MDG ACHIEVEMENT AND DEBT SUSTAINABILITY IN HIPC AND OTHER CRITICALLY INDEBTED DEVELOPING COUNTRIES: THOUGHTS ON AN ASSESSMENT FRAMEWORK

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Abbreviations and Acronyms

CPIA	Country Policy and Institutional Assessment
GDP	Gross Domestic Product
HIPC	Highly Indebted Poor Country
IDA	International Development Association
IMF	International Monetary Fund
LIC	Low Income Country
MDG	Millennium Development Goal
MDRI	Multilateral Debt Relief Initiative
MFPED	Ministry of Finance, Planning and Economic Development
NPV	Net Present Value
PAF	Poverty Action Fund
PEAP	Poverty Eradication Action Plan
PRSP	Poverty Reduction Strategy Paper
UPE	Universal Primary Education
WB	World Bank

Executive Summary

This paper reviews the evidence on post-HIPC debt sustainability, 10 years on from the start of the HIPC process. In light of the evidence, it discusses the assessment of debt sustainability in the context of MDG achievement in low income countries.

The evidence on post-HIPC debt sustainability is not encouraging, although the volumes of debt relief delivered by the HIPC initiative have been significant. An independent World Bank evaluation[2] shows that debt ratios have deteriorated in 11 out of the 13 countries for which post-completion point data is available, with ratios having risen above the HIPC thresholds in 8 of them.

Meanwhile, the World Bank and IMF have introduced a new post-HIPC methodology for assessing debt sustainability in low income countries[3], the purpose of which is to provide guidance on future borrowing policies in low-income countries. This new Low Income Country (LIC) framework uses the quality of a country's institutions, as defined by its World Bank Country Policy and Institutional Assessment (CPIA) score, to establish sustainability thresholds. It paints a more optimistic picture of debt sustainability in post HIPC countries, suggesting that at least 4 of the 8 post-completion point countries which have breached their HIPC thresholds have debt levels which are considered sustainable under the new framework.

As definitions as to what constitutes debt 'sustainability' change, and international donors seek ways of scaling up their assistance to HIPC and other critically-indebted countries to meet the MDGs, the paper examines whether the new World Bank/IMF LIC framework provides an appropriate tool for assessing debt sustainability and the effectiveness of sustainable resource scale-up. The paper is of the view that while the framework goes some way in addressing some of the shortcoming of debt sustainability analysis under the HIPC initiative, to maximise its credibility, it should be managed by an independent body which has no role in lending to the countries whose debt sustainability it is measuring. Consequently, assessments of debt

[2] Independent Evaluation Group (2006)
[3] IMF and IDA (2004)

sustainability and absorptive capacity for new borrowing will be free of the suspicion of ‘vested’ interests.

The paper also makes a number of proposals, the purpose of which is to enhance the framework’s capacity as a tool for assessing not just debt sustainability, *but also* the effective use of resources to meet the MDGs.

Furthermore, the paper suggests that MDG financing requirements need to be assessed on a case by case basis, even when it can be demonstrated that a low income country can absorb more aid in a sustainable and effective manner, as MDG attainment may not require additional financing in all cases.

I. Introduction

The Highly Indebted Poor Countries (HIPC) initiative was designed to provide a sustainable solution to debt problems and poverty reduction in some of the world's poorest countries. While many of these countries were already beneficiaries of debt re-scheduling with bilateral creditors such as the Paris Club, their debt remained 'unsustainable'; the HIPC initiative aimed to provide a lasting solution to repeated debt crises by providing a comprehensive framework for multilateral debt relief for the first time. The HIPC initiative also provided a new approach to debt relief, by creating a specific link between the savings arising from relief and expenditures focused on poverty reduction.

The IMF and World Bank launched the Highly Indebted Poor Country (HIPC) initiative in 1996. It was swiftly followed by the Enhanced HIPC initiative in 1999, the aim of which was to provide faster, deeper and broader debt relief, and to strengthen the links between debt relief and poverty reduction, in particular through linking debt relief to a Poverty Reduction Strategy produced by the country.

The basic principle of the initiative was that participating countries should benefit from a reduction in the stock of their external debt sufficient to bring it to permanently sustainable levels, providing an exit from the repeated cycle of debt rescheduling. However, relief would not be provided unconditionally. Instead, it would be contingent on continued efforts in macroeconomic stabilisation, structural adjustment, and poverty reduction. The initiative was premised on the idea that savings from the reduced debt service would allow HIPC countries to finance higher spending in poverty-reducing programs. This was to be complemented by increased grant and highly concessional financing to those countries that benefited from the HIPC initiative.

Has the HIPC initiative met its objectives? Ten years on since the launching of the initiative, there's no doubt that the debt relief it has provided so far has reduced debt overhang in the concerned countries. The HIPC initiative has reduced US$ 22 billion of debt in NPV terms in 18 countries which have passed their HIPC completion point, thereby halving their debt ratios, while the amount of debt relief pledged to all 29 countries that have passed either their decision point or their completion point

amounts to US$ 35 billion in NPV terms[4]. However, as the G8 embarks on another round of debt relief (under the Multilateral Debt Relief Initiative (MDRI)) for qualified HIPCs, it is becoming clear that the debt stock reduction provided by the HIPC initiative[5] has not succeeded in reducing the debt overhang permanently in a number of countries, raising the question as to why the initiatives failed to meet its objective of providing an exit from debt crises and an endless cycle of debt rescheduling.

Likewise, evidence on poverty reduction and progress towards the Millennium Development Goals (MDGs) is mixed. Although the HIPC initiative has brought a welcome increase in both the number of countries explicitly tracking their poverty-reducing expenditures[6], and the amount of money being spent on poverty reduction[7], progress on poverty reduction and the MDGs is at best modest[8]. Whilst the HIPC approach of linking debt relief savings to poverty-reducing expenditures has been successful in many cases, few, if any HIPC countries, are likely to achieve all their MDGs by 2015.

As international donors seek ways of scaling up their assistance to HIPC and other critically-indebted countries to meet the MDGs, what lessons can be learned from the HIPC initiative? Was its measurement of debt 'sustainability' unrealistic? Is the new World Bank/IMF LIC debt sustainability framework a more appropriate tool for assessing debt sustainability and capacity for new borrowing? Can the MDGs be financed without triggering another round of debt crises? Is money the key to meeting the MDGs anyway?

This paper seeks to explore some of these questions, drawing in particular on the experience of Uganda, the first country to qualify for HIPC debt relief. The paper is structured as follows; Section Two gives more detail on the criteria used in assessing

[4] IMF and IDA (2006)
[5] Includes both HIPC and Enhanced HIPC initiatives
[6] According to the World Bank's Independent Evaluation Group, 19 HIPC countries were tracking poverty-reducing expenditures in 2005, as compared to 4 in 2002.
[7] Poverty-reducing expenditures in 29 countries that had reached the HIPC decision point by 2005 had risen from 6% of GDP in 1999 to 9% of GDP in 2005.
[8] Independent Evaluation Group (2006).

debt sustainability under the HIPC initiative. Section Three gives an overview of debt sustainability in post-completion point HIPCs, while Section Four assesses the new World Bank/IMF debt sustainability framework. Section 5 Five looks at the issue of resource scale-up to meet the MDGs, while Section 6 concludes.

II. Assessing Debt Sustainability – the HIPC Approach

At its broadest level, a country is considered to have achieved external debt sustainability if it is expected to be able to meet its current and future debt-service obligations in full, without recourse to debt relief, rescheduling of debts, or the accumulation of arrears, and without unduly compromising growth. The HIPC initiative has a range of criteria for evaluating debt sustainability, using the Net Present Value (NPV) of debt and debt service as shares of GDP, exports and revenues. Nonetheless, it uses a single debt measure to establish the critical threshold for permanent debt sustainability, and the amount of relief required to bring a country to that threshold. Debt relief can either be accessed through the 'export' window, which targets a threshold level for the NPV of debt as a ratio of exports, or through the 'fiscal' window, which targets a threshold level for the NPV of debt to Government revenues.

Out of the 18 countries that had passed their HIPC completion point as of February 2006, 13 had qualified under the 'export' window, whilst 5 had qualified under the 'fiscal' window. Use of the 'fiscal' window is considered when countries have very open economies, such that reliance on external indicators such as exports does not provide an adequate picture of a country's debt burden.

Under the 'export' window, the original HIPC initiative used an NPV of debt to exports ratio of no more that 200 percent as a measure of debt sustainability, whilst the Enhanced HIPC initiative revised the ratio downwards to 150 percent. The comparable threshold for the NPV of debt to revenues under the Enhanced HIPC initiative is 250 percent. In effect, the first and Enhanced HIPC initiatives have provided eligible countries with sufficient relief to bring their sustainability ratios down to the threshold levels set out under the initiative *at the time of completion point*. It is assumed, and country debt sustainability analyses conducted during the

HIPC process lend weight to the assumption, that the ratios will be maintained at or below the threshold levels thereafter.

It should be noted that while this single threshold/single point in time approach has the advantage of bringing uniformity to debt sustainability levels in post-HIPC countries, it could be seen as 'penalising' those countries which had managed to keep their debt closer to sustainable levels in the first place, as they receive relatively less debt relief savings - or none, if below the thresholds, to channel into poverty eradicating expenditures In addition, there is an inter-temporal inequality to relief provided under the HIPC initiative, as different countries reach their completion points at different points in time; changes in commodity prices over time alter the value of the same volume of exports, thereby varying the level of relief required to deliver the same NPV debt to exports ratio.

In the absence of sufficient non-debt relief grant resources to finance the MDGs, these inequalities have the potential to feed into the level of future debt burdens of post-HIPC countries striving to meet their international obligations with respect to poverty reduction.

III. The Sustainability of HIPC Relief

As at March 2006, 18 low income countries had passed their HIPC completion point. Another 11 were at the decision point stage, while a further 17 were either pre-decision point or potentially eligible for HIPC[9]. This means that in total, 46 low income countries are involved in the HIPC initiative in one way or another.

Since just 40 percent of countries involved in the HIPC initiative (18 out of 46) have passed their completion point, it might seem premature to assess the success or otherwise of the HIPC initiative in meeting its objective of providing a permanent exit from debt crises and rescheduling. Moreover, out of the 18 countries which had passed their HIPC completion point as at February 2006, 5 had done so within the previous eighteen months, limiting the scope for meaningful post-HIPC sustainability analysis in those countries.

[9] IMF and IDA (2006)

Nonetheless, given the current debate about scaling-up aid to enable low income countries to meet the Millennium Development Goals, and the introduction of a new debt relief mechanism for post-HIPC countries (the G8 Multilateral Debt Relief Initiative), it is clearly important to try to establish the current status of debt sustainability in post-HIPC countries, however incomplete.

The data available on 13 out of the 18 countries shows that debt ratios have deteriorated in 11 of them since completion point[10]. Out of these 11 countries, 8 have seen a rise in their debt ratios which breaches the HIPC thresholds, while 6 of these countries are not expected to be able to maintain their HIPC threshold ratios throughout the nine year period following completion point[11]. Moreover, debt ratios have deteriorated more in those countries which reached their completion point earlier, with Uganda, the first country to qualify for HIPC, seeing the worst deterioration in its ratio. Uganda had an NPV debt to exports ratio of 229 percent[12] as at end June 2005, fully 79 percentage points above the HIPC threshold of 150 percent, and 131 percentage points above the NPV debt to exports ratio of 98 percent projected for June 2005 at the time of Uganda's HIPC Completion Point in 2000.

These preliminary findings are not inspiring. To summarise, 60 percent of the 18 post-completion point HIPC countries have seen their debt ratios rise post-HIPC, whilst 44 percent have seen their ratios rise above the HIPC sustainability thresholds. In 33 percent (one-third) of post-completion point countries, debt ratios are not expected to return to HIPC sustainability levels during the entire nine year period following their completion point. These ratios worsen when restricted to 13 post-HIPC countries for which data is available; of those post-HIPC countries for which data is available, 85% have seen their debt ratios rise post HIPC, 62% have seen their ratios rise above the HIPC sustainability thresholds, and 46% (almost half) are not expected to return to HIPC sustainability levels during the entire nine year period following their completion point.

[10] Independent Evaluation Group (2006).
[11] Burkina Faso, Ethiopia, Guyana, Nicaragua, Rwanda and Uganda
[12] Measured as per the HIPC assessment of debt sustainability

The question here would then be what's the cause of this poor performance? While some of the deterioration in debt ratios in post-completion point can be explained by changes in the exchange rate and discount rate, other key factors include higher than anticipated new borrowings post-HIPC, which offset improvements in exports and revenue mobilisation. Moreover, the projections that have been used to forecast GDP and export growth in HIPC debt sustainability analyses appear to be highly optimistic. Average GDP projections for 2005 to 2010 are more than twice the average level realised from 1990-2000, whilst export projections are 1.7 times higher.[13] In Uganda's case, annual export earnings for the period 2001-2005 were on average 23% lower than the levels projected at the time of the Completion Point, mainly due to considerably lower coffee prices and export volumes.

These issues raise a question as to whether the return of certain HIPC countries to post-HIPC 'unsustainability' is indicative of a return to debt crises, or shortcomings in the chosen sustainability indicator, and its forecasting framework. After all, no post-HIPC country has defaulted on its post-HIPC debt repayments, or entered an episode of 'debt-distress'[14]. A related question is whether a single debt indicator, measured at a single point in time, is the most suitable way of assessing debt sustainability. The answers will undoubtedly have implications for the scope for scaling-up lending to Low Income Countries (LICs) to meet the MDGs.

IV The WB/IMF LIC Debt Sustainability Framework

In light of the pattern of evidence emerging from post-HIPC countries, it seems reasonable to propose that in order to assess long-term debt sustainability attention needs to shift away from a single debt indicator to a more complex and comprehensive view of debt sustainability, in which policies, institutions, exogenous factors and debt management play an integral role.

Three specific characteristics of low income countries have been identified as adversely affecting their ability to cope with high levels of debt, as follows[15]:

[13] Independent Evaluation Group (2006)
[14] The IMF defines an episode of debt distress as a situation marked by significant arrears accumulation (in excess of five percent of total debt) on obligations to official creditors.
[15] IMF and IDA (2004)

i. Risks of misuse and mismanagement of resources, due to weak public institutions, poor governance, and generally low implementation capacity
ii. Returns on investment that frequently accrue over the long-term, and whose benefits (such as, from improved security and health care) may be diffuse and cannot be easily captured by Governments in the form of higher taxes to repay debts
iii. Narrow and highly volatile production and export bases that make these countries particularly vulnerable to exogenous shocks that can considerably worsen their debt dynamics.

The World Bank and IMF have developed a new lending and debt sustainability assessment framework which aims to take into account some of these risks. The framework is geared to a country's capacity to carry debt, which in turn is assessed as depending on the country's ability to use resources effectively for development and growth, and its vulnerability to shocks[16]. In theory, this approach should provide a guide not just to the amount of new IDA/IMF resources a low-income country can absorb without triggering an episode of debt distress, but also an indicator of the prudent level of new borrowings by a low income country, if resources are to be scaled-up to meet the MDGs.

The new IMF/IDA Low Income Country debt sustainability framework is built around the World Bank's annual Country Policy and Institutional Assessment (CPIA) results, which are used as the measure of institutional quality which determines a country's capacity to carry debt. In effect, a higher level of institutional quality, as measured by a country's overall CPIA score[17], is associated with a higher set of thresholds for debt sustainability, and vice versa, as shown in Table 1.

[16] IMF and IDA (2004)
[17] A strong CPIA performer is defined as one whose CPIA score is 3.75 or above, whilst a medium performer has a score within the range of 3.25 -3.75, and a weak performer has a score of less than 3.25.

Table 1: Comparison of IMF/IDA LIC Debt Sustainability Framework Policy-Dependent Thresholds and HIPC Initiative Benchmarks

	NPV external debt/exports	NPV external debt/GDP	Debt service/ Exports	NPV public debt/revenues	Debt service/ Revenues
Strong CPIA performer	200%	50%	25%	300%	35%
Medium CPIA performer	150%	40%	20%	250%	30%
Weak CPIA performer	100%	30%	15%	200%	25%
HIPC initiative benchmarks	150%		15% - 20%	250%	

Source: World Bank

As can be seen from Table 1, under the new IMF/IDA Debt Sustainability Framework, the debt sustainability thresholds of a medium CPIA performer are broadly equivalent to those used in the HIPC initiative in percentage terms[18]. A strong CPIA performer is considered able to tolerate higher thresholds, while a weak CPIA performer is allocated lower thresholds.

In addition to evaluating a country's expected baseline performance against its policy-dependent thresholds over a twenty year period, the new LIC debt sustainability framework also explicitly evaluates performance against two alternative scenarios, which take into account the possibility that key variables (such as GDP) might only grow at the rate of their historical average, as opposed to the rate projected in the baseline scenario, and that new loans might be contracted on less concessional terms than anticipated. In addition, it also tests for the impact of a number of shocks to variables such as GDP, export growth, the exchange rate and aid flows.

In theory, then, the new LIC debt sustainability framework redresses a number of the short-comings identified in the HIPC assessment of debt sustainability. Firstly, instead of using a single indicator, at a single point in time, to determine a country's potential for permanent debt sustainability, it evaluates a number of key debt sustainability indicators over a forward-looking time period. Secondly, it explicitly builds in an assessment of the impact of a range of possible shocks on debt

[18] However, although the ratios are similar, key absolute variables used to compute the ratios differ. A major difference relates to the level of exports used in the NPV Debt/exports ratio; while the HIPC initiative uses a backward looking three-year average, the new framework uses the value of the current year of exports.

sustainability. Thirdly, in acknowledgement of the evidence that countries operating in weaker institutional and policy environments are likely to experience debt distress at significantly lower debt ratios, it varies the thresholds for 'sustainable' ratios according to the strength of a country's policies and institutions.

One issue that the new framework does not address, however, relates to conflict of interest. It is debatable whether it is appropriate for global thresholds for debt sustainability in Low Income Countries to be developed and measured by the leading multi-lateral lending institutions. Not only did their loans contribute significantly to previous episodes of debt distress, but it can be charged that they have a vested interest in measuring debt sustainability in such a way that Low Income Countries appear more able to 'tolerate' additional levels of new debt, thus allowing new lending programmes to continue uninterrupted. A key question, therefore, is whether the new LIC debt sustainability framework appears objective in its analysis, and is geared towards addressing some of the perceived 'weaknesses' of the HIPC framework, or whether it is skewed towards painting a more 'favourable' picture of debt sustainability than the HIPC initiative, which will enable it to continue with its lending programmes in spite of the deterioration in post-HIPC debt sustainability indicators in a number of completion point countries. (An allied question, which this paper will not seek to address, is whether the World Bank's CPIA assessment is sufficiently objective to merit becoming the key pillar of a new debt sustainability framework.)

The eight LIC debt sustainability analyses conducted for post-HIPC countries show that none of them can be considered to have a baseline level of debt which is unsustainable, while 6 of them have a moderate risk of debt distress, and two have a high risk (see table 2). This is a more positive assessment than the equivalent assessment of performance against the HIPC threshold, which shows that 6 of the 8 countries have ratios above the HIPC sustainable threshold (and therefore, technically speaking, have levels of debt that are 'unsustainable'), and 4 are not expected to see their ratios return to the HIPC threshold within the nine year period after completion point.

Table 2: Comparison of LIC Sustainability Analysis and HIPC Analysis

	CPIA rating	LIC baseline	LIC risk assessment	Latest HIPC indicators	HIPC nine year forecast
Burkina Faso	Medium	Sustainable	Moderate	Unsustainable	Unsustainable
Mali	Medium	Sustainable	Moderate	Sustainable	Sustainable
Mauritania	Strong	Sustainable	Moderate	Unsustainable	Sustainable
Tanzania	Strong	Sustainable	Moderate	Sustainable	Sustainable
Uganda	Strong	Sustainable	Moderate	Unsustainable	Unsustainable
Rwanda	Medium	Sustainable	High	Unsustainable	Unsustainable
Ethiopia	Medium	Sustainable	High	Unsustainable	Unsustainable
Ghana	Medium	Sustainable	Moderate	Unsustainable	Sustainable

Source: World Bank

However, this comparison masks a significant difference between the LIC evaluation methodology, and the HIPC evaluation methodology. Under the HIPC framework, the NPV of debt to exports ratio uses a backward-looking three year average for exports, to even out volatility in export earnings, whereas under the LIC framework, the value of the current year's exports is used. The justification for this change is based on the forward-looking nature of the LIC framework:

> '… the debt burden denominators used under the HIPC initiative … are derived as backward-looking three-year averages. The use of the three-year averages was introduced to obtain a more stable, and representative, measure that evens out any observed volatility in export earnings and revenues. The average was backward looking, rather than centred around the year for which the debt data are determined, because HIPC assistance was not to be based on projections. For the new framework, which explicitly focuses on the *future* path of the relevant debt burden indicators, neither consideration is relevant'.[19]

However, this reasoning is disingenuous, since the impact of using the current year's exports, instead of a backward-looking three year average, can be significant in the first two years of a LIC debt sustainability assessment time frame, therefore potentially influencing near-term lending decisions. For example, the LIC debt sustainability analysis for Uganda shows that, as at end June 2005, Uganda's NPV

[19] IMF and IDA (2005)

debt to exports ratio (using the current year of exports) was 179 percent, which is *below* Uganda's policy dependent threshold (as a strong performer) of 200 percent, and therefore is considered 'sustainable' (although above the HIPC threshold of 150 percent). However, using the HIPC methodology of a backward-looking three year average, the same ratio for end June 2005 is 229 percent, which is *above* both Uganda's policy dependent and HIPC thresholds, and therefore considered 'unsustainable'.

Given the significance of its effect, this switch in computation of exports raises questions about shifting goal posts. In the example of Uganda, an NPV debt to exports ratio that is considered 'unsustainable' using a backward-looking three year average for exports, even when measured against a higher debt sustainability threshold, reflecting Uganda's status as a strong institutional and policy performer, has now been recast as 'sustainable' under the new WB/IMF approach of using the current year of exports. This has implications for analysis of the future volume of 'sustainable' debt that can be absorbed in the short-term as Uganda attempts to meet the MDGs.

While it is true that the LIC assessment framework adopts a multi-year time horizon, and makes use of a number of indicators when assessing debt sustainability, there is little doubt that current performance against some of the best-known indicators will grab the greatest 'headlines', and have the most significant effect on short-term lending and borrowing decisions. It is also fair to say that, in spite of the increasing awareness amongst the donor community of the importance of multi-year aid commitments, most donors continue to operate within very short time horizons[20]. It is therefore critical that the LIC framework should not be seen to be 'massaging' near-term ratios, which can have a significant effect on immediate donor behaviour, through a change in technical criteria.

For the purposes of transparency, as well as consistency with the HIPC initiative, the LIC framework should retain the methodology of using a backward-looking three

[20] For example, projections for donor aid in the third year of Uganda's Medium Term Expenditure Framework are consistently lower than the projections for the first and second year, due to the inability of donors to make funding commitments for a full three year period .

year average for exports, even though this will have the effect of raising ratios marginally throughout the assessment period[21]. If the LIC framework retains its approach of using a higher denominator for exports than the HIPC initiative, whilst continuing to use the same percentage ratios for debt sustainability, then it continues to remain open to the suspicion that it is skewed towards painting a more 'favourable' picture of debt sustainability than the HIPC initiative, given the deterioration in post-HIPC debt sustainability indicators in a number of completion point countries.

There are a number of other aspects of the LIC debt sustainability framework which are open to question, particularly with respect to its use of the CPIA. The first relates to a country's categorisation as being either a strong, medium or weak performer, based on its overall CPIA score. The CPIA, which is published annually, does not show a country's individual CPIA score. Instead, it shows its performance by quintile, with the weakest performers being in the lowest (5^{th}) quintile, and the strongest performers in the highest (1^{st}) quintile. In the absence of the publication of the CPIA score[22] , the mapping of overall performance across the five quintiles to the LIC three-fold categorisation of strong, medium or weak, is unclear, with countries rated in different CPIA quintiles receiving the same LIC categorisation, particularly for countries categorised as 'medium' performers.

For example, Burkina Faso has been given a 'medium' LIC rating whilst attaining CPIA scores in the first and second quintile between 2001 and 2004, whilst Ethiopia receives the same 'medium' rating even though its CPIA scores uniformly placed it in the third quintile over the same time period. Table 3 illustrates.

[21] Assuming that future export growth is projected to be positive, rather than negative.
[22] CPIA scores are expected to be published for the first time in 2006, alongside the quintile ratings

Table 3: LIC CPIA Categorisation and Overall CPIA Quintile Rating

	LIC CPIA rating	CPIA Quintile			
		2004	2003	2002	2001
Burkina Faso	Medium	1	2	2	2
Mali	Medium	1	2	2	4
Mauritania	Strong	4	1	1	1
Tanzania	Strong	1	1	1	1
Uganda	Strong	1	1	1	1
Rwanda	Medium	3	2	2	2
Ethiopia	Medium	3	3	3	3
Ghana	Medium	2	2	2	2

Source: World Bank

If the mapping between CPIA performance and debt sustainability categorisation is unclear, then the use of the CPIA as a determinant of debt sustainability could be considered cosmetic, allowing the major lending institutions to select 'favoured' countries as candidates for new borrowing via their debt sustainability ratios, even when their CPIA ratings are weaker than other countries in the same debt sustainability category.

Table 3 also neatly illustrates another weakness with respect to the use of the CPIA in the LIC debt sustainability framework, namely the potential for change in CPIA performance over time, altering a country's baseline thresholds for debt sustainability within a relatively short time period. While for countries such as Mali, which moved progressively from the fourth CPIA quintile in 2001, to the first quintile in 2004, such changes are relatively benign (according to the LIC approach, this shift means that Mali can absorb a higher level of new borrowing relative to the same debt stock), for a country such as Mauritania, which moved from the first quintile in 2003 to the fourth quintile in 2004, such changes are more concerning; debt ratios that were considered sustainable one year, verge on the unsustainable the following year, having an impact on the level of future new borrowing, and future expenditure plans.

While it is hard to argue that the same level of new borrowing should continue to be extended to a country with a rapidly deteriorating policy and institutional environment, at the same time, an abrupt reduction in the extension of new loans

based on a deterioration in a debt sustainability assessment could lead to a fall in net positive aid flows, potentially triggering a debt repayment crisis. However, it is notable that the LIC framework does not appear to evaluate the risk of varying policy performance. Perhaps, in addition to assessing the vulnerability of countries to exogenous shocks, the LIC framework should also attempt to explicitly assess the possible impact of a negative endogenous shock, as represented by a shift in CPIA performance which leads to a downgrading in baseline debt sustainability thresholds, and devise a strategy for smoothing the subsequent fall in aid flows, such that they do not trigger a debt repayment crisis.

The third issue with respect to the use of the CPIA relates to the appropriateness of using the *overall* CPIA score (or quintile rating) as the determinant of the LIC baseline debt sustainability thresholds. The CPIA is made up of four key clusters, each of which contains a number of criteria[23]. Scores for each criteria receive an equal weight within the cluster[24], and likewise, each cluster score carries an equal (25%) weight within the overall CPIA[25]. The four clusters are; Economic Management (A), Structural Policies (B), Polices for Social Inclusion (C), and Public Sector Management & Institutions (D).

Although each cluster carries an equal weighting within the CPIA, it is not clear that each one is of equal importance with respect to the capacity of a country to sustain or 'carry' debt. If countries tended to display reasonably uniform performances across clusters, this might not be important. However, in actual fact, countries' overall CPIA quintile ratings[26] mask considerable variation in their quintile rating per cluster. For example, it is possible to attain an individual cluster quintile rating of 3 within an overall quintile rating of 1 (Mali 2004, Clusters B & C), an individual cluster quintile rating of 5 within an overall quintile rating of 3 (Ethiopia 2003 & 2004, Cluster B), and an individual cluster quintile rating of 4 within an overall rating of 2 (Ghana 2001, Cluster A). Table 4 illustrates.

[23] The number of subcomponents was reduced from 20 to 16 in 2004

[24] Countries are graded on a scale of 1 to 6 on their performance against each of the criteria. A score of 1 is the lowest attainable, whilst a score of 6 is the highest

[25] IDA (2004)

[26] Actual scores are not as yet published. CPIA scores are expected to be published for the first time in 2006, alongside the quintile ratings.

Table 4: CPIA Quintile Ratings 2001-2004; Overall and broken down by Cluster

	LIC CPIA rating	CPIA Quintile Ratings															
		2004				2003				2002				2001			
		A	B	C	D	A	B	C	D	A	B	C	D	A	B	C	D
Burkina Faso	Medium	1				2				2				2			
		1	3	1	2	1	3	2	1	2	3	3	2	2	3	2	1
Mali	Medium	1				2				2				4			
		1	3	3	1	1	3	3	2	2	2	3	2	3	3	3	3
Mauritania	Strong	4				1				1				1			
		5	3	2	3	1	2	2	1	1	1	1	1	1	1	1	2
Tanzania	Strong	1				1				1				1			
		1	2	2	1	1	2	1	1	1	2	1	1	1	2	2	1
Uganda	Strong	1				1				1				1			
		1	1	1	2	1	1	1	2	1	1	1	2	1	1	1	2
Rwanda	Medium	3				2				2				2			
		3	4	2	2	3	2	3	2	3	2	2	1	2	3	3	1
Ethiopia	Medium	3				3				3				3			
		2	5	3	2	3	5	3	2	3	4	2	2	4	4	2	2
Ghana	Medium	2				2				2				2			
		2	3	2	1	3	2	2	1	3	2	2	1	4	2	1	2

Source: World Bank

The extent to which usage of the overall CPIA score in setting debt sustainability thresholds can obscure key information on prospects for debt sustainability is illustrated by the fact that, whereas all low income countries have improved their overall CPIA performance since 1999, at the same time, all low income countries have seen a worsening of their debt service and debt management capacity as measured by the CPIA[27].

So, which clusters are more relevant with respect to a country's capacity to carry debt? It can be argued that each cluster has a different function with respect to analysis of debt sustainability and effective utilisation of future resources, as follows:

[27] Independent Evaluation Gr oup (2006)

Table 5: Analysis of CPIA Clusters

Cluster	Criteria	Comment
Economic Management	Macroeconomic Management	Links to the level of new debt a country can absorb
	Fiscal Policy	
	Debt Policy	
Structural Policies	Trade	Links to a country's capacity to generate economic & export growth
	Financial Sector	
	Business Regulatory Environment	
Policies for Social Inclusion & Equity	Gender Equality	Links to a country's effectiveness in spending its resources to meet human development goals
	Equity of Public Resource Use	
	Building Human Resources	
	Social Protection & Labour	
	Environmental Sustainability	
Public Sector Management & Institutions	Property rights & Rule-based Governance	Links to a country's ability to utilise resources in an effective way (absorptive capacity)
	Quality of Budgetary & Financial Management	
	Efficiency of Revenue Mobilisation	
	Quality of Public Administration	
	Transparency, Accountability & Corruption in the Public Sector	

Performance under Cluster A directly impacts on the amount of debt a country can manage without triggering a debt crisis, and effectively links to the numerator of many debt sustainability ratios. Performance under Cluster B impacts on a country's capacity to generate economic growth and improve its capacity to meet future debt obligations, effectively linking to the denominator of many debt sustainability ratios. It can be argued that performance under Cluster C has little relevance with respect to debt sustainability, but is critical when evaluating a country's potential to spend its resources effectively to meet human development goals such as the MDGs. Likewise, performance under Cluster D is critical when assessing the effectiveness with which a country will absorb new resources, and thereby relates to absorptive capacity and value-for-money, as opposed to debt sustainability per se (although the criteria on revenue mobilisation is also linked to a country's capacity to generate revenues to repay future debt).

Given the extent to which overall CPIA performance masks variations in performance at cluster level, and given the varying roles of each of the clusters with respect to

signalling information about a country's capacity to sustain debt, absorb new resources effectively and channel spending towards human development goals, the LIC debt sustainability framework should adopt a disaggregated approach with respect to the CPIA indicators. Performance under Clusters A and B should be used to establish country-specific thresholds for debt sustainability, using the strong, medium and weak categorisation employed at present. Additionally, performance under Clusters C and D should be used to establish a country's *suitability* with respect to receiving sustainable new resources (whether grants or sustainable/concessional loans) for the purposes of meeting the MDGs. This dis-aggregation would effectively tackle one of the main weaknesses of the current LIC framework, which is that it does not pay explicit attention to absorptive capacity and the effectiveness of resource utilisation with respect to meeting development goals.

It may be useful to illustrate this approach briefly with respect to Uganda. Uganda has a quintile rating of 1 for both Cluster A and Cluster B. As such, it would continue to be rated a 'strong' performer in terms of the LIC framework debt sustainability thresholds, and would be assessed against the upper range of thresholds. However, its slightly lower quintile rating of 2 for Cluster D would flag (slight) concerns about its ability to absorb new resources effectively, even though its rating of 1 for Cluster C implies that *subject to it being able to absorb the resources effectively*, it would be likely to channel them appropriately towards human development outcomes. In this respect, the modified approach proposed here provides additional information on which new lending decisions can be based, and provides a basis for comparison between countries which extends beyond debt sustainability to the utilisation of resources. At the margin, given the overall constraint on new resources to finance the MDGs, the approach can help donors make resource allocation decisions between countries with similar ability to 'carry' debt.

To summarise, in this section we have made a number of proposals with respect to the new LIC debt sustainability framework, the purpose of which is to enhance its capacity as a tool for assessing debt sustainability *and* the effective use of resources to meet the MDGs, in cases where it can be established that resources can be scaled-up without adversely affecting a country's prospects for debt sustainability. These proposals include:

- Reverting to a three year backward-looking average for exports when computing debt ratios,
- Explicitly incorporating debt sustainability analysis stress tests for deterioration in a country's institutional and policy environment, as measured by the CPIA,
- Establishing a clear relationship between CPIA performance and debt sustainability ratings,
- Adopting a disaggregated approach with respect to the CPIA indicators, such that Clusters A and B are used to establish a country's thresholds for debt sustainability, and Clusters C and D are used to evaluate its capacity to use sustainable new resources effectively.

However, these proposals only relate to ways in which the current LIC debt sustainability framework can be improved, to make it more transparent and to improve its ability to signal prospects for debt sustainability and absorptive capacity. They do not address the core issue of whether it is appropriate for global thresholds for debt sustainability in Low Income Countries to be developed and measured by the leading multi-lateral lending institutions. In our view, it is not. For a debt sustainability framework to be wholly objective, it should be managed by an independent body which has no role in lending to the countries whose debt sustainability it is measuring.

V. Resource Scale-Up and the MDGs

The preceding analysis assumes that additional resources are required if low income countries are to meet the MDGs by 2015, and that the key issue is providing these resources in a sustainable way, to countries which can utilise them most effectively.

The introduction of the HIPC initiative in the 1990s was ground-breaking, in that it tied the delivery of debt relief to increases in expenditure targeted towards poverty reduction. As such, it represented the first comprehensive attempt by multilateral and bilateral donors to deliver aid scale-up in the context of a framework simultaneously geared towards debt sustainability and poverty reduction. In many ways, therefore, it

can be considered a precursor to the current global initiative to scale-up sustainable donor resources to enable low income countries to meet the MDGs.

In many respects, the results of the HIPC initiative with respect to resource scale-up for poverty reduction so far are impressive. Fully US$ 58 billion of debt relief in nominal terms has been committed to the 29 HIPC countries which have passed their decision point, all of which is expected to be channelled into poverty-reducing spending. Out of the 29 countries, 25 have now completed Poverty Reduction Strategies (PRSP), and poverty reducing expenditures in these countries have risen from 6 percent of GDP in 1999 to 9 percent in 2005[28]. In addition, the number of HIPC countries explicitly tracking their poverty-reducing spending has risen to 19, as compared to just 4 in 2002[29].

However, in spite of these achievements, progress in these countries towards meeting the MDGs is currently modest at best. Analysis available for the 18 countries which have passed their HIPC Completion Point shows that they have made progress in improving gender equality and reducing child mortality. Their progress with respect to universal primary education, ensuring environmental sustainability, and developing global partnerships for development is more modest. In addition, they have failed to achieve any measurable progress on development goals such as poverty and infectious diseases, while data on maternal health is insufficient to be able to measure performance[30].

While it is beyond the scope of this paper to assess why progress towards the MDGs to date has been modest in HIPC countries, we nonetheless wish to address the more limited question of whether additional resources are necessarily the key to MDG attainment. Tentative answers to this question feed back into the paper's proposals for modifications to the current LIC debt sustainability framework, particularly in as much as it provides a tool for assessing the scope for sustainable new lending to low income countries. Our answers will be provided with respect to Uganda (see annex I), the first country to qualify for the HIPC initiative, and therefore the one with the

[28] IMF and IDA (2006)
[29] Independent Evaluation Group (2006)
[30] Independent Evaluation Group (2006)

longest track record in channelling its HIPC savings towards poverty-reducing expenditures. The broader intuition that can be drawn from the Ugandan experience is that MDG financing requirements need to be assessed on a case by case basis, even when it can be demonstrated that a low income country can absorb more aid in a sustainable and effective manner. Any debt sustainability framework which builds in an element of assessing a country's capacity to absorb additional resources should also provide an assessment of the need for such resources on a case by case basis.

VI Conclusion

The HIPC debt relief initiative has been ground breaking. It represents the first comprehensive attempt by multilateral and bilateral donors to deliver aid scale-up in the context of a framework simultaneously geared towards debt sustainability and poverty reduction. The results have been impressively far-reaching. Out of the 46 countries engaged with the initiative, 29 have reached their Decision Point, while 18 have passed their Completion Point to date. The amount of debt relief in NPV terms committed to the 29 countries that have reached their Decision Point is US$ 35 billion, all of which is earmarked to poverty-reducing expenditures.

Nonetheless, it appears that the HIPC initiative is unlikely to achieve its twin goals of (i) debt reduction, and (ii) contribution towards poverty reduction. Post-HIPC debt ratios have already risen above the HIPC thresholds in 11 out of the 18 countries which have passed their Completion Point, whilst progress towards achieving the MDGs is modest.

The new World Bank/IMF LIC debt sustainability framework is intended as a tool on which future lending decisions can be based. It tries to address some of the perceived short-comings of the HIPC initiative's assessment of debt sustainability, by making debt sustainability thresholds contingent on a country's policy and institutional framework, as measured by the CPIA, and by explicitly evaluating the sensitivity of debt sustainability to a number of the risks faced by low income countries.

This paper has argued that any such framework needs to be modified, so that it provides a more explicit assessment of a country's ability to use additional sustainable resources effectively, in addition to analysing debt sustainability. It examines the

World Bank/IMF LIC framework's use of the a country's overall CPIA score to signal its ability to sustain varying thresholds of debt, and suggests a disaggregated approach, whereby performance against two of the four CPIA clusters (A and B) is used to establish a country's policy-dependent debt sustainability thresholds, whilst performance against the remaining two (C and D) is used to assess a country's ability to use new resources effectively, and channel them towards human development outcomes. This modified approach provides additional information on which new lending decisions can be based, and provides a basis for comparison between countries which extends beyond debt sustainability to the utilisation of resources. At the margin, given the overall constraint on new resources to finance the MDGs, the approach can help donors make resource allocation decisions between countries with similar ability to 'carry' debt.

In addition, the paper suggests that the framework should explicitly evaluate the risk of a deterioration in a country's policy environment when assessing debt sustainability. It further suggests that it should devise a mechanism for smoothing any subsequent fall in aid flows resulting from a downgrading of policy-dependent debt sustainability thresholds, so that they do not trigger a debt repayment crisis.

It also proposes that, for the purposes of transparency, as well as consistency with the HIPC initiative, the framework should retain the HIPC methodology of using a backward-looking three year average for exports.

However, the paper is also of the view that for a new global debt sustainability framework to be credible, it should be managed by an independent body which has no role in lending to the countries whose debt sustainability it is measuring. Consequently, assessments of debt sustainability and absorptive capacity for new borrowing will carry greater credibility, as they will be free of the suspicion of 'vested' interests.

Finally, increasing resource flows to low income countries is not a sufficient condition to the attainment of the Millennium Development Goals. Therefore, the proposed debt sustainability framework should not only build in an element of assessing a country's capacity to absorb additional resources, but also provide an assessment of the need for such resources on a case by case basis.

ANNEX I

Uganda's Progress with the MDGs

Concern has been expressed in Uganda that the current levels of budgetary funding are insufficient to the MDGs. While on some goals, such as HIV/AIDS, primary school enrolment, gender and access to safe water, Uganda's progress has been undisputedly fast, on the other hand, progress has been slow on goals such as child mortality and maternal health. The question we wish to address here is the extent to which Uganda's progress towards the MDGs can be assisted by additional resources, taking each of the MDGs in turn.

The following text boxes provide the analysis on Uganda's current performance against the MDGs

Text Box: Uganda's progress towards the MDGs

Eradicate extreme poverty and hunger: The goal for poverty eradication translates into the target of the proportion of people whose income is less than $1 a day of 28 percent by 2015. Even with the most cautious macroeconomic projections within the existing resource envelope forecast in the Uganda's current PEAP, income poverty should fall to 28 percen t by 2013 and 26 percent by 2015, and further if inequality is reduced or fertility falls.

Achieve universal primary education: When universal primary education was introduced in Uganda in 1997, primary enrolment in absolute numbers doubled, and net prima ry enrolment rates increased. The current rate of net enrolment is now 85 percent. Achievement of the target of 100 percent by 2015 will depend on addressing the reasons why children drop out of school. According to the Government, this objective is achi evable within existing expenditure projections, provided the education sector remained focused on outcomes and on including the poorest within the education system.

Promote gender equality and empower women: This goal evokes gender parity in primary and secondary education by 2005, and no later than 2015. Uganda has succeeded in reducing gender imbalance so that no gender disparity is now evident in primary and secondary enrolment.

Reduce child mortality: The goal is to reduce child mortality by two thir ds by 2015. However, between 1995 and 2000, infant mortality in Uganda increased from 81 to 88 deaths per 1000 births. During the same period, under -five mortality increased from 147 to 152 deaths per 1000 births, while maternal mortality fell only margina lly from 527 to 505 per 100,000 live births. The reason

Improve maternal health: The goal for maternal health is to reduce the maternal mortality ratio by three quarters by 2015. In Uganda, maternal health has registered no significant improvements over the last decade. Between 1989 and 2001, maternal mortality fel l only slightly from 523 to 505 deaths per 100,000 live births, making Uganda one of eight countries with the highest mortality rates in the world. The MDG target of 131 deaths per 100,000 live births by 2015 is unlikely to be met.

Combat HIV/AIDS, malari a, and other diseases: The target is that by 2015 the spread of these diseases should have been halted and the trend reversed. Recent statistics show a national prevalence rate of 6.2 percent for HIV/AIDS in Uganda. This represents a significant decline fr om the HIV prevalence rates of 30% recorded at the beginning of the 1990s, partly reflecting the deaths of many people infected by HIV/AIDS, but also a marked reduction in new transmission. Malaria remains the leading cause of morbidity and mortality in U ganda. Its estimated to cause 51 percent of all infant deaths, and to be one of the most prominent causes of death for children under - five, and pregnant women. Available data shows that proportional morbidity for adults and children associated with malari a increased from 25 percent to 37 percent between 1995 and 2000.

Ensure environmental sustainability: The goal seeks to ensure that the principles of sustainable development are integrated into country's policies and programmes, and to reduce the loss of environmental resources. In Uganda, this is one of the key issues that have been integrated into the planning framework for the eradication of poverty. The revised PEAP 2004 includes more analytical work on the economic importance of environment and natura l resources in Uganda.

Develop a global partnership for development: The Government, in close consultation with other key stakeholders formulated partnership principles in 2001. The principles have played a major role in enhancing cooperation activities between Government and the development partners. There's a shared commitment that development assistance be sought/provided for those

As the above analysis shows, Uganda is currently on track for meeting some MDGs, and not others. Improving progress towards those MDGs which are currently off-track may require funding in some cases, and policy interventions in others, or a mix of the two. MDGs relating to health care in particular may require additional resources, whilst MDGs in other areas do not. The table below gives a summary.

Uganda's Resource Needs and the MDGs

MDG	Progress	Resource needs
Eradicate extreme poverty and hunger	Currently at 38%. But even with the more cautious macroeconomic projections in the revised PEAP, poverty should fall to 26% by 2015.	Can be met within current resource projections.
Achieve Universal Primary Education	After huge increases in net enrolment in 1997, there has been little change since.	Objective can met within existing expenditure projections provided education sector remains focused on outcomes.
Promote gender equity and empower women	Gender imbalance has been greatly reduced.	Achievement of the target does not require extra public expenditure, but rather non-resource interventions.
Reduce child mortality	The indicator has stagnated since the 1990s and reducing it by two-thirds is highly ambitious.	May require additional resources.
Improve maternal mortality	Little progress has been made on achieving this goal.	The objective will not be met within the existing resource projections, as it involves costly medical interventions.
Combat HIV/AIDS, malaria and other diseases	Significant progress made on HIV/AIDs. Data is lacking on the other diseases.	Objective will be met within existing resource projections.
Ensure environmental sustainability	Little progress has been made on this goal.	Achievement of this target does not require extra public expenditure, but rather non-resource interventions such as increasing efficiency and value for money spending.

From this, it appears that in Uganda, additional funding is not the sole solution to meeting the MDGs – a mixed pattern emerges, in which additional funding may be required in some circumstances but not others. The conclusion which can be drawn from this is that MDG financing requirements need to be assessed on a country by country basis, even when it can be demonstrated that a low income country can absorb more aid in a sustainable and effective manner.

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