2014). Third, low interest rates in advanced economies and declining risk aversion among international investors translated into a growing appetite for frontier markets (see IMF, 2014b and Section 3.2 of this paper).

Baduel and Price (2012)¹¹ found the global financial and economic crisis did not significantly change long-run LIC debt vulnerabilities (based on DSAs).¹² Average DSA debt ratios remained comfortably below their respective thresholds along the projection horizon.¹³ Thus, even in the face of the noticeable deterioration in key

¹¹ Baduel and Price (2012) measured an adverse impact on debt ratios in short to medium term though.

¹² A DSA is a standardised analytical tool to monitor debt sustainability for a particular country. It is part of the Debt Sustainability Framework (DSF), a standardised tool introduced by the World Bank and the IMF in 2005 to inform the borrowing decisions of LICs, to provide guidance for creditors' lending and grant allocation decisions and to advise 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.

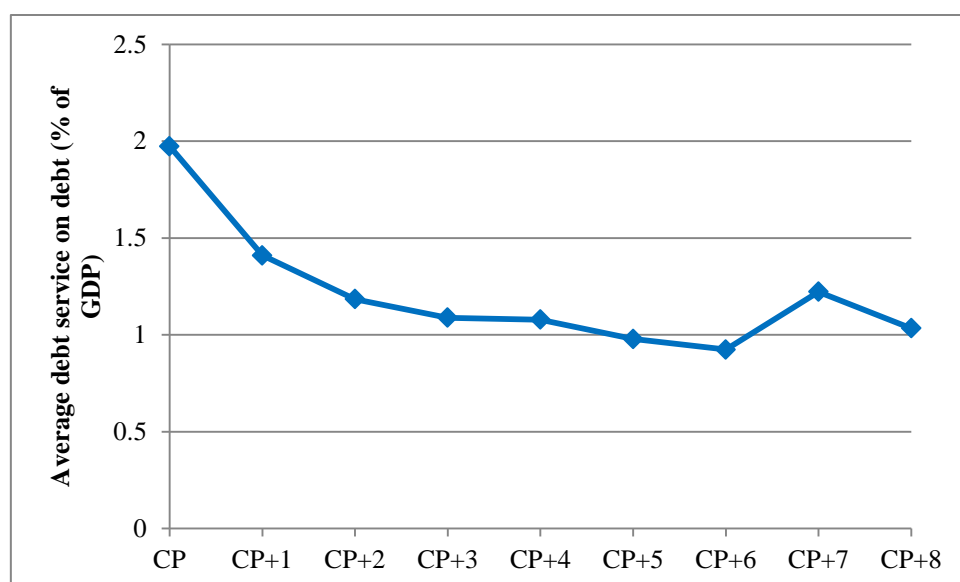
¹³ The debt burden threshold under the DSF ranges from 30% to 50% of GDP, increasing with the quality of a country's Institutions and policies (based on empirical findings that a LIC with better policies and institutions can sustain a higher level of external debt). For further details, see IMF and World Bank (2012).

debt ratios in 2010, DSA baseline projections for most LICs did not point to a major increase in vulnerabilities.

2.2 More fiscal space has been created to allow for greater social spending

Lower debt stocks also determine a lower debt service burden and, keeping all other variables equal, more fiscal space for social spending.¹⁴ HIPC/MDRI countries more than halved their debt service in 10 years. They spent 1.4% of GDP in 2011 on debt service compared with 3.9% in 2000. As Figure 3 shows, the sharpest decline in debt service occurred right after reaching completion point. According to the Jubilee Debt Campaign (JDC) (2012), in 2000, 30 completion point countries spent more than 10% of government revenue on foreign debt payments. In 2010, the number fell to two: The Gambia and Togo.

Figure 3: Declining debt service in 35 post-completion countries after completion point



Note: CP corresponds to the year when the country reached completion point.

Source: IDA and IMF (2013).

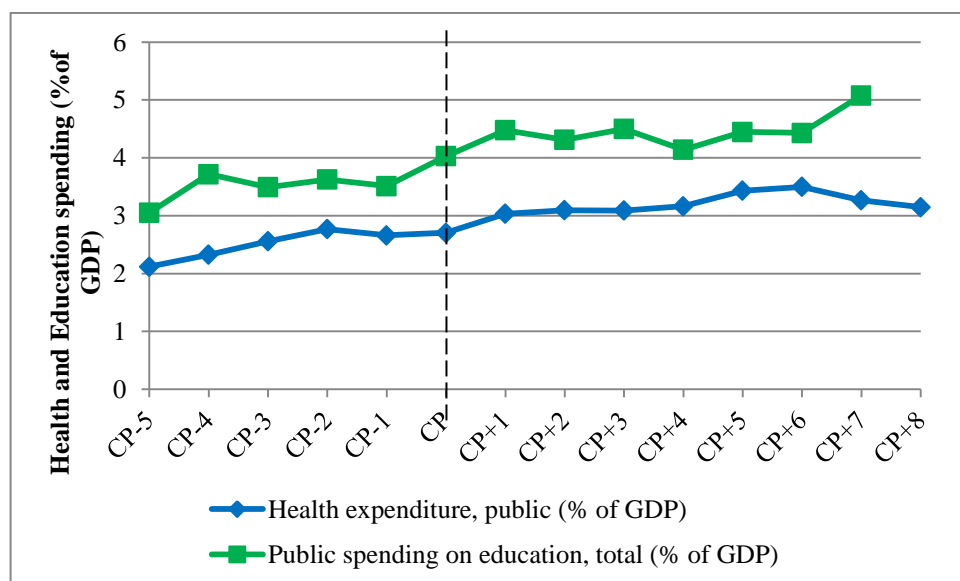
However, when it comes to assessment of the impact of debt relief on social spending,¹⁵ studies so far have been rather inconclusive, or have shown a positive, albeit small, effect. More importantly, we cannot assess the direct contribution of debt relief to social spending on a cross-country basis (if cancellation had been for obligations in arrears the impact on debt service reduction would have been nil). While this cannot be attributed directly to debt relief (given the difficulty of finding a good counterfactual), HIPC countries have seen their social spending rising, more visibly since reaching completion point (Figure 4). Public education expenditure was 3.15% of GDP on average in 2000 and reached a peak of 4.33% in 2010; public health expenditure was 2% of GDP in 2000 and the ratio reached 2.8% in 2011 (see Figure 4). The HIPC and MDRI Statistical Update estimated that

¹⁴ The analysis and measurement of fiscal space goes well beyond the scope of this paper. For its definition and assessment, see Heller (2005).

¹⁵ There is limited evidence on the impact of debt relief on social spending, with most papers analysing data pre-MDRI. According to Alun (2006), debt relief has a small but significant influence on social spending: a fall of 1% in debt service increases social spending by 0.4%. Depetris Chauvin and Kraay (2005) do not find any significant relationship between debt relief and social spending.

poverty-reducing expenditure¹⁶ increased by about 2.5% (of) GDP between 2001 and 2011, from 6.3% to 8.8% (IDA and IMF, 2013).

Figure 4: Rising education and health public spending in HIPCs



Source: World Bank World Development Indicators 2014.

It is worth noting that progress in reaching the MDGs has been uneven across HIPC/MDRI countries (IDA and IMF, 2013). A total of 94% of 35 post-completion point HIPCs are ‘seriously off target’ in halting HIV/AIDS and other diseases. Countries are also struggling to meet MDGs in areas of increased access to improved sanitation facilities and on reducing infant mortality. HIPC performance has been better in the areas of increased access to improved water sources and girls’ enrolment in primary and secondary education.

2.3 Some countries have seen their debt ratio rising

In previous sections, we have seen that the HIPC and MDRI initiatives have charted a course towards restoring debt sustainability and are associated with other positive outcomes: (i) debt ratios have declined in HIPCs, and they are much lower than in advanced countries; and (ii) more fiscal space has been created to allow for greater social spending.

While these achievements are remarkable, they are short-term, and exiting the HIPC Initiative neither precludes the rapid build-up of new debt nor guarantees long-term external debt sustainability (Beddies et al., 2009; Yang and Nyberg, 2009). On the other hand, an increasing debt ratio is not per se a signal of unsustainability of public liabilities: foreign or domestic debt obligations may be one of the few options available to finance public investment and can lead to higher growth, revenues and exports – and therefore to lower debt ratios – over time. Nonetheless, rapidly increasing debt ratios must be considered a warning signal deserving of further scrutiny.

Notwithstanding the decline in debt burdens through HIPC debt relief, long-term debt sustainability remains a challenge for many HIPCs, and there are a few examples of debt ratios starting to rise in recent years.

¹⁶ Poverty-reducing expenditure usually includes education, health and social protection spending.

First, based on the latest DSA (as of January 2014), none of the 35 post-completion point HIPCs is classified as being in debt distress, although the risk is still high or moderate for 22 countries.¹⁷ More specifically, six countries are classified as being at a high risk of debt distress and sixteen are at moderate risk (Table 1).¹⁸ Moreover, 26 of these 35 countries were at high or moderate risk at least once after completion point, although for the majority the debt distress rating improved on reaching completion point.

It is important to note that the risk of debt distress is guided solely by an analysis of the NPV of external public debt relative to the thresholds in the external DSA. The central role of external public debt in the DSF stems from the fact that, historically, external public debt has been the largest component of debt in LICs, and the largest source of risk. Given the frequency of DSAs, these ratings are useful shortcuts for tracing changes in a country's debt projections over time.¹⁹

Table 1: None of the post-completion point HIPCs is in debt distress, but six are at high risk

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

Source: Adapted from IMF (2014a).

Since 2006 or the earliest DSA,²⁰ the following 15 former HIPCs have seen their risk of debt distress unchanged:

- *Afghanistan* remained at high risk of distress between 2008 and 2012 despite reaching completion point in 2010.
- *Benin* has remained at moderate risk since reaching completion point in 2003.
- *Bolivia* has remained at low risk since reaching completion point in 2001.
- *Cameroon* has remained at low risk since reaching completion point in 2006.

¹⁷ On criteria for debt ratings, see IMF (2013c).

¹⁸ In six countries rated as being at high risk of debt distress at end-2012 (The Gambia, Ghana, Malawi, São Tomé and Príncipe, Senegal and Tanzania), debt ratios have been rising rapidly, with increments in their debt to GDP ratios of at least 5% since they obtained debt relief; in addition, their debt to GDP ratios were 40% or higher (IMF, 2013c), taking advantage of the borrowing space created by debt relief in the past decade (see Section 2.1 – it does also include public domestic borrowing).

¹⁹ However, for reasons outlined throughout this paper, these debt distress ratings should be interpreted with caution.

²⁰ The first set of DSAs was conducted in 2006.

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- *Ghana* has remained at moderate risk since reaching completion point in 2004.
 - *Guyana* has remained at moderate risk since reaching completion point in 2003.
 - *Haiti* has remained at a high risk of distress since 2006, even after reaching completion point in 2009.
 - *Mauritania* has remained at moderate risk since reaching completion point in 2002.
 - *Nicaragua* has remained at moderate risk since reaching completion point in 2004.
 - *São Tomé and Príncipe* has remained at high risk since reaching completion point in 2007.
 - *Senegal* has remained at low risk since reaching completion point in 2004.
 - *Sierra Leone* has remained at moderate risk since reaching completion point in 2006.
 - *Tanzania* has remained at low risk since reaching completion point in 2001.
 - *Malawi* has remained at moderate risk since reaching completion point in 2006.
 - *Zambia* has remained at low risk since reaching completion point in 2005.

The following two countries have seen their risk of debt distress worsen since reaching completion point:

- *Mali*'s risk increased from low (2007-2009) to moderate in 2011 and 2013 after reaching completion point in 2003.
- *Mozambique*'s rating increased from low in 2006 to moderate in 2013 after reaching completion point in 2001.

Finally, 18 countries saw their risk of debt distress improve since reaching completion point:

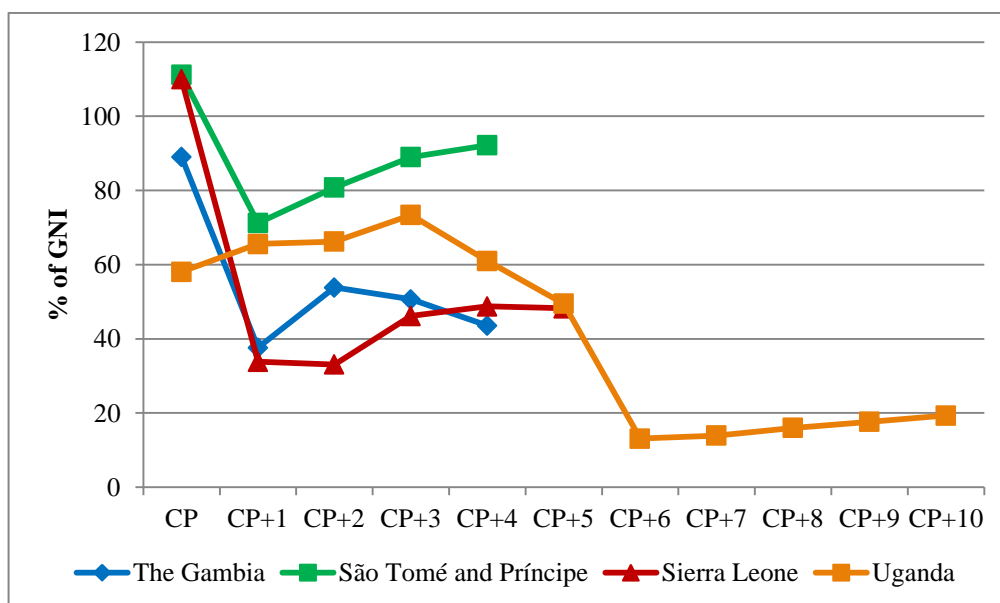
- *Burkina Faso* went from high risk of debt distress in 2008 to moderate risk in 2013 after reaching completion point in 2002.
- *Burundi* went from being in debt distress in 2007 to being at high risk on reaching completion point in 2009.
- *Côte d'Ivoire* fluctuated from being in debt distress to being at high risk between 2007 and 2011. However, its rating improved to moderate risk on reaching completion point in 2012.
- *Central African Republic* shifted from high to moderate risk between 2009 and 2010 after reaching completion point in 2009.
- *Comoros* went from being in debt distress in 2006 to high risk on reaching completion point in 2012.
- *The Republic of Congo*'s rating fell from high risk in 2007 to moderate in 2010 and further to low in 2011 after reaching completion point in 2010.
- *DRC* went from being in debt distress in 2007 to high risk on reaching completion point in 2010.
- *Ethiopia* improved from moderate to low risk between 2008 and 2010 after reaching completion point in 2004.

-
- *The Gambia* improved from high risk in 2007 when it reached completion point to most recently moderate in 2013.
 - *Guinea's* rating fell from being in debt distress in 2006 to moderate in 2013 after reaching completion point in 2012.
 - *Guinea-Bissau* was in debt distress in 2009, but has remained moderate since reaching completion point in 2010.
 - *Honduras* went from moderate to low between 2006 and 2008 after reaching completion point in 2005.
 - *Liberia* went from being in debt distress in 2009 to low in 2010 after reaching completion point in 2010.
 - *Madagascar* shifted from moderate to low between 2006 and 2008 after reaching completion point in 2004.
 - *Niger* moved from high risk in 2006 to moderate in 2007 after reaching completion point in 2004. It subsequently fell to low in 2010, but has returned to moderate since 2011.
 - *Rwanda* fell from high risk in 2006 to moderate in 2010 and most recently to low after reaching completion point in 2005.
 - *Togo* went from being in debt distress in 2008 to moderate risk of distress in 2011 after reaching completion point in 2010.
 - *Uganda's* rating shifted from moderate to low between 2006 and 2007 after reaching completion point in 2000.

Second, a World Bank report notes that for eight African countries (Benin, Ghana, Malawi, Mozambique, Niger, São Tomé and Príncipe, Senegal and Uganda), a third of the gain in debt stock ratios since HIPC and MDRI relief has been eroded over about four years since completion point (Lewis, 2013; World Bank n.d.). The authors warn that if these rates of new borrowing are to persist, these countries could return to pre-relief debt to GDP ratios within a decade, regardless of improved economic growth. In addition, Ethiopia, Burkina Faso and Tanzania's debt stock indicators are rising quite swiftly again.

On the other hand, looking specifically at external debt as a percentage of GNI for the 35 post-completion point countries, four experienced an increase in this ratio within four years of reaching completion point (as Figure 5 shows): The Gambia, São Tomé and Príncipe, Sierra Leone and Uganda. Countries that showed debt creeping upwards in the years even further away from completion point include Ghana, Ethiopia, Senegal and Tanzania. However, while six of these countries overlap with the 11 flagged in the World Bank report cited above (Ethiopia Ghana, São Tomé and Príncipe, Senegal, Tanzania and Uganda), this data is not in terms of present value and can be misleading, given that loans to LICs tend to vary considerably in their interest rates and length of repayment, and hence may not be suitable for comparisons over time and across countries.

Figure 5: Increasing external debt to GNI for four post completion point countries, 2000-2011



Source: World Bank International Debt Statistics.²¹

In sum, while HIPC countries, on average, have experienced substantial improvements in their debt ratios over the past seven years, there is some variation across countries. For example, some have seen their debt indicators deteriorate after receiving debt relief. Uganda's NPV of external debt to exports had reduced to 150% at end-June 1999 and swelled to 260% (30% of GDP) within three years of reaching completion point in 2000 (IDA and IMF, 2004).²² More recently, its ratio of present value of external debt stood at 21% in 2011, compared with 13.5% in 2009. In present value terms, Tanzania's external debt has also steadily crept upwards, from about 14.5% of GDP in 2007 (post HIPC/MDRI) to 32.9% of GDP by end-June 2011.²³

Moreover, fiscal balances and public debt ratios in Sub-Saharan Africa have exhibited notable heterogeneity and variations, including during the aftermath of the global financial crisis. Although 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, 2013c). Most of the other countries, especially some of the fragile states, could not adopt counter-cyclical measures during the crisis, because of 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 the international financial institutions. Overall, with some exceptions (e.g. Cameroon and Eritrea, the latter a pre-decision point HIPC), there was little accumulation of arrears (ibid.).

While not necessarily being a problem by themselves, rising debt ratios should be monitored and their underlying dynamics and drivers analysed. The next section (on drivers of debt accumulation) and Section 3.2 (on relatively 'new' debt-creating flows) serve this scope.

²¹ See Annex for graphs for all 35 post-completion point countries.

²² This owes primarily to a sharp decrease in the international price of robusta coffee, Uganda's principal export, lower-than-projected growth of services exports and a decline in the discount rate

²³ DSAs for FY2013, 2011 and 2010.

3 Risk and opportunities for debt sustainability

3.1 Is debt sustainable in HIPCs? Mixed evidence is emerging from the literature

While there is no agreed definition of debt sustainability, one of the key definitions underlying the HIPC/MDRI 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).²⁴ Based on this broad definition, there is a range of criteria for evaluating debt sustainability, using the NPV of debt and debt service as shares of GDP, exports and revenues, with this report mostly using the first ratio.

Why debt is sustainable

One argument is that debt is sustainable since debt relief has succeeded in eliminating the debt overhang and most HIPCs are engaging in what some have described as responsible borrowing (World Bank, n.d.). As mentioned previously, debt stock ratios – which fell dramatically with debt relief – have risen only slightly in most post-completion point HIPCs. The World Bank estimates that, in the 26 African countries that benefited from HIPC/MDRI, nominal public debt fell from a GDP-weighted average of 104% of GDP before debt relief to 27% after irrevocable debt relief (in most cases around 2006); by 2011, the ratio had risen to only 34% (ibid.). More importantly, this slow build-up of debt pattern holds for both natural resource- and non-resource-endowed economies, and thus goes beyond favourable commodity prices. An additional contributing factor identified in the literature includes responsible lending by the World Bank and other development banks that gave grants in place of loans to poorer, riskier countries (owing to their debt limit policy), and offered loans on blend terms to countries that were slightly better off. On the demand side, a prudent approach to borrowing has also taken hold in some countries that benefited from debt relief, with countries monitoring debt ratios against projections of future needs and future economic growth through joint assessments of their debt sustainability with the IMF and the World Bank. In fact, most of the existing analysis that defends the sustainability of debt levels in HIPCs relies heavily on these quantitative assessments of projected debt trajectories.

The two main approaches to quantitatively assess debt sustainability are (i) the DSA undertaken by the IMF and the World Bank, which compares baseline five-year forecasts with thresholds combined with stress testing for adverse shocks; and (ii) the debt-stabilising primary balance approach. In its simplest form, the latter looks at the current debt to GDP ratio and computes the primary balance that would permanently keep this ratio unchanged. This requires two assumptions: what the

²⁴ There is also a human factor approach to debt sustainability, which this paper does not address. A debt is deemed to be 'affordable' if it is compatible with the stabilisation of the debt to GDP ratio and it allows for an improvement in the standard of living. In general, this means that part of GDP, or of the value of exports, has to be set aside for poverty reduction expenditures, prior to debt service. Thus, debt may be regarded as sustainable in financial terms, but may be absolutely unaffordable for a LIC (see Vaggi and Prizzon, 2013).

evolution of the real interest rate will be and what the potential growth rate is. Typically, past trends are assumed to remain stable over the indefinite future, but shocks can be factored in just as in the DSA.

The DSA suggests the medium-term debt outlook for Sub-Saharan Africa is generally favourable, given projected economic outlooks for the region (IMF, 2013c). This favourable prognosis tends to hold even when more conservative thresholds are adopted. The second approach, the debt-stabilising primary balance, is used in another IMF report (IMF, 2013b). The IMF report concludes that, in most Sub-Saharan African 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, the major exception being in some fragile states. Nonetheless, it is important to note that the reliability of the IMF and World Bank's projections has been criticised on the grounds that the economic assumptions are overly optimistic (Beddies et al., 2009; JDC, 2012; UN, 2013b).

Most commentators on the sustainability of new borrowing emphasise that debt is sustainable provided it is channelled to growth-enhancing assets that generate the export income to repay the debt back. In fact, several authors defend the increase in non-traditional sources of finance, such as loans from China, on the grounds that 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 (Brautigam, 2011; Davies, 2007; Mwase and Yang, 2012; Reisen and Ndoye, 2008) (see also Section 3.2 on the role of emerging lenders on debt sustainability). Conversely, borrowing for low-return spending at real interest rates that exceed longer-term economic growth, with repayments that spike in a given time period, reflects poor economic management, and can lead to insolvency and liquidity crises as market sentiment turns. Selecting good public investments is therefore critical to keep debt levels under control. Unfortunately, the extent to which post-completion HIPCs have succeeded in this regard has not been adequately assessed in the literature.

Why (and when) debt is unsustainable

Despite the favourable outlook noted above, several authors express concerns over the recent and rapid accumulation of increasingly non-concessional debt in several post-completion point HIPCs. In particular, they 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; Yang and Nyberg, 2008). In general, several LICs may not be in a position to generate sufficient revenues to repay the debt incurred, exposing them to greater solvency and 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 towards unproductive uses (Beddies et al., 2009).

Furthermore, several studies identify persistent 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, the natural consequence of some countries running persistent deficits is that they have to borrow to finance them (Ellmers and Hulova, 2013). One study finds that, for 31 HIPC completion countries for which there are data, only one (Bolivia) had a current account surplus on average between 2001 and 2011 (JDC, 2012). Of the other 30, 22 had a current account deficit of more than 5% of their GDP over the decade. In general, improving a negative current account

in a low-income economy with undiversified exports 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). Thus, substantial debt reduction to make debt manageable needs to go hand in hand with collective effort to enable debtor countries to generate the surpluses they need to repay new debt.

The sustainability of new external debt commitments also remains vulnerable to external shocks such as natural disasters or volatile commodity prices (JDC, 2012).

Another potential threat to debt sustainability flagged in the literature is the increasing use of riskier sources of debt financing such as PPPs (some of which can result in fiscal risks and contingent liabilities) and foreign borrowing on less concessional terms (Beddies et al. 2009; IMF, 2013c; Presbitero, 2009; World Bank, n.d.). The subsequent section explores this threat in more detail. Moreover, as mentioned before, in the long run it is not just the volume and terms on which countries borrow that determine debt sustainability, but what they borrow for.

In sum, while the benefits of debt relief have persisted in most post-completion countries, studies so far provide mixed evidence on long-term prospects for debt sustainability, with several caveats attached to even the most positive assessments.

Debt dynamics

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. While external debt relief under the initiatives inevitably contributes to debt stock reduction, other critical variables include GDP growth (g), the interest rate on new debt (r), changes in the real exchange rate over time (e), the level of primary surplus as a percentage of GDP (ps),²⁵ a variety of contingent liabilities as a percentage of GDP (c)²⁶ and seignorage (s) as a percentage of GDP.²⁷ In its simplest form, the fundamental drivers of debt to GDP ratio (d) can be expressed as:

$$\dot{d} = d(r + e - g) - ps + c - s$$

This equation shows debt relief can fundamentally change debt dynamics when the sum of the interest rate and the rate of depreciation of the real exchange rate exceed the growth rate of the economy. Thus, what have been the main driving factors of debt dynamics in recent years?

First, for low-income Sub-Saharan African countries between 2002 and 2012, the IMF (2013b) found the most crucial factor driving the decline in debt ratios was real GDP growth (-32.9), with no significant impact from real exchange rate appreciation (-13.7). Among fragile states, a few still exhibit high debt to GDP ratios, but most have experienced sharp declines (e.g. Burundi, Central African Republic, DRC and Liberia) (ibid.).

Second, despite having a slight different sample, Dömeland and Kharas (2009) largely confirm the findings of the above analysis for the case of 24 HIPC completion point countries (as of 2009). The overall decline in the debt ratio in

²⁵ The primary balance is the government's fiscal balance excluding interest payments from expenditure.

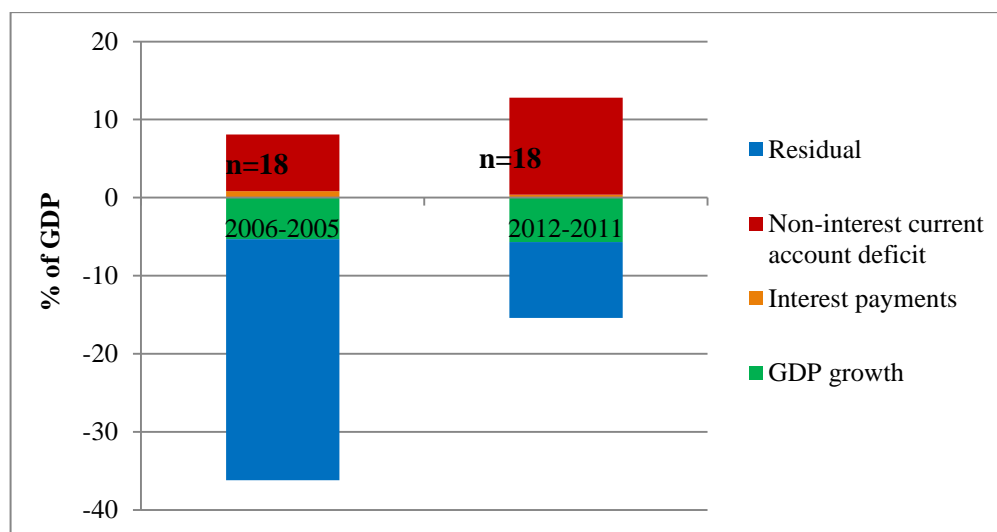
²⁶ Contingent liabilities are typically off-budget items and, for HIPCs they typically include government guarantees and unfunded pension liabilities. Other forms of contingent liabilities are bailouts of the financial system to protect bank deposits. In other instances, they include payments by governments to companies that are too big to fail or payments tied to a previously guaranteed level of activity.

²⁷ Seignorage refers to interest-free high-powered money creation.

post-completion point countries was much higher than the decline attributable to debt cancellation, suggesting these countries would have shown a market reduction in their debt ratios even in the absence of debt relief (assuming debt relief does not affect growth). The main additional factors contributing to the decline in debt in post-completion point countries over 2001-2007 were higher growth and real appreciation of the currency (caused in part by strong commodity prices in recent years), though the latter appears relatively less important. These factors reduced the debt to GDP ratio by about 10 percentage points each year between 2001 and 2007. More recently, the IMF (2013b) found strong spending growth (e.g. public investment) was pushing up debt ratios in LICs, despite negative interest rate growth differentials.

In Figure 6 we consider a simplified approach as in Borensztein et al. (2006) and decomposed debt dynamics for the external debt to GDP ratio for 18 HIPC countries²⁸ for which data were available both right before the MDRI and most recently (2011 and 2012). The residual component (including debt relief) unsurprisingly dominated debt dynamics in mid-2000. Changes attributed to GDP growth were more or less constant across the two time periods. What differs is the role played by negative (non-interest) current account balances in debt accumulation, which increased from 7.3% of GDP in 2005-2006 to 12.4% in 2011-2012.

Figure 6: Debt accumulation decomposition, 2005-2006 vs. 2011-2012



Source: Authors' calculations on the basis of World Bank World Development Indicators 2014.

²⁸ Bolivia, Burundi, Cameroon, Ethiopia, Gambia, Ghana, Guinea, Guyana, Haiti, Honduras, Malawi, Mozambique, Nicaragua, São Tomé and Príncipe, Sierra Leone, Tanzania, Uganda and Zambia.

3.2 The new landscape of development finance: new sources may pose a threat for debt sustainability in HIPCs

It is widely acknowledged that the development finance landscape has changed visibly in the past 10 years in terms of actors, motives and instruments (Severino and Ray, 2009; Shakif, 2011), and developing countries have more options to finance their national development strategies. These range from assistance from non-DAC donors, philanthropic organisations and the private sector to climate finance, PPPs and vertical health funds, to cite just some (Greenhill et al. 2013). However, some of these flows are debt creating, and their financial terms and conditions may also be non-concessional terms.

At the same time, some former HIPCs – such as Ghana, Senegal and Zambia – have graduated from low-income to lower-middle income status in recent years, approaching the income threshold from which they will no longer be eligible for financing via the World Bank (and regional development banks’) soft window (the IDA in the case of the World Bank). Some development partners consider phasing out countries or shifting aid modalities from grants to (concessional) loans when they reach middle-income status, so as to concentrate efforts on the poorest and most fragile countries.

Against this backdrop, what are the implications for debt sustainability of the relatively new debt-creating flows and of the changing financing mix of development finance for lower-middle International Bank for Reconstruction and Development (IBRD) countries? This section first provides a few reflections of the potential outlook of non-concessional financing following IDA graduation. Afterwards, it reviews the opportunities and challenges for debt management associated with ‘new’ (or less explored than external) debt-creating flows such as access to international capital markets, PPPs, blended and climate finance, development finance from (re-)emerging sovereign donors and domestic debt.

Graduation into MIC status and from IDA and soft windows

At the time of writing, 62 countries are IDA-eligible. This means they can access concessional loans²⁹ from the soft loan window of the World Bank Group (the IDA). Loans have a 40-year maturity, a 10-year grace period, principal repayment at 2% for 11 to 20 years and 4% for 21 to 40 years with a service charge of 0.75% of the loan (no interest payments). These conditions are such that loans are highly concessional (see World Bank, 2013).

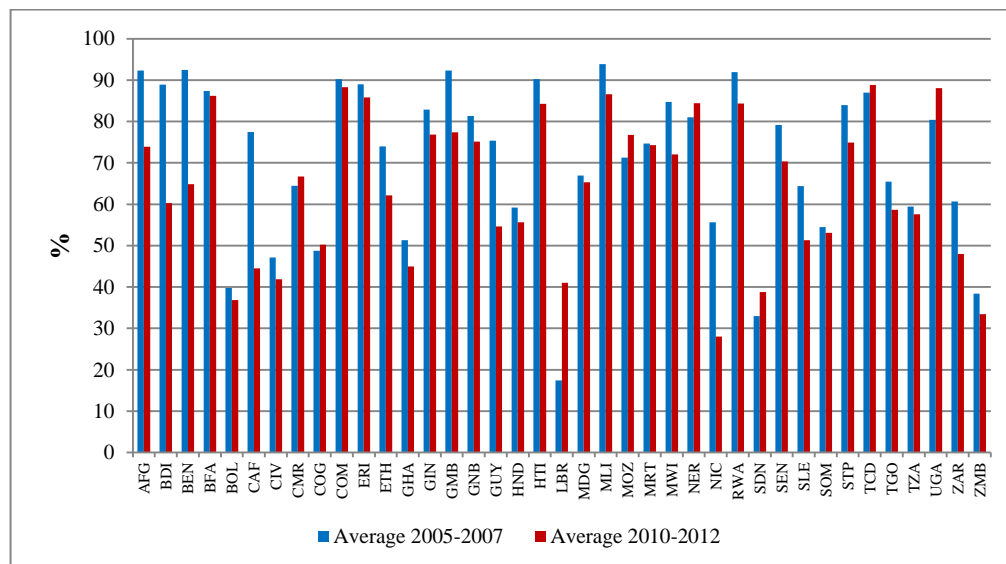
According to some projections (Moss and Leo, 2011), by 2025, only 37 countries will be IDA-eligible: 24 are former HIPCs. More than 80% will be African, and nearly 60% will be those currently considered fragile or post-conflict, based on conservative growth estimates. The graduation into first blend and then IBRD entails different terms and conditions for loans in terms of shorter maturity (up to 30 years including the grace period, as long as the weighted average maturity does not exceed 18 years),³⁰ higher interest rates (0.24% or 0.60% above the London Interbank Offered Rate (LIBOR) depending on whether the loan is on a variable or fixed rate over LIBOR), a front-end fee rate and flexible repayment terms. Ultimately, if the fast-growing economies continue to expand at the rates they are experiencing, the IDA and the African Development Bank (AfDB) are set to become relatively less important creditors to them. It is worth noting that World Bank (n.d.) evidence shows that countries move into commercial borrowing once

²⁹ Concessional loans measured on the basis of the DAC rule of 25% grant element based on a 10% discount rate.

³⁰ See http://treasury.worldbank.org/bdm/pdf/Handouts_Finance/Major_Terms_Conditions_IFL_Jan_10.pdf

IDA ceilings have been reached.³¹ Uganda was mentioned as the only exception but its unused IDA balance was less than 1% of its financing needs.

Figure 7: One out of four HIPCs have less than 50% of their external debt in concessional terms (minimum 25% grant element) – share of concessional debt (%) of total external debt



Note: Based on 2010-2012 and 2005-2007 average, respectively.

Source: World Development Indicators (2014).

The share of concessional financing declined in nearly all HIPC countries from 2005-2007 up to 2010-2012 (Figure 7)³² – the blue bar indicates the 2005-2007 average and the red one the 2010-2012 average. The rise in non-concessional financing has also to be attributed to new architecture of facilities for LICs by the IMF in 2009 designed to make the facilities more flexible and responsive to the different needs of LICs (Baduel and Price, 2012). Furthermore, more flexible guidelines on external debt limits were introduced in IMF-supported programmes where LICs can take on more debt to support investment in high-return, macro-critical infrastructure.

Finally, it is worth recalling that, as Berg et al. (2014) point out, the DSF remains the main instrument to determine the share of grants and loans from sovereign donors and MDBs (in particular the World Bank and AfDB) and that the grant/concessional loan mix depends on the credit rating: countries at high risk of debt distress are expected to receive all their assistance in the form of grants.

Access to international capital markets

Many LICs are seeking to exploit this borrowing space to finance public investment and are increasingly relying on borrowing on non-concessional terms. Since 2007, several HIPC countries (such as Ghana, Mozambique, Rwanda, Senegal, Tanzania and Zambia) have issued sovereign US dollar-denominated bonds in international capital markets, with an average of a \$1 billion tranche; te Velde (2014) estimates that bonds issued in Sub-Saharan Africa in 2013 were equivalent to 20% of bilateral aid and 12% of foreign direct investment to the region (for a total of nearly \$6 billion in 2013). According to Sy (2013), countries like Kenya³³ and Uganda are

³¹ For those countries that are eligible for loans under the DSF.

³² Chad, Comoros, Liberia, Mozambique, Niger, Sudan and Uganda are the exceptions.

³³ Kenya was not eligible under the HIPC Initiative

expected to issue bonds in the near future as well. These Sub-Saharan African governments – including several HIPCs – have issued international sovereign bonds for a variety of reasons, ranging from deficit financing (including to increase public infrastructure spending, with sovereign bonds being one of the few financing options (see Greenhill et al., 2013 and Prizzon, 2013 for the case of Zambia)), to benchmarking (see te Velde, 2014 on expanding international market access for firms), from public debt management (including debt restructuring) to increasing public spending and replacing public debt falling due.

Ability to access international financial markets is partly the result of declining debt ratios and better macroeconomic conditions, but it also reflects growing flexibility in IMF limits on borrowing at non-concessional rates (for those LICs under an IMF programme) and interest rates in frontier Sub-Saharan African economies that are high enough to attract foreign investors (Sy, 2013), associated with quantitative easing in developed countries (te Velde, 2014) and low global risk aversion.

While these instruments offer diversification at a substantially lower cost than domestic debt (but again are far more expensive than concessional loans), Eurobonds bring interest rate and exchange rate/currency rate risks. This section outlines benefits and risks associated with this financing option.

Among the benefits, first, sovereign bonds reduce the pressure on the government's cost of borrowing, as terms and conditions are usually more favourable than alternative public external debt instruments (IMF, 2013c). In other words, sovereign bond issuance can help lower debt servicing costs by substituting outstanding public external debt instruments (also denominated in a foreign currency) contracted at higher interest rates with sovereign bonds with lower coupon rates, longer maturities and no amortisation for a significant time.³⁴ For instance, Senegal issued a 10-year \$500 million Eurobond in the first half of 2011, replacing a five-year \$200 million bond issued in 2009; this allowed it to achieve a significant maturity extension (IMF, 2013c).

Second, international sovereign bond issuance can provide a benchmark for pricing corporate bonds in international markets, over time expanding the yield curve, and help increase access for the private sector and parastatal companies. The rise in sovereign bond issuances can be ascribed to prevailing good macroeconomic conditions in issuing countries.³⁵ Accessing international markets through a sovereign bond can strengthen macroeconomic discipline and move forward transparency and structural reforms as a result of increased scrutiny by international market participants.

Finally, the size of the sovereign bond issuances can help finance long-term projects such as infrastructure development when other financing resources, such as traditional ODA, are not available or sufficient to meet financing needs.

³⁴ According to IMF (2013c), however, the main effect of bond issuances to date has been on the composition of public debt, rather than levels. For the non-restructuring cases, the immediate impacts on the size of total debt are modest, although Ghana and Senegal saw their debt ratios rising after their bond issuances. For the debt-restructuring cases, debt ratios declined significantly, with the new international sovereign bonds replacing debt in default or restructured.

³⁵ Symmetrically, for example, the Ghanaian government has suspended Eurobond issuances due in spring 2014 because of the high large spread associated with high fiscal deficit (see <http://www.africanbondmarkets.org/news-events/article/update-2-ghana-puts-1-bl-eurobond-on-hold-till-markets-improve-46413/>). In the same vein and in non-HIPC countries there are concerns about forthcoming issuances of Eurobonds by the Kenyan government, as debt levels above 50% of GDP are considered 'worrying' in light of rising recurrent expenditure and sluggish development expenditure (see All Africa (2014) here). More recently, Zimbabwe failed to secure funding on international markets owing to concerns about its national debt overhang (see http://allafrica.com/stories/201404240530.html?aa_source=nwsltr-debt-en).

However, leveraging on Eurobond issuances among the government's financing options brings considerable macroeconomic risks, which need to be managed carefully to avoid unaffordable debt payments or even default.

First, there is an interest rate risk (and roll-over risk). After years of historically low global interest rates, borrowing costs on long-term debt are expected to rise. Under these conditions rolling over the debt may not be a feasible option any longer and investors' interest may shift (Sy, 2013). For instance, Zambia's yield on its first Eurobond increased from 5.2% in 2012 to 8% in early 2014 (te Velde, 2014). Repayment is usually at maturity (bullet repayment) rather than amortised over time; a strategy for ministries of finance consists of setting aside resources (such as via a sinking fund) to repay the bonds back at maturity.

Second, these bonds are usually denominated in US dollars, entailing an exchange rate risk. According to te Velde (2014), Ghana issued a foreign-currency denominated bond in 2013 and its coupon rate was 7.875%. Interest rates on local debt are much higher, at around 19-23%. However, if we take into account exchange rate devaluation (more or less 14% each year since 2007), the nominal difference between the two rates (on foreign-currency denominated bonds and on domestic debt) becomes much narrower.

Third, there are significant policy challenges for macroeconomic management. For instance, Sy (2013) indicates that the Seychelles³⁶ defaulted on a \$230 million Eurobond in 2008 following a sharp fall in tourism revenues during the global crisis, as well as years of excess government spending.³⁷ Côte d'Ivoire missed a \$29 million interest payment in 2011 on a bond that was issued in 2010 following election disputes. Furthermore, there are risks of sudden reversal in investor risk appetite and of exchange rate appreciation as a result of pressure for the domestic currency.

Fourth, Eurobonds may be harder to restructure than bank loans, given the multitude of creditors involved.

Finally, as per other development finance flows, capacity to serve these obligations may be affected by limited administrative capacity, weak fiscal institutions, low efficiency of public investment expenditure and governance issues prevailing in some Sub-Saharan African countries, with projects poorly selected or executed.

Public-private partnerships

According to the Organisation for Economic Co-operation and Development (OECD) (2011b), PPPs are a way of delivering and funding public services using a capital asset where project risks are shared between the public and the private sector. There is increasing interest in this financing modality, which features prominently in several national development strategies (see Greenhill et al., 2013), and thus technical assistance programmes by MDBs.

PPPs are perceived as a financing modality to leverage private sector resources to contribute to large-scale infrastructure projects that the government may not otherwise be able to finance and/or implement.

However, PPPs do not come at no fiscal cost, and they can entail risks for debt sustainability (Caliari, 2014), with some (notably Ellmers and Hulova, 2013) referring to contingent liabilities (which also include liabilities of state-owned enterprises beyond PPPs) as a time bomb that could detonate at any time. Managing

³⁶ Seychelles was not eligible under HIPC assistance.

³⁷ The default led to debt restructuring and government spending cuts.

PPPs has proved challenging also in the case of advanced economies, such as the UK (see HM Treasury, 2012) with the Private Finance Initiative (PFI), which did not bring sufficient value for money or transparency, on both deals and future liabilities to taxpayers.

First, PPPs usually require upfront fiscal incentives and transfers from the host government (Caliari, 2014). Second, although the debt to pay for the infrastructure in PPPs is officially taken on by the private sector and does not appear in the government's books, PPPs give rise to obligations on the part of the government to purchase services from a private operator and to honour calls on guarantees (JDC, 2012). In the same vein, services provided by private operators have implicit opportunity costs in terms of foregone revenues from levying tariffs or user fees (Caliari, 2014). Third, Caliari (2014) also points out that PPPs may appear less fiscally onerous by pulling expenses off the balance sheets, bypassing controls and taking advantage of loopholes in accounting conventions with a lower level of transparency and accountability than on-budget public liabilities. Fourth, PPPs are the most expensive financing modality (DG for External Policies of the Union, 2014). More and more countries are leveraging on this financing modality (PPP finance more than a third of Infrastructure for IDA-eligible governments), with costs being non-transparent and non-accountable to auditors, parliaments or civil society.³⁸

Estimates of the impact of contingent liabilities on debt sustainability are not included in the current DSF, but it has been noted among issues for discussion (IMF, 2013a). PPPs are treated as off-budget transactions, thus encouraging countries to use them in order to circumvent national or IMF-agreed debt limits (DG for External Policies of the Union, 2014). Given the potential impact of these instruments on public debt, now more than ever the expansion of infrastructure financing should be matched with an improved monitoring framework in relation to macroeconomic risk.

Lending from (re-)emerging sovereign donors

Financial resources from non-DAC donors to developing countries have surged in recent years, especially from countries such as Brazil, China and India. They view their financing as based primarily on the principles of South–South cooperation, focusing on mutual benefits (without policy conditionality) (Greenhill and Prizzon, 2012; Mwase and Yang, 2012). However, most of these new resources are not ODA-equivalent (i.e. grants or concessional loans), but they could be assimilated to other official flows (OOFs), which, among other criteria, may fail to meet the minimum 25% grant element for ODA eligibility. For example, Brautigam (2011) argues that China provides only a small amount of ODA to Africa – only around \$1.4 billion in 2007 – as the majority comes as OOFs. Another study (Lum et al., 2009) took a broader approach, characterising many more types of flows, including state-owned companies investing abroad, as ‘aid and related activities’. The authors arrived at an estimate of \$18 billion in annual aid and related activities to Africa.

These wide-ranging estimates – \$0.58 to \$18 billion in annual aid to Africa – have significant implications for how China should be considered as a donor on the continent in comparison with DAC donors. If the upper estimate is to be believed, China gave three times more assistance to Africa in 2007 than the US provided the continent in ODA (\$5.3 billion). According to Strange et al. (2014), at country level China is a larger source of official finance than the US in Ghana, DRC, Ethiopia

³⁸ A recent publication by Oxfam (2014) reviewed the case of the Queen Mamohato Memorial Hospital in Lesotho, opened in 2011 – with PPPs delivering all clinical services. Running costs were three times higher than for the old public hospital and not matched by improved outcomes, estimated at half of the government health budget.

and Sudan, to cite just a few examples. In the early 2000s China was already providing almost the same amount of official financing to Africa as the US. At its peak in 2007, China was providing almost twice the amount of total US ODA and OOFs to Africa, and almost half the amount of ODA and OOFs of the entire OECD-DAC combined (ibid.).

Furthermore, according to the latest World Bank International Debt Statistics (2014), most bilateral debt inflows are coming from non-traditional developing country creditors, notably China, and to a lesser extent Brazil and India.³⁹ The bulk of these flows (not necessarily concessional) have been directed to large-scale infrastructure projects, and half of net inflows have been concentrated in four countries: Ethiopia, Ghana, Mozambique and Senegal.

In some cases, loans from emerging lenders are considered a potential threat to debt sustainability.⁴⁰ This was the case for DRC in 2007-2009, when the government negotiated a much lower deal with the Chinese Exim bank (from \$9 billion initially negotiated, down to \$3 billion dollars), as a result of concerns among traditional donors with regard to future debt sustainability (most of the loan was not on concessional terms and the debt stock at that time was around \$13.1 billion (see Jansson, 2011)). Loans from emerging economies have harder terms than those from the soft windows of MDBs (see Greenhill et al., 2013 for a review).

Against this backdrop, what are the risks for debt sustainability associated with growing (non-concessional) liabilities from these providers?

First, several authors have argued that there is little transparency on the exact terms of Chinese loans and on which countries what loans are given to, so it is difficult to know if Chinese lending is a threat to the debt sustainability of poor countries, and if so how big a problem this is (Davies, 2007). However, in principle, all the information on all the loans should be recorded in the DSA if the country is under an IMF programme. Transparency – at least with IMF authorities – may be lacking only when, unsurprisingly, the country does not currently have or has suspended an IMF programme in the past, and when liabilities are attributed to state-owned enterprises.

Second, criteria to evaluate the sustainability of loans from emerging lenders differ from those applied by more traditional sovereign actors. 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; Reisen and Ndoye, 2008). More specifically, China and India look at the potential of African countries in the long term (what Kaberuka in a recent interview defined as development sustainability),⁴¹ rather than assessing their immediate ability to repay loans. The argument would be that China's assistance and cooperation contribute to better terms of trade, increased export earnings and growth figures, and the countries will be better placed to service their loans and thus less vulnerable to a new debt crisis (see also Section 3.1).

³⁹ Most of the assistance provided by bilateral donors is recorded in the form of grants, though.

⁴⁰ Both China and India not only offer a mix of concessional and non-concessional financing but also have a long history of debt forgiveness. In fact, a common response from Chinese scholars to the question of the risk of a debt build-up for African countries is that China does not expect African countries to pay back if it is a government-to-government loan, and that China will cancel debts if borrowing governments face pay back difficulties (Davies, 2007). Brautigam and Gaye (2007) and Sautman and Hairong (2009) note that China regularly cancels African loans, usually extended at zero interest, without policy conditionalities attached. In some cases, China has provided debt relief that exceeds the HIPC Initiative (Mwase and Yang, 2012). Moreover, India offers bilateral debt relief (by 2008, India had written off debt totalling \$24 million) (Kragelund, 2010).

⁴¹ See <http://www.africa-confidential.com/interview-with-donald-kaberuka>

However, these are familiar arguments about effectiveness and the growth-enhancing effects of development projects (and in turn of their financing source). They should be valid for all liabilities negotiated and contracted, not only for those from emerging lenders: the ability of the project approved and financed to generate additional revenues (not only to service the loan) should be embedded in any feasibility study and assessment. Although high project returns are essential to debt sustainability at the macroeconomic level, it does not automatically lead to sufficient fiscal revenue to repay the associated debt (Mwase and Yang, 2012). Repayment is unlikely if the project is not self-financing (i.e. it does not generate its own revenues; – a toll road, for instance, would be self-financing) or growth enhancing (i.e. the tax base does not expand) and/or if there is no tax reform (on tax rates) and/or tax administration reform (on tax and revenue collection).

Against this backdrop, all the authors who have investigated these issues so far have not found any threats – or at least a different set of threats – associated with liabilities from these emerging lenders. The financing model whereby loans are guaranteed by natural resources (agricultural and mineral) – traditionally known as the ‘Angola mode’ – do not come with an implicit threat to debt sustainability (Brautigam, 2011). However, this argument overlooks the fact that, while debt sustainability may be preserved, natural resources are generally estimated and sold at prices below market rates, jeopardising potential total revenues, and they mortgage future export revenues, which may be needed to pay for imports or other debt payments. At the same time, extraction may not take place at the pace agreed in the deal, and loan tranches may be released with a delay, as in the case of Ghana (Prizzon, forthcoming). Reisen and Ndoye (2008) found little evidence of ‘imprudent lending’ to debt relief beneficiaries in the figures up to 2006. Analysis of debt dynamics shows the Asian giants lower debt ratios a little through debt relief, but they do this even more through stimulating exports and growth. This holds in particular for those countries towards which most of their lending is directed – the resource-rich countries (see Melina et al., 2014) – rather than the debt-relief beneficiaries.

Overall, any alleged China-induced deterioration of debt ratios is not (yet) visible in the broad values of NPV debt to GDP or exports when looking at post-HIPC/MDRI debt relief (Reisen and Ndoye, 2008). Once again, debt sustainability is influenced by the extent to which new liabilities are effectively growth (and export) enhancing. African countries have achieved exceptionally high growth rates over the past decade (including non-resource-rich countries such as Ethiopia and Rwanda), and low interest rates more recently (also note that Chinese Exim Bank and Chinese Development Bank loans have variable interest rates). Again, a sudden change in both these variables (interest rates are quite low at the moment and they can only rise) can be the litmus paper of the ‘development and debt sustainability’ of these new projects. This set of issues would deserve further scrutiny and update of previous contributions.

New sources of development finance: the cases of climate finance and blended finance

Among the new motives behind the provision of development finance, climate change is one of the most prominent (Greenhill and Prizzon, 2012; Severino and Ray, 2009). While there is no agreed definition of climate finance, for the purposes of this section we consider climate finance to be ‘capital flows targeting low-carbon and climate-resilient development’ (CPI, 2013). There are several international commitments linked to the Copenhagen Accord in 2009 (\$30 billion by 2012, better known as fast-start finance, and \$100 billion each year by 2020, meant to be ‘new and additional’ – see Nakhouda et al., 2013 for a review on this issue). The

sheer size of commitments to address climate change-related issues raise an obvious question: to what extent might these flows affect debt sustainability?

One would expect climate finance to be delivered in the form of grants, meaning additional flows are not expected to have an impact on debt stocks: there have been strong arguments for the provision of climate finance in the form of grants, in line with the ‘polluter pays’ principle of compensating developing countries for the damage done by developed countries (Jones and Edwards, 2009). However, looking at the landscape of climate finance, this is not actually the case. According to the Climate Policy Initiative (CPI) (2013), climate finance provided by private and public investors in the form of grants was at \$11 billion on average in 2012, corresponding to only 3% of total climate finance. On the contrary, climate finance disbursed in the form of concessional debt (defined as financing provided at terms preferable to those prevailing on the market and including concessional loans) was \$69 billion (or 19% of total climate finance flows); the majority of climate-related finance was investment at market rate returns (\$279 billion, or 78% of total climate finance).

Reliance on loans to fund climate-related projects is motivated partially by the large volume of funds required, and the range of climate-related activities to be funded (Baudienville, 2009). Furthermore, one major concern is that, given the budgetary constraints of many donors, allocating a large share of funding to climate finance is likely to have a negative impact on the overall level of ODA (there is limited evidence on the extent to which climate finance is ‘new and additional’ to ODA flows (see Nakhouda et al., 2013). Donors are also increasingly using grants as a way to leverage larger funding volumes, notably through the use of concessional loans. In addition, concessionary loans, equity participation and partial risk guarantees with similar grant-equivalent value can often be more cost-efficient for both donors and recipients and more effective in addressing specific market failures than pure grants (Baudienville, 2009).

Blending refers broadly to the combination of grants or grant-like instruments with complementary non-grant financing from private and/or public sources with different financial terms to gain leverage and thereby increase impact (Mustapha et al., 2013). We have highlighted in previous sections that most partner countries have a large financing gap in terms of implementing infrastructure-intensive national development plans. Blended finance is one such innovative approach, enabling large infrastructure projects to be financed that would otherwise be too costly for a single donor (ibid.).⁴²

The relationship between blending and debt sustainability applies specifically to blended finance projects that increase public sector liabilities – in other words debt-creating transactions – and are therefore recorded in governments’ ledgers, as opposed to private sector debt. Blending instruments that use grant support to promote public borrowing for development investments can aggravate the debt situation of partner countries, since they can encourage countries to take on more debt. On the other hand, in comparison with pure loans, depending on its terms, blending can contribute to maintaining debt sustainability in heavily indebted countries. Indeed, blending loans with interest rate subsidies have been used by the European Union (EU)–Africa Infrastructure Trust Fund (ITF) blending facility to enhance the concessionality of loans, enabling HIPCs to comply with debt sustainability requirements (Mid-Term Evaluation of EU-Africa ITF, 2012).

⁴² In this section we refer to facilities leveraged on grant financing to mobilise private and/or private resources. PPPs are specified in an earlier section.

Rising domestic debt

External public debt is still the main component of overall public debt, but it is not as dominant as it once was, mainly as a result of debt relief. Domestic debt is likely to grow in importance as domestic savings increase and governments seek to develop domestic debt markets with the active support of the international financial institutions and other international organisations (see IMF et al., 2013). Domestic debt is also a highly heterogeneous concept, which complicates cross-country comparisons. In fact, there are three possible definitions of domestic debt: liabilities issued in domestic currency, liabilities held by residents, or debt issued under domestic jurisdiction.⁴³ Although the DSF recognises the importance of domestic debt, the framework emphasises the risks associated with external public debt.

According to Bua et al. (2014), whose analysis looks into LICs more broadly rather than just HIPCs, domestic government debt rose over the period 1996-2011.⁴⁴ We have seen in Section 2.1 that external debt in HIPCs is on a declining path; meanwhile, domestic debt is on the rise in LICs (most of them are former HIPCs) – from 12.3% of GDP in 1996 to 16.2% in 2011.⁴⁵ Moreover, in LICs, 40% of public debt in 2011 was domestic, almost three times the share observed in 1996.⁴⁶ Ghana is a notable example of domestic debt becoming larger than external debt. There are exceptions to this upward trend, such as Ethiopia, Rwanda and Tanzania, whose levels of domestic debt have decreased (Bua et al., 2014).

Proponents of domestic debt stress that domestic debt may bring some prominent benefits: lower exposure of the public debt portfolio to currency risk if and when the domestic debt is denominated in the local currency (Bacchiocchi and Missale, 2012; Hausmann et al., 2006); a lower vulnerability to capital flow reversals (Calvo, 2005); the possibility of undertaking counter-cyclical monetary policy to mitigate the effect of external shocks (Mehrotra et al., 2012); and the improved institutional infrastructure underlying the organisation and functioning of local financial markets (Arnone and Presbitero, 2010). In general, long-term domestic currency-denominated debt reduces maturity and currency mismatches and hence tends to be safer.

However, many developing countries are unable to issue long-term government securities at a reasonable cost, so they are more vulnerable to roll-over and interest rate risks. In fact, while it reduces exposure to exchange rate fluctuations (if it is dominated in the domestic currency – see Hausmann and Panizza (2003) on the ‘Original Sin’ literature for foreign currency-denominated obligations), domestic debt has harder financial terms than external debt in LICs (which is still highly concessional, despite the rising share of non-concessional borrowing in some countries). [Table 2](#) summarises data analysed by the IMF and World Bank in 2012 of 12 medium-term debt management strategies (MTDSs) elaborated by the authorities of IDA-eligible countries in 2010-2011.

⁴³ Most countries end up reporting figures for external and domestic debt by using information on the place of issuance and jurisdiction that regulates the debt contract (Panizza, 2008).

⁴⁴ Bua et al. (2014) define domestic debt on a residency basis, with the exception of for Kenya, Nepal, Rwanda, the Solomon Islands and Yemen, where the currency basis is used. On a creditor residency basis debt is domestic if owed to residents; on a currency creditor residency basis debt is domestic if denominated in the local currency.

⁴⁵ Again according to Bua et al. (2014), trends on domestic debt between HIPCs and non-HIPCs have differed since the mid-2000s – HIPCs have reduced their domestic debt since their peak of 20% in 2002 whereas non-HIPCs increased it from 12% GDP to 18% of GDP between 2001 and 2011.

⁴⁶ Arnone and Presbitero (2010) argue the share of domestic debt increased drastically in HIPCs soon after receiving external debt relief. But it decreased slightly after 2006, possibly because HIPCs have re-engaged in securing foreign financing to take advantage of the new borrowing space created by the debt relief and the lower global interest rates. The authors observed a scaling-up of public investment projects in some HIPCs.

Table 2: Cost and risk indicators of the debt portfolio in 12 IDA-eligible countries

| | | External debt | Domestic debt | Total debt |
|------------------|---|---------------|---------------|------------|
| Cost of debt | Weighted-average interest rate ¹ (%) | 1.1 | 8.9 | 3.0 |
| Refinancing risk | Average time to maturities (years) ² | 13.4 | 2.5 | 10.1 |
| | Debt maturing in 1 year (% of total) ³ | 3.5 | 45.1 | 10.4 |

Notes: 1 Interest payments in 2010 or 2011 divided by debt stock at the end of the previous year, in local currency; 2 Average of years of repayment weighted by the share of principal payments in the debt portfolio; 3 Domestic (external and total) debt maturing in one year in terms of percent of domestic debt (external and total), respectively.

Source: IMF and World Bank (2012).

In the two years considered, domestic debt recorded higher interest rates than external debt (the median interest rate on domestic debt was nine times higher than it was on external debt – 8.9% for domestic debt vis-à-vis 1.1% for external debt) as well as shorter maturities (the sample median of the average time to maturity of the domestic debt portfolio was only 2.5 years, compared with an average of more than 13 years for external debt, reflecting the latter’s concessional component). Less favourable financing terms for domestic debt are such that the interest burden of domestic debt may absorb significant government revenues, and thereby crowd out pro-poor and growth-enhancing spending. It could also crowd out credit to the private sector. When governments borrow domestically, they use up domestic private savings that would otherwise have been available for private sector lending. Given the short-term structure of the domestic debt portfolio in many LICs and emerging markets – see, for example, Christensen (2004) on Sub-Saharan Africa – governments also face a significant liquidity risk from having to constantly roll over large amounts of debt.

It is worth recalling that the discussion of total public debt (both external and domestic) has tended to be less rigorous than the discussion of external public debt in the DFS, partly because of data limitations. With domestic debt playing an increasingly important role in some countries, public debt sustainability requires more attention.⁴⁷

⁴⁷ Countries with significant vulnerabilities related to public domestic debt or private external debt, or both, are assigned an overall risk of debt distress that flags these risks in the DSA. This assessment of overall debt vulnerability complements the rating on the risk of external public debt distress.

4 What might the future look like? A few reflections on future scenarios

In the previous sections, we reviewed potential financing opportunities, but more importantly, the risks for debt sustainability of a series of financing sources that are becoming more and more prominent in LICs and former HIPC/MDRI economies that have benefited from multilateral and bilateral debt relief over the past decade, notably (external) sovereign bonds, PPPs, climate-related and blended finance, domestic debt and non-concessional flows from emerging lenders (non-DAC development partners). What do prospects for debt sustainability look like in these countries over the medium term? We have already argued in several parts of this paper that sustained growth performance in borrowing countries and low interest rates have helped keep the debt service low and increased debt affordability. Nevertheless, debt service remains very sensitive to changes in prevailing interest rates in international markets. Here, we first review the most recent forward-looking IMF analysis.

Projection of debt indicators is a necessary, albeit not sufficient, element for assessing the likelihood of keeping debt sustainable. Based on the relation between a measure of the debt burden – the numerator – and the capacity of repayment – the denominator -- we review two key debt ratios – general gross government debt to GDP and debt service to GDP – to identify which former HIPC/MDRI countries may deserve further scrutiny. This section analyses trends and projections over the period 2006-2018 for the 35 post-completion HIPCs, unless stated otherwise, based on IMF forecasts.⁴⁸

4.1 General government gross debt to GDP⁴⁹

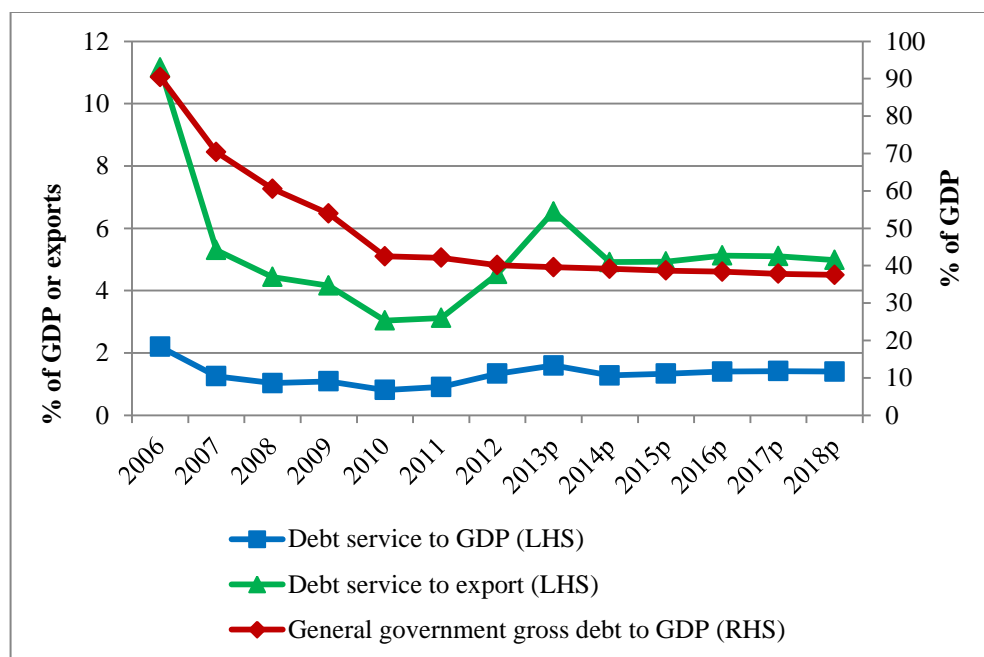
As [Figure 8](#) shows, once analysed in aggregate terms, the average public debt ratio for HIPC and MDRI countries halved between 2006 and 2010, from 90.4% in 2006 to 42.5% in 2010. While the IMF estimates this steady decline will persist for the next eight years, from 40.1% in 2012 to 37.5% in 2018, it is projected to be at a much slower rate. However, this overall positive outlook at aggregate level for all

⁴⁸ General gross government debt to GDP projections come from the IMF World Economic Outlook database and assume no changes in government policies (IMF, 2013e). Debt service to GDP figures are based on the DSA projections in the most recent HIPC/MDRI Statistical Update (IDA and IMF, 2013).

⁴⁹ 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 special drawing rights (SDRs), currency and deposits, debt securities, loans, insurance, pensions and standardised guarantee schemes and other accounts payable. Thus, all liabilities in the IMF Government Finance Statistics Manual 2001 system are debt, except for equity and investment fund shares and financial derivatives and employee stock options

HIPC/MDRI masks very different dynamics at country level. Once disaggregated by country, public debt ratios are expected to rise in 15 countries for the following 5 years (out of the 34 in Figure 9). 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 figures) (in descending order).

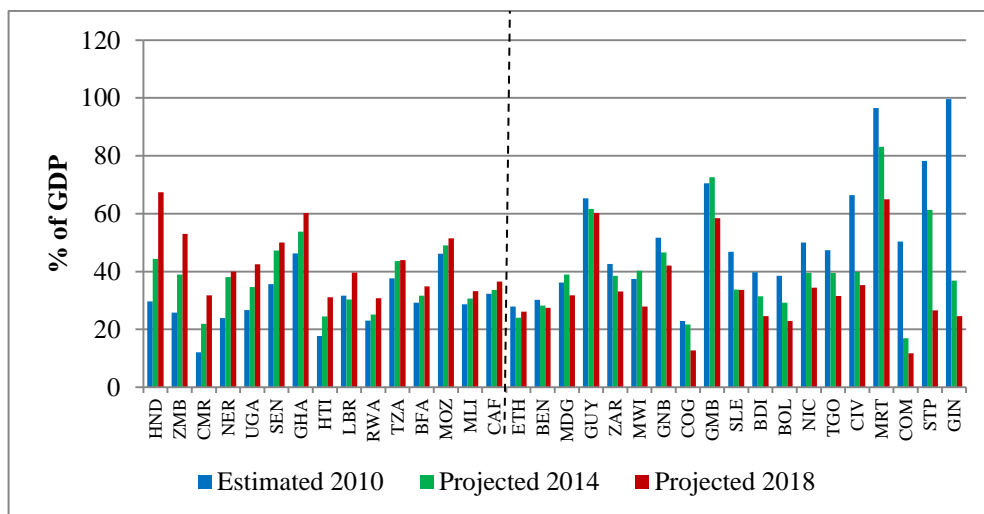
Figure 8: Average debt service to GDP and exports – general government gross debt to GDP, HIPC and MDRI countries, 2006-2018



Note: p = projections.

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

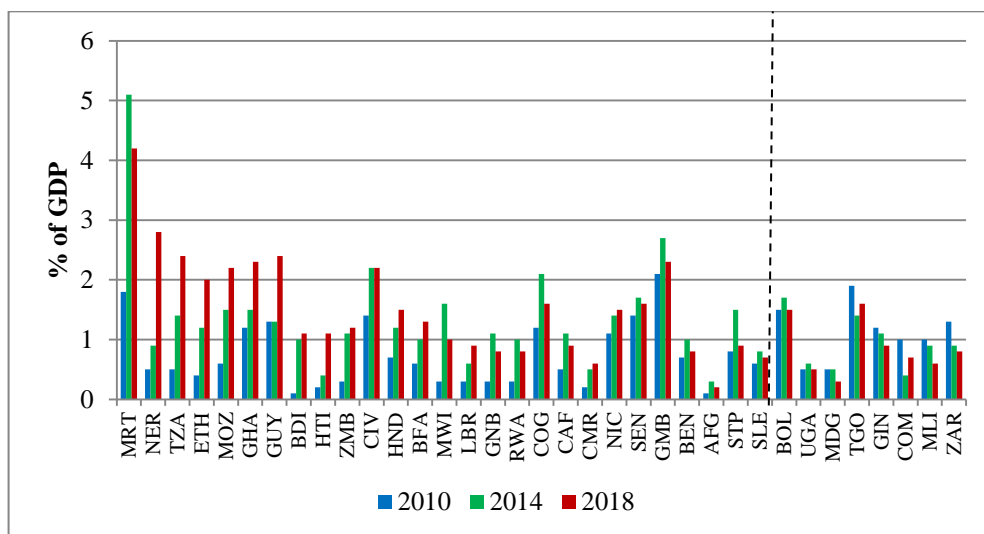
Figure 9: General government gross debt of 34 post-completion HIPCs, 2010, 2014 and 2018 (% of GDP)



Notes: The black 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). Afghanistan is excluded owing to lack of data.

Source: IMF (2013e).

Figure 10: Debt service of 35 post-completion HIPCs, 2010, 2014 and 2018 (% of GDP)



Notes: The black 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). Projections for 2018 were substituted with 2017 projections for four countries for which they were not available (Afghanistan, Benin, Mozambique and Senegal).

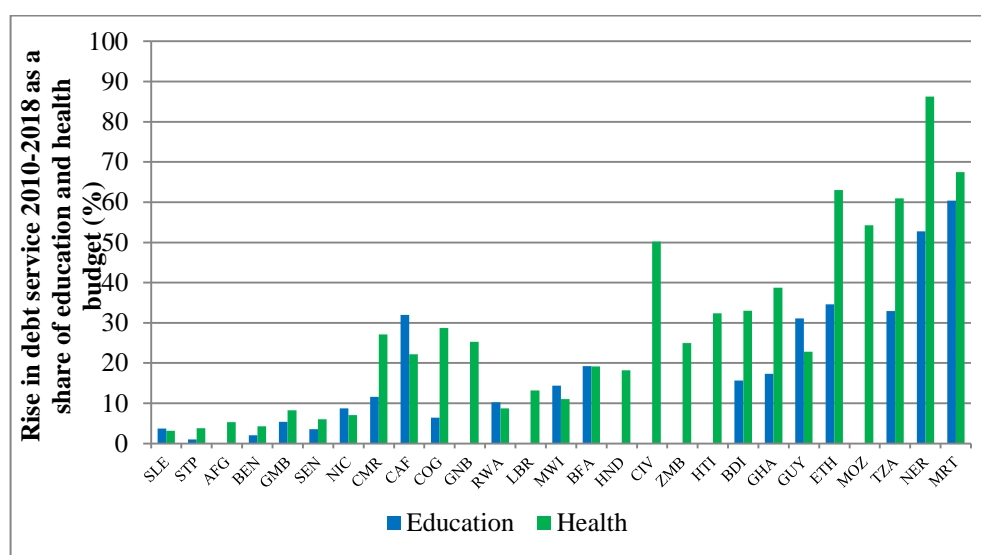
Source: IMF (2013e).

4.2 Debt service to GDP ratio

The average debt service to GDP ratio for HIPCs has been relatively stable, although it experienced a modest decline throughout most of the period, with a slight increase in the most recent years (Figure 8:). In fact, debt service as a percentage of GDP has more than halved, from a high of 2.2% in 2006 to a low of 0.8% in 2010. Based on IMF projections, 27 countries are expected to see their debt service ratio increasing between 2010 and 2018 (so half of the countries

surveyed in [Figure 10](#):). In descending order, the top 10 countries with the largest projected increases are Mauritania, Niger, Tanzania, Ethiopia, Mozambique, Ghana, Guyana, Burundi, Haiti and Zambia. In the case of Sub-Saharan African countries, DSA projections suggest the medium-term debt outlook is generally favourable, based on the projected economic outlook for the region. 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. They are based on the assumption of continued strong growth and favourable financing conditions: the interest rate growth differential – a key driver of debt dynamics – is still negative for most Sub-Saharan African countries (IMF, 2013c).⁵⁰

Figure 11: Rise in debt service 2010-2018 as a share of current education and health budgets in HIPC countries



Source: IDA and IMF (2013) and World Bank World Development Indicators.

Based on IMF and World Bank projections, JDC (2012) argues that some impoverished country governments, such as those of Ethiopia, Mozambique and Niger, could be spending as much of their government revenue on foreign debt payments in a few years as they were before debt relief. Looking at IMF projections on debt service, the rise in debt service between 2010 and 2018 would represent 4% of the current education budget in Sierra Leone and Senegal, 2% in Benin and 1% in São Tomé and Príncipe; and 5%, 6% and 7% of the health budget in São Tomé and Príncipe, Benin and Sierra Leone ([Figure 11](#)). However, while budgets may be relatively small, the rise in debt service from 2010 to 2018 could reach more than half of the education budget in Niger and Mauritania (53% and 60%, respectively) and more than half of the health budget in Côte d’Ivoire, Ethiopia, Mozambique, Tanzania, Niger and Mauritania (86.2% in the case of Niger).

While rising debt ratios are a warning signal for debt sustainability rather than a problem per se (see Section 3), the fact that public debt ratios are expected to rise in 15 HIPC countries and debt service in 27 HIPC countries by 2018 (and in some countries by a sizable amount compared with the education and health budgets), means it requires close monitoring.

⁵⁰ According to Baduel and Price (2012), in 2010, more than half of the sample countries in their study were expected to face debt growth rates that exceeded GDP growth over the near term. Some countries are projected to pay debt service costs in percentage of export earnings in excess of 10%. The grant element in new disbursements falls below 20% in Bolivia, Chad and Ghana.

5 Future agenda: what can borrowing countries and the international community do to avoid another trap?

We can summarise the analysis of the previous sections in four key messages.

First, the HIPC Initiative and MDRI have been effective in achieving their goals and objectives. In particular:

- Debt ratios have declined in HIPCs, and they are much lower than in advanced countries, having been quite resilient to the financial crisis shocks. Debt ratios in 2011 were on average a quarter of those prevailing in 2000, from 145% of GNI in 2000 to 35% in 2011.
- There is more fiscal space for social spending: HIPC/MDRI countries spent 64% less in debt service in 2011 than they did in 2000 (1.4% of GDP in 2011 compared with 3.9% in 2000).

Second, evidence from the literature on whether debt is sustainable is mixed. On the one hand, DSA suggests the medium-term debt outlook for Sub-Saharan Africa is generally favourable, given the projected economic outlooks for the region (IMF, 2013c). Several authors defend the increase in non-traditional sources of finance (such as loans from China), on the grounds that the growth effects of new lending (which is contributing to better infrastructure) and terms of trade and export performance have to be weighed against higher debt and worsened grant elements (Brautigam, 2011; Davies, 2007; Mwase and Yang, 2012; Reisen and Ndoye, 2008). Conversely, several authors express concerns over the recent and rapid accumulation of increasingly non-concessional debt in several post-completion point HIPCs because of the persistence of structural deficiencies of several HIPCs – such as a narrow export base, weak institutions and governance, poor domestic resource mobilisation, inadequate debt management capacity and irresponsible lending – undermine debt sustainability (Beddies et al., 2009; Ellmers and Hulova, 2013; UN, 2013b; Vaggi and Prizzon, 2013; Yang and Nyberg, 2008).

Third, while it has contributed to remarkable progress, as outlined above, debt relief does not guarantee future debt sustainability: some HIPC/MDRI countries, such as Ghana and Senegal, have seen their debt ratios rising.

Fourth, the changing landscape of development finance may pose a threat for debt sustainability in HIPCs, notably the following:

- Graduation into MIC status and from IDA and soft windows implies a rising share of non-concessional sources of financing.
- Financing infrastructure via international capital markets, PPPs and blended finance brings opportunities but also threats.
- (Re-)emerging sovereign donors can boost growth, but financial terms are harder.
- Domestic debt is rising: its impact on debt service will be larger than that of external debt, being more expensive.

In sum, we have seen that the initiatives have been successful in achieving some of their objectives, and most of the countries still have low debt ratios, which are on a sustainable path (at low risk of debt distress), according to the latest DSAs. However, we have also seen how some former HIPC countries (such as Ghana and Senegal) have been experiencing rising debt ratios, and the outlook may not be too favourable in terms of both debt ratios and debt service ratios. Moreover, new sources of development finance and modalities such as Eurobonds and PPPs, among others, may jeopardise results if these flows are not properly managed. How can mistakes of the past be avoided?

While discussions are ongoing regarding the principles of Responsible Sovereign Lending and Borrowing (within the UN Conference on Trade and Development (UNCTAD)), as is a review of the IMF's policy on debt limits, there are still some areas (such the definition of debt workout mechanisms) that deserve further consideration. Based on the literature and evidence reviewed in this study and also considering, more broadly, the literature on debt sustainability in the context of low-income countries, we make the following recommendations for borrowing countries, sovereign lenders and international bodies managing part of the debt agenda at international level (such as the UN Department for Economic and Social Affairs (UNDESA) and UNCTAD):

- Foster transparency of contract negotiations, debt management and public expenditure
 - ◆ More information should be provided on domestic debt at country level. As Section 3.2 showed, few analytical pieces have been published on domestic debt, as data are limited. Recently revised Guidelines for Public Debt Management (IMF, 2014c) reiterated that debt managers/government should regularly (monthly or quarterly) publish information on the outstanding stock and composition of debt liabilities and financial assets.
 - ◆ While we understand negotiations and deals between a government (particularly in the case of state-owned enterprises) and private companies are bound to confidentiality, information on general financial terms and conditions should be made public. If the government is insolvent on these deals, these liabilities may become a public concern.
 - ◆ Transparency (and auditing) should also be applied on public expenditure – that is, on how new liabilities are spent.
 - ◆ Parliamentary scrutiny should be strengthened, with members of parliament responsible for approving deals on an ad hoc basis and not the entire envelope for new borrowing for the year. If approval on a loan-by-loan basis becomes a bottleneck, scrutiny may be required for contracts above a certain threshold.
 - ◆ Transparency should also be applied to costs and risks associated with contingent liabilities, and they should be disclosed in public accounts (IMF, 2014c).

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- Continue improving debt management and coordination (whole-of-government approach) and consider developing a development finance strategy
 - ◆ Continue strengthening debt management capacity. Several training programmes mean debt management capacity has been fostered in recent years, but this new complexity of financing options requires a new skill set (towards private financial markets) that government officials may not have been developed yet, as Section 3.2 showed.
 - ◆ Empower inter-ministerial committees. Greater coordination between central agencies and line agencies means better evaluation of future commitments and provision of counterpart funding.
 - ◆ Elaborate a development finance strategy. Recently graduated MICs should actively seek to elaborate and implement an aid exit strategy or a development finance strategy to harness the challenges associated with managing less concessional sources of finance.

 - Do not underestimate risks associated with contingent liabilities
 - ◆ Debt managers should ensure the impact of risks associated with contingent liabilities on the government's financial position, including its overall liquidity, are taken into consideration when designing debt management strategies (IMF, 2014c).
 - ◆ We already have a good monitoring tool to measure whether liabilities are sustainable – and it is the DSF. This framework should aim to include contingent liabilities as well.

 - Develop a debt work-out mechanism
 - ◆ There is no debt work-out mechanism at the moment (HIPC/MDRI were meant to be one-off initiatives), and there is no mechanism for resolving debt crises when they arise. The shift towards Eurobonds/private sources are such that previously adopted bilateral and multilateral debt relief mechanisms (also under the Paris Club) may no longer be a viable option (debt restructuring and default may be the only solutions at hand). When it comes to debt restructuring in the case of Eurobonds, the international community could help define collective action clauses in developing countries' bond issues, which would protect them from minority hold-out creditors, or help promote responsible lending principles.
 - ◆ In the same vein, while there is resistance associated with potential moral hazard issues (but at the same it will provide creditors incentives to keep lending at a sustainable level for the borrower), design of ex-ante and counter-cyclical automatic triggers should be again taken into consideration to avoid further accumulation and to reduce debt service during economic downturn. Debt rescheduling in the 1980s and 1990s has not proved an effective solution to restore debt sustainability.

 - Continue strengthening macroeconomic fundamentals and achieving export diversification
 - ◆ Debt relief should be considered an opportunity for fiscal consolidation and breathing space for fiscal policy, but it does not solve the root causes of unsustainable debt accumulation. Debt relief has to be matched with lower current account deficits; lower exposure to commodity price volatility via export diversification (and the revamped negotiations towards economic partnership agreements is very welcome news); well-designed investment programmes with identification of key bottlenecks

for the economy and timely project implementation; a fight against corruption and misappropriation of funds; greater efficiency in government spending and revenue collection; performance-based budgeting; and a strategic approach to the identification of the best financing options in terms of financial costs, maturity and payment structures to be matched with new projects. This is no easy recipe, but without these policies a debt trap may still manifest on a cyclical basis.

- More analytical work is needed to shed some light on the implications of the new sources of development finance for debt sustainability
 - ◆ There is scope for some of the analysis to be updated, as data availability has expanded (e.g. on Chinese engagement in partner countries: see Chinese White Aid Paper⁵¹ and Strange et al. (2014)), and the impact of debt relief initiatives can now be evaluated in the medium term. Both the impact of rising lending on non-DAC donors and that of graduation from the soft windows of the MDBs on debt sustainability deserve further scrutiny.

⁵¹ See link [here](http://news.xinhuanet.com/english2010/china/2011-04/21/c_13839683.htm): http://news.xinhuanet.com/english2010/china/2011-04/21/c_13839683.htm

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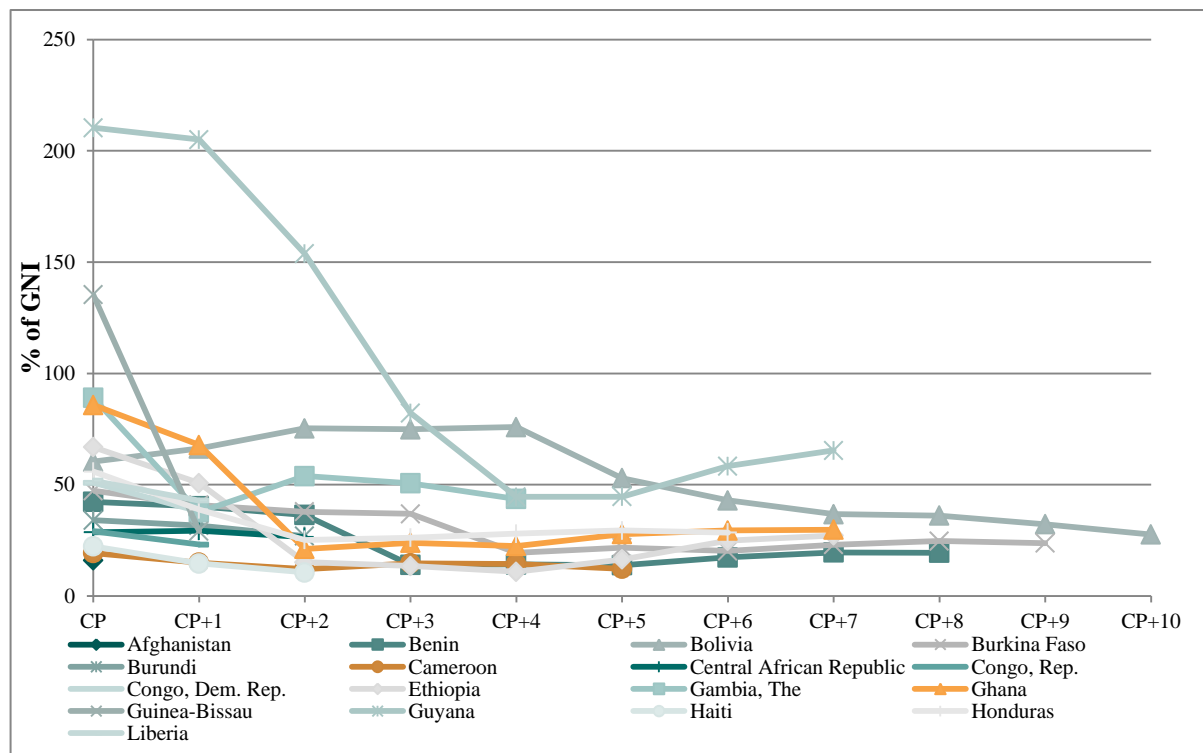
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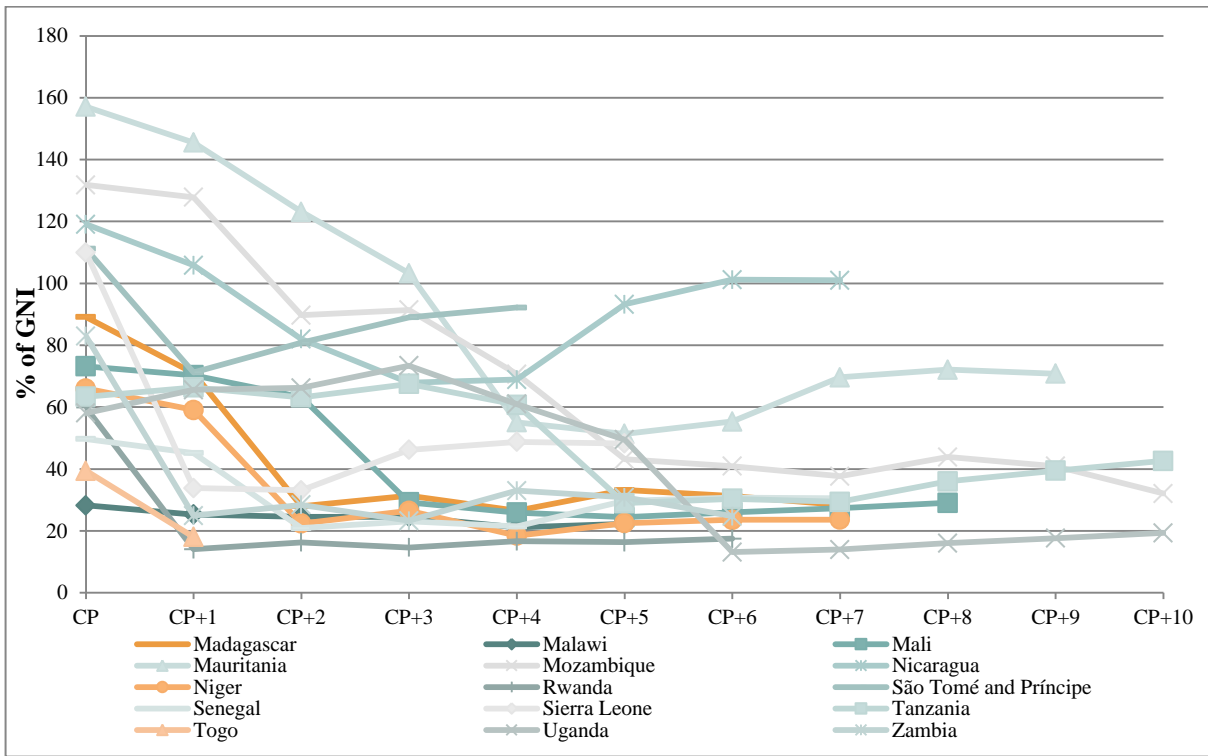
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Appendix

External debt to GNI since reaching HIPC completion point, 2000-2011 (%)





Note: CP indicates the year the country reached completion point.

Source: World Bank International Debt Statistics.



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ISSN (online): 1759-2917

ISSN (print): 1759-2909

Cover image: Lauren Parnell Marino

Overseas Development Institute
203 Blackfriars Road
London SE1 8NJ
Tel +44 (0)20 7922 0300
Fax +44 (0)20 7922 0399