United States General Accounting Office

GAO

Testimony

Before the Subcommittee on International Monetary Policy and Trade, Committee on Financial Services, House of Representatives

For Release on Delivery
Expected at
2:00 p.m., EDT
Tuesday,
May 15, 2001

DEVELOPING COUNTRIES

Challenges Confronting Debt Relief and IMF Lending to Poor Countries

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GAO/GAO-01-745T

Mr. Chairman and Members of the Subcommittee:

I am pleased to have the opportunity today to discuss our assessments of two important programs that are intended to help increase economic growth and reduce poverty in low-income countries, most notably countries in sub-Saharan Africa. These multilateral programs are the Heavily Indebted Poor Countries (HIPC) Initiative and the International Monetary Fund's (IMF) concessional (below-market terms) lending facility—the Poverty Reduction and Growth Facility. The HIPC Initiative, the first comprehensive debt relief effort to include all creditors (multilateral as well as bilateral), is projected to provide about $29 billion in debt relief to 32 potential recipients, 24 of which are in sub-Saharan Africa. The initiative is intended to provide recipients with sufficient debt relief to resolve their debt problems and free up resources that will be spent for poverty reduction. The purpose of the IMF's concessional lending facility is to strengthen countries' balance-of-payments positions and foster lasting economic growth, leading to higher living standards and a reduction in poverty. Both programs require recipient countries to prepare "country-owned" poverty reduction strategies. These strategies are to be developed with the participation of civil society, are to address a broad array of policies aimed at reducing poverty, and are to reflect each country's unique circumstances.

Today I will highlight challenges confronting these programs as discussed in two reports we prepared.[1] We reported that, even with debt relief and continued concesssional lending, many low-income countries (1) need to achieve strong, sustained economic growth in excess of historical growth rates to resolve their debt problems and to graduate from eligibility for concessional lending; and (2) face challenges in preparing comprehensive, country-owned poverty reduction strategies, including macroeconomic

[1]See *Developing Countries: Debt Relief Initiative for Poor Countries Faces Challenges* (GAO/NSIAD-00-161, June 29, 2000) and *International Monetary Fund: Few Changes Evident in Design of New Lending Program for Poor Countries* (GAO-01-581, May 8, 2001).

policies, within the programs' timeframes. Before I get into the specifics of these topics, let me provide a brief summary of our assessments.

SUMMARY

In our review of the HIPC Initiative, we found that the initiative provides significant debt relief. However, it is not likely to provide a lasting exit from debt problems unless countries achieve strong, sustained growth far greater than what they have achieved in the past. For example, exports for most of the seven countries we analyzed are projected by the World Bank and the IMF to grow at rates significantly in excess of historical averages.[2] We believe such growth rates are overly optimistic, since these countries rely on primary commodities, such as coffee, for much of their export revenue. Past experience has shown that the prices of these commodities tend to fluctuate over time and, in fact, decline in certain years. Failure to achieve the projected levels of economic growth could lead, once again, to these countries having difficulty repaying their debt. Similarly, we found that most of the current recipients of the IMF's concessional assistance will require high, continuous economic growth to reach the point of graduation from concessional IMF assistance. To reach this point within 15 years, the 32 countries that borrowed from the IMF's concessional facility in 2000 must average a real per capita income growth in excess of 6 percent annually during the entire period. This growth rate significantly exceeds the countries' average growth rate of negative 1 percent over the last 15 years.

In both reports that we prepared, we found that governments face challenges in preparing "country-owned" poverty reduction strategies. According to our analysis, by linking debt relief and poverty reduction, the HIPC Initiative has created tension between the desire for countries to receive quick debt relief and the time required to create such comprehensive strategies. Preparing the strategies is complicated and can tax already limited government resources by seeking to address the high incidence and diverse

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[2]Our analysis focused on seven of the eight countries in which a debt sustainability analysis from the World Bank and the IMF was available at the time of our study. These seven countries are Bolivia, Honduras, Mauritania, Mozambique, Nicaragua, Tanzania, and Uganda.

causes of poverty. For this and other reasons, country ownership of the strategy can be difficult to achieve. In particular, the development of a country-owned macroeconomic framework—which is included in a country's poverty reduction strategy—is hard to accomplish. Many recipient governments have limited technical capacity to independently analyze and effectively negotiate macroeconomic policies. Also, the challenges to effectively engaging civil society in a dialogue on these very complex matters are significant. Furthermore, even if these challenges were overcome, a national dialogue on the choice of effective policies is constrained by the limited knowledge within the economics profession about how different policies actually affect elements of the macroeconomic framework.

BACKGROUND

In 1996, at the urging of the Group of Seven (G-7) industrialized countries, the World Bank and the IMF agreed to undertake a comprehensive approach, called the Heavily Indebted Poor Countries Initiative, for providing debt relief to the poorest and most indebted countries in the world. In 1999, in response to the G-7's concerns about the continuing vulnerability of these countries, the creditors agreed to enhance the initiative by providing increased debt relief more quickly to more eligible countries. Under the enhanced initiative, the debt levels of eligible countries are expected to be lowered to a point that is considered sustainable; that is, countries will continue to be able to meet their future debt obligations on time without the need for further debt relief. The Bank and Fund staffs assume that donor assistance will be an important source of external flows for these countries and may help finance any future gaps that countries experience in meeting their debt obligations. Creditors also called for a strong link between debt relief and poverty alleviation and said that debt relief should free resources for spending on priority poverty reduction areas.

In order to strengthen countries' balance-of-payments positions, support their reform programs, and foster their economic growth, the IMF has provided loans on concessional terms to eligible low-income members.[3] In order to receive loans, countries agree to implement macroeconomic and structural reforms. Eligibility for these concessional loans has been based mainly on a country's per capita income and eligibility for World Bank concessional lending.[4] The IMF provides advice on macroeconomic issues such as achieving and maintaining stability. At the same time, the IMF seeks to integrate social policies into its programs and advice, with the World Bank taking the lead on these issues. As part of a concerted international effort in 1999 to reduce poverty, the IMF expanded the goals of its concessional lending program to include an explicit focus on poverty reduction. To emphasize this focus, the IMF renamed its lending program from the Enhanced Structural Adjustment Facility to the Poverty Reduction and Growth Facility. As of May 4, 2001, 38 of the 77 countries eligible for the Poverty Reduction and Growth Facility had current loan commitments totaling about $4.5 billion. Twenty-four of the 38 countries are in sub-Saharan Africa.

Countries eligible for HIPC debt relief and IMF concessional loans are among the poorest in the world, with many classified by the United Nations as being in its lowest category of human development, based on life expectancy, literacy, and annual per capita income. Many depend on development assistance from governments, multilateral organizations, and nongovernmental organizations and have significant development needs.

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[3]The lending terms include a 5-½ year grace period, 10-year maturity, and annual interest rate of 0.5 percent. A country's balance-of-payments accounts summarize its financial dealings with the outside world.

[4]This threshold was based on a 1998 per capita income of $895 or less. The World Bank provides concessional lending through the International Development Association.

OPTIMISTIC ECONOMIC GROWTH REQUIRED TO ACHIEVE A LASTING EXIT FROM DEBT PROBLEMS OR GRADUATE FROM CONCESSIONAL BORROWING

Countries' Ability to Repay Debt Requires Strong Economic Growth

Last June, we reported that the HIPC Initiative will provide significant debt relief to recipient countries.[5] Our analysis showed that for the seven countries we analyzed the total amount of debt was expected to initially fall by more than a third in most cases, with debt service also expected to decline considerably. However, our analysis showed that the debt levels of the seven countries will resume rising following the receipt of debt relief under the initiative. This will occur because in order to have the funds that are expected to be spent on poverty reduction—the so called "freed-up resources" from debt relief—these countries must continue to borrow at the same level as in the years prior to qualifying for debt relief. Countries previously borrowed for several reasons, including debt payments, and they will need to continue borrowing after receiving debt relief in order to meet their remaining debt payments and increase spending on poverty reduction. Thus, these countries cannot both increase their spending on poverty reduction and reduce their annual borrowing by the amount their debt service was lowered.

Countries' ability to repay their future debt depends on the assumption that countries will achieve strong, sustained economic growth. Most recipient countries that we analyzed are projected by World Bank and Fund staffs to have robust growth in income and export earnings, with the projected export growth of four of these countries—Honduras, Nicaragua, Tanzania, and Uganda--expected to average at least 9.1 percent a year over 20 years. These growth levels are presumed to contribute considerably to these countries' ability to meet their future debt obligations. Sustaining such levels over a 20-year period will be difficult. These countries rely on a small number of primary commodities, such as coffee, for a majority of their export earnings, and the price of these commodities tend to fluctuate over time, with export earnings in fact declining in

[5] See *Developing Countries: Debt Relief Initiative for Poor Countries Faces Challenges*.

certain years. At an April 11, 2001, IMF Executive Board meeting, several Directors expressed concern that some countries' debt might not be sustainable if the projected output and export growth rates do not materialize.

Shortfalls in these growth projections will lower the amount of revenue these countries will be able to contribute toward their future debt service. If these countries are to remain debt sustainable (that is, be able to make their debt payments on time without the need for future debt relief), this shortfall will need to be made up through increased donor assistance. Without such assistance, countries will no longer be debt sustainable and will require additional debt relief, or they will accumulate arrears. For example, in the case of Tanzania, if actual export growth is 20 percent less than projected, Tanzania will not be able to repay its debt obligations unless donor flows (both loans and grants) increase by more than 30 percent. Such an increase in lending could more than double Tanzania's total debt over what was originally forecast for the projection period.

<u>Strong, Sustained Economic Growth Essential to Reach Consideration for Graduation</u>

As we reported last week, most of the 32 countries that borrowed concessional resources from the IMF in 2000 will need to achieve strong, sustained economic growth to reach eligibility for graduation within the next 15 years.[6] These countries would have to achieve an annual average growth rate of 6 percent, which is substantially greater than the negative 1 percent growth rate the countries averaged over the previous 15 years. Standard & Poor's DRI projected the countries to have an average of 2.5 percent growth over the next 15 years.[7] Based on these projected growth rates, as shown in figure 1, most countries need considerably more than 15 years to reach the graduation threshold.

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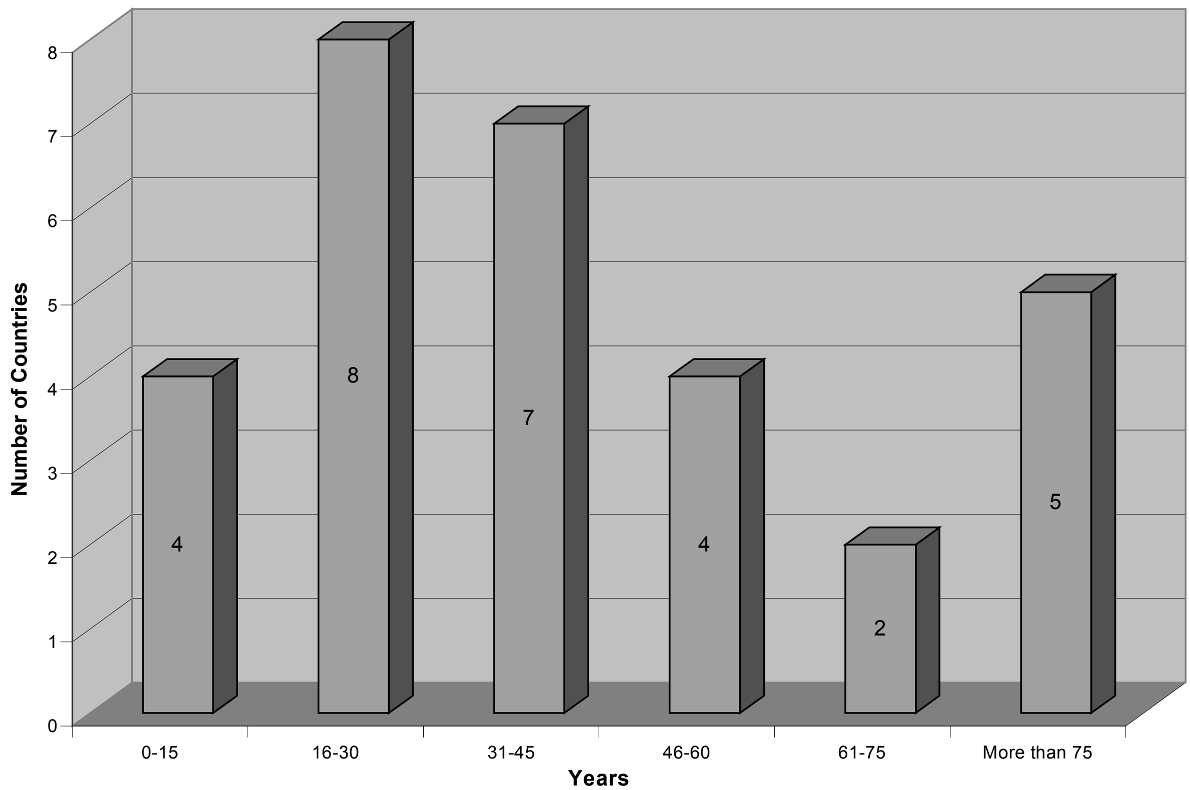
[6]See *International Monetary Fund: Few Changes Evident in Design of New Lending Program for Poor Countries*.

[7]DRI is a unit of Standard & Poor's, which is a division of The McGraw Hill Companies. It is a leading provider of industry and economic data, forecasting, and consulting services. Its World Forecast Database includes historical and forecast data for 170 countries.

Figure 1: Number of Years Until Countries Reach Eligibility to Graduate From Concessional Borrowing



Note: The median number of years to reach the graduation income level is 34 years; the average is 59 years. These values include two countries (Bolivia and Macedonia) whose income levels already exceed the eligibility threshold.

Source: GAO analysis using data from the World Bank and Standard & Poor's DRI.

Given that the current annual per capita income levels of these countries is generally quite low (an average of $427), the median length of time required for these countries to reach the graduation threshold at their projected per-capita income growth rates is 34 years, with five countries requiring more than 75 years.

If the changes announced by the IMF for its lending program to its poorest members, particularly country ownership of the macroeconomic framework, improve the overall effectiveness of a country's development program, the likelihood of earlier graduation from the IMF's program could increase. However, the actual impact of these changes on economic growth is unknown at this time. Moreover, as discussed below, there are many challenges and obstacles to establishing country ownership.

COUNTRIES FACE CHALLENGES IN PREPARING POVERTY REDUCTION STRATEGIES

Linking Debt Relief and Poverty Reduction Creates Tension Between Quick Debt Relief and Comprehensive Strategies

Last year we reported that linking HIPC debt relief and poverty reduction creates tension between quick debt relief and comprehensive strategies.[8] Preparing a comprehensive, "country-owned" poverty reduction strategy can be complicated and resource intensive, with success dependent on countries reaching widespread agreement on sensitive and complex issues. Given the high incidence and the numerous and diverse causes of poverty, the donors have called for a multifaceted approach to reduce poverty. This approach is to include rapid economic growth, civil society participation, good governance, and measures targeted at the specific causes of poverty. However, coordinating so many actions can tax already limited government resources. Moreover, while the World Bank and the IMF call on governments to describe how their actions will reduce poverty, there is limited evidence showing which actions have the greatest impact on reducing poverty. Moreover, weaknesses in recipient countries' capacity to collect and analyze data on the nature, extent, and major causes of poverty may limit efforts to develop baseline data against which future progress can be measured.

Finally, country ownership and donor support of the poverty reduction strategy can be difficult to achieve. While having countries (government and civil society) take ownership of their strategies is increasingly seen as important for greater effectiveness, operational issues take time to resolve. For example, it is not clear how to define ownership at the country level or determine who will represent civil society. Nongovernmental organizations and some donor governments raised the concern that in

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[8]See *Developing Countries: Debt Relief Initiative for Poor Countries Faces Challenges*.

order to receive HIPC debt relief quickly and irrevocably, recipients may "shortcut the quality" of their strategies and limit the extent of civil society participation. They therefore suggested separating the link between the timing of debt relief and the preparation of poverty reduction strategies, recognizing that recipient countries are likely to be monitored under World Bank and IMF programs for many years. However, the World Bank, the IMF, and the U.S. Treasury argued that the link should remain, since some countries do not have to prepare a full poverty reduction strategy in order to begin receiving debt relief, and the link is needed to ensure that governments undertake reforms and use resources effectively.

Developing a Country-owned Macroeconomic Framework Is Difficult

Last week we reported that there are few differences between the IMF's new lending program for poor countries and its previous program.[9] The one major design change, getting countries to take ownership of their macroeconomic policies—which are to be included in their poverty reduction strategies—is difficult to achieve. This is true for three reasons. First, many recipient governments have limited technical capacity relative to the substantial complexities inherent in establishing macroeconomic policies and targets. Governments' limited ability to independently analyze and effectively negotiate the macroeconomic framework reduces the opportunity for country-specific elements to be addressed. Second, the challenges to effectively engaging civil society in a dialogue on these very complex matters are significant. For example, while the government of Benin has begun a dialogue with civil society, many people told us that they were unsure how to use this dialogue to address the country's complex macroeconomic policies and targets, other than the composition and level of spending. Moreover, although there is ample donor assistance in Benin, we were not told of any research organizations that are assisting Benin in the development of its macroeconomic framework. Finally, a national dialogue on the choice of effective policies is hampered by the limited knowledge of all parties about how different policies actually affect elements of the macroeconomic framework. Even if country ownership increases, given the need for poor countries to maintain macroeconomic stability, which is essential for economic growth and poverty reduction, the actual policies and targets within the macroeconomic framework are not likely to be altered substantially from the past.

OBSERVATIONS

Last year we made the following observations on the HIPC Initiative. We believe they still hold true. The HIPC Initiative represents a step forward in the international community's efforts to relieve poor countries of their heavy debt burdens, and it does so by seeking to include all creditors and providing significant debt relief to recipient countries. However, unless strong, sustained economic growth is achieved, the initiative will not likely provide recipient countries with a lasting exit from their debt problems. Furthermore, as long as the initiative links debt relief to poverty reduction strategies, the tension between quick debt relief and comprehensive country-owned strategies is likely to continue. These issues should not be seen, however, as a reason to abandon efforts to provide debt relief to eligible countries. Heavily indebted poor countries continue to carry unsustainable debt burdens that are unlikely to be lessened without debt relief, but participants and observers need to have a more realistic expectation of what the initiative may ultimately achieve.

While countries face difficulties in achieving ownership of their macroeconomic frameworks, efforts to involve civil society have potential benefit. Although civil society may not be able to influence the macroeconomic framework through the initial poverty reduction strategy, civil society may help improve the allocation of resources and increase the amount of resources donors are willing to provide by helping establish priorities for poverty reduction.

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[9] See *International Monetary Fund: Few Changes Evident in Design of New Lending Program for Poor Countries*.

Mr. Chairman and Members of the Subcommittee, this concludes my prepared statement. I will be happy to answer any questions you or other Members may have.

CONTACTS AND ACKNOWLEDGMENTS

For future contacts regarding this testimony, please call Susan Westin or Tom Melito at (202) 512-4128. Individuals making key contributions to this testimony included Cheryl Goodman and R.G. Steinman.

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