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What to do after the clean slate?

Post-relief public debt sustainability and management

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April 2015

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0 Introduction

Now that the major international public debt relief initiatives for low-income countries, that gained momentum from the mid-1990s onwards, are coming to an end, the time seems ripe to reflect on their legacy and to cast some light on the future. The aim of this report is therefore twofold. First, it summarises the body of evidence on the evolution and effects of past debt relief efforts, with a focus on the relief granted to Heavily Indebted Poor Countries (HIPCs). Second, the report documents a number of (post-relief) trends in development financing and (existing and proposed) initiatives that are deemed of importance for developing countries' public debt situation and its longer-term outlook.

The structure of the report is the following. Sections 1 and 2 describe the main initiatives that official creditors have concocted over the years to ease developing countries' public debt burdens, before and since HIPC respectively. More than other, previous accounts, such as Gamarra et al. (2009) and Cassimon and Essers (2013), we pay special attention to the (few) countries that could still benefit from debt relief under the HIPC Initiative in the years to come, and to certain creditors that have not (yet) delivered their share of the envisioned relief, including the role of so-called 'vulture funds'. Section 3 brings together the available, often tentative, evidence regarding the effects of debt relief on HIPCs' public debt stocks and debt service, governance, creditworthiness and pro-poor spending; as well as on economic growth and poverty reduction. In Section 4 the issue of post-relief, longer-term debt sustainability is examined, based on the conclusions of the IMF's most recent debt sustainability analyses (DSAs) in HIPCs and other Poverty Reduction and Growth Trust (PRGT)-eligible countries. Section 5 then zooms in on the current risks to such debt sustainability. More particularly, we discuss the ongoing changes in the development (finance) landscape and provision of official development aid (ODA), and developing countries' shifting debt structure; due to their increased access to non-concessional sources of financing from emerging donors and international and domestic capital markets. As a logical follow-on, Section 6 looks at ways and mechanisms to maintain debt sustainability now and in the future: the need for countries to focus on a solid macroeconomic basis; the monitoring of debt sustainability under improved DSA exercises; externally provided support for debt management on various levels; and a series of (proposed) reforms aimed at facilitating orderly debt work-outs if needed. With respect to the last point we make a start in comparing 'market-based' and 'statutory' approaches to future restructuring of (non-concessional) sovereign debt, i.e., adaptations to the contractual clauses of international bonds vs. a full-fledged multilateral legal framework. Section 7 concludes the report with a list of the most important takeaways.

1 Debt relief preceding HIPC

In the first decades after the end of World War II, the number of countries requesting a restructuring or relief on their debt titles remained minimal. From 1946 to 1972, the year before the first global oil crisis broke out, only nine Asian and South American countries sought help in fulfilling their debt obligations. Official creditors' main motivation was to assist debtor countries in bridging periods of repayment problems by providing assistance, thereby avoiding imminent default in the short run and increasing the chance of recuperating their full claims in the longer run. To achieve this objective, all creditors needed to be convinced to make equal concessions and the debtor countries to undertake maximum effort to redress their economic problems. The establishment of a coordinated framework for the work out of such debt restructurings was thought to facilitate this process (Gamarra et al., 2009). In May 1956, an informal group of creditor nations gathered under the auspices of the French Treasury in Paris to discuss a renegotiation of debt provided to Argentina. This group came to be commonly known as the 'Paris Club', an "informal group of official creditors whose role is to find coordinated and sustainable solutions to the payment difficulties experienced by debtor countries" (see www.clubdeparis.org for more information). Given the short-term perspectives of these initial reschedulings, many of the first debtor countries could not but return to the Paris Club several times.

TABLE 1: PARIS CLUB DEBT RESCHEDULINGS (1956-1974)

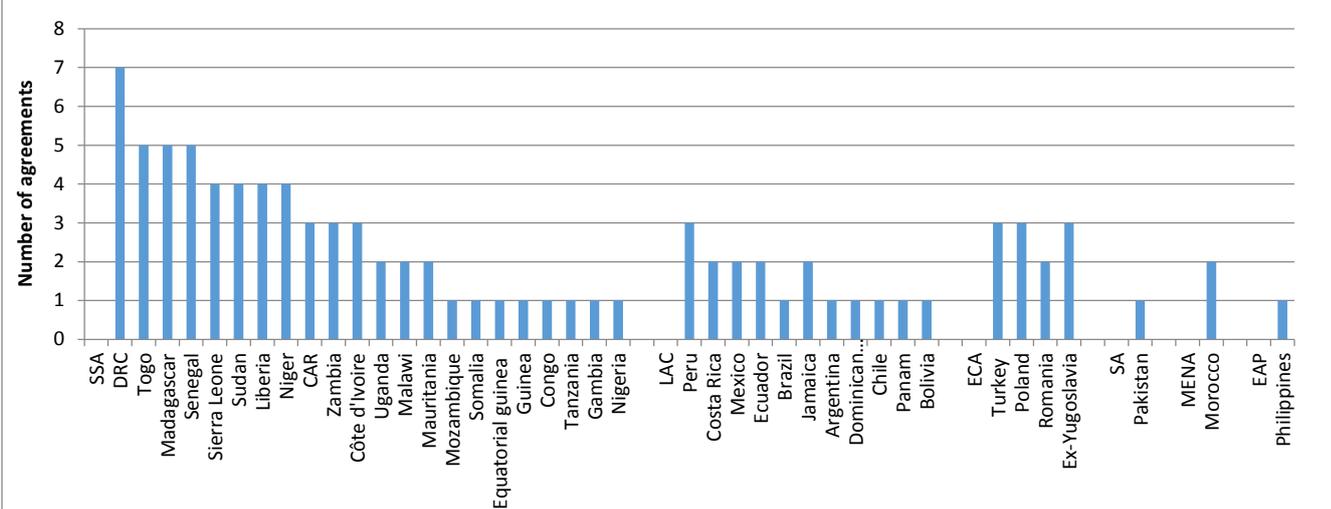
Country	Number of reschedulings	Years of reschedulings
Argentina	3	1956, 1962, 1965
Brazil	2	1961, 1964
Chile	3	1965, 1972, 1974
Indonesia	4	1966, 1967, 1968, 1970
Peru	2	1968, 1969
Cambodia	2	1972, 1972
Pakistan	2	1972, 1974

Source: Paris Club (2015)

International economic instability in the 1970s and 1980s, more particularly commodity price booms and busts, oil shocks, high interest rates and a global recession, accompanied by a huge build-up of the external debt of developing countries (partly because of easily given credit by the debtors), increased the number of requests to the Paris Club (Cassimon et al., 2011a). In 1976, Zaire was the first African country to reach an agreement with the Paris Club, but many others followed soon after. In line with their earlier, not necessarily successful, experiences with middle-income countries, the Paris Club members also considered the debt problems of low-income countries to be temporary cash flow problems which could be solved by a simple rescheduling of debt service. They believed debt service rescheduling would create the necessary fiscal space for debtor countries to get back on track and grow out of their debt problems; when commodity prices would rise again, for example

(Gamarra et al., 2009). Despite these efforts, the underestimation of the problem led to a continued build-up of debt stock and repetitive debt reschedulings. By the end of 1986, the Paris Club had restructured the debt of 40 countries in 93 agreements.

FIGURE 1: PARIS CLUB DEBT RELIEF AGREEMENTS PER COUNTRY AND REGION (1976-1986)



Source: Paris Club (2015)

Most countries approached the Paris Club more than once and 15, mostly Sub-Saharan African, went even three times or more, generally to re-structure previously rescheduled claims. The perception that debt problems were temporary liquidity problems which could be solved by short-term debt reschedulings slowly lost ground. The need for a more radical approach to solve the deeper-rooted problems was increasingly recognized.

In September 1987 the Special Program of Assistance (SPA) to Low-Income, Debt Distressed Countries in Sub-Saharan Africa was established as another informal consortium of leading bilateral donors (and creditors) to debt-distressed African countries, together with the IMF and the World Bank’s concessional lending arm, the International Development Association (IDA) (Cassimon and Essers, 2013). The program was an important milestone, in the sense that it marked the international community’s first coordinated response to the widespread debt and development crisis on the African continent. Eligible African countries with credible and sustained economic reform programs were given balance of payment support by multilateral and bilateral donors, including debt relief, to spur economic growth. To be eligible, countries needed to have a low per capita income; be eligible for concessional loans from the World Bank’s IDA; be in debt distress, defined as having a debt-service-to-export ratio of 30% or more; and engage in adjustment by implementing a program supported by the IMF and IDA (Gamarra et al., 2009).

A significant breakthrough in the debt crisis was reached in 1988 when the Paris Club, following a G7 summit in Toronto, agreed for the first time on a partial *reduction* of the debt of poor countries.

Under these 'Toronto terms' up to a third of the net present value (PV) of non-concessional bilateral public or publicly guaranteed debt of low-income countries was reduced (Cassimon, 2011a). Donors could choose from a menu of options, including:

- debt stock reduction,
- debt service reduction at a reduced interest rate, or
- a rescheduling at a commercial interest rate but with longer repayment and grace periods

The percentage of PV debt cancellation was raised to 50% when the London terms replaced the Toronto terms in 1991, and finally to 67% when the Naples terms were agreed in 1994 (Paris Club, 2015). In the meantime, Paris Club members also agreed on a number of enhancements to the Classic terms² for lower middle-income countries. These Houston terms however did not provide for debt stock relief. The table below provides the number of deals under each of the terms:

TABLE 2: NUMBER OF PARIS CLUB DEALS UNDER SPECIFIC TERMS

Period	Terms	Number of deals
1988-1991	Toronto	28
1991-1994	London	26
1995-2009	Naples	53
1990-2008	Houston	35

Source: Paris Club (2015)

One additional form of debt relief which has been on the Paris Club menu since the inception of the Houston and London terms, are so-called 'debt-for-development swaps'. These mechanisms offer the possibility of converting, on a voluntary basis, part of ODA debt or non-ODA debt into investments with a social, commercial or environmental finality, executed by the debtor country in local currency. The debt swap provision built further on the debt-for-equity, debt-for-nature, debt-for-health and other debt exchanges that had been conducted earlier with claims obtained on the secondary market for discounted commercial debt. Following their consideration by the Paris Club, the use of debt swap agreements got a boost through different bilateral initiatives.

For debt owed to commercial creditors, such as international banks, relief on external debt followed a similar pattern. While initially the arrangements were negotiated bilaterally, they evolved towards a more coordinated restructuring in the 'London Club', a special advisory committee whose composition reflected the respective size of individual banks' exposure to non-performing loans for

² Under Classic terms debts were rescheduled at the market rate.

the country under consideration. Within the London Club, usually only principal payments were rescheduled, and arrears were expected to be paid at the time the restructuring agreement went into effect. As with the bilateral creditors, the inefficiency of these reschedulings became clear by the mid-1980s. Therefore, in 1989, the Brady Plan was established, laying out a number of voluntary debt reduction mechanisms designed for commercial creditors to exchange non-performing debt titles of (primarily) middle-income countries for new bonds with more favourable (softer) terms (Gamarra et al., 2009). For commercial debt owed by low-income countries, the World Bank created in 1989 the IDA Debt Reduction Facility (IDA-DRF). Under this World Bank-sponsored facility, low-income debtor governments were typically provided grants to buy back their own commercial debt at a deep discount on the secondary market, effectively eliminating these obligations.

2 Debt relief since HIPC

2.1 HIPC

By the mid-1990s the existing debt relief mechanisms seemed to have improved substantially the debt situation of most middle-income countries. For the majority of low-income, mainly African, countries the burden of external debt remained high. By the mid-1990s, following repetitive debt relief operations on bilateral debt, the unsustainability of these countries' debt was increasingly due to the growing share of debt they owed to multilateral institutions, which had been kept out of the traditional debt relief initiatives up till then³. Evidence presented to the Executive Boards of the World Bank and the IMF in February 1996 convinced the members of the Board that even with strong policy performance and full use of existing debt relief mechanisms the debt burden of about half of the so-called HIPCs⁴ was unlikely to be solved. Hence the necessity of debt interventions at the multilateral level was made clear (Gamarra et al, 2009).

In response to this situation, the World Bank and IMF launched the Heavily Indebted Poor Countries (HIPC) Initiative in September 1996. The key objective of the program was to ensure that adjustment and reform efforts by debtors were not put at risk by continued high debt stock and debt service burdens. To achieve this, the initiative aimed to mobilize the international community to reduce the debt burden of eligible countries to sustainable levels subject to satisfactory policy performance and a willingness to carry out strong programs of macroeconomic adjustment and structural reforms. After two years, and on the basis of a comprehensive review, it would be decided whether or not to

³ Only under the fifth dimension of the SPA Programme, concessional bilateral assistance was used to fulfil debt service payments on outstanding obligations on IBRD loans from IDA-only countries.

⁴ For more details on this initial list of HIPC countries, see section 2.1.3

continue the debt-relief-cum-adjustment program (Gautam, 2003; Gamarra et al., 2009). The initiative was based on six guiding principles (Gamarra et al., 2009):

- Overall debt sustainability should be assessed on a case-by-case basis that focuses on the totality of a country's debt.
- Action should be taken only when a debtor has shown the ability to put the debt relief provided to good use.
- Existing debt-relief mechanisms should be built on.
- The provision of debt relief should be coordinated between all creditors, with broad and equitable participation.
- The delivery of debt relief by multilateral creditors should preserve the financial integrity of the institutions and their preferred creditor status.
- New external financing to beneficiary countries should be provided on appropriate concessional terms.

In November 1996, the Paris Club joined HIPC by agreeing on new 'Lyon terms' for eligible HIPCs, increasing the PV of relief to up to 80%. From this moment onwards, international debt relief got onto two parallel tracks: one for HIPCs, for which debt relief was further broadened and deepened in the subsequent years (see further); and one for non-HIPCs, for which debt relief initially remained limited to pre-1996 practices.

2.1.1 The HIPC process

Country eligibility for the HIPC Initiative was based on a number of criteria:

- a country must have a GDP per capita low enough to be eligible for World Bank's and IMF concessional windows, respectively IDA and the Poverty Reduction and Growth Facility (PRGF);
- have established a strong record of policy performance under IMF- and IDA-supported programs;
- and face an unsustainable level of debt. A country's debt sustainability was evaluated in PV in line with Paris Club treatments and to reflect the concessionality of a country's debt, and after taking into account relief provided through traditional relief mechanisms, such as under the Naples terms. At the time, within the HIPC Initiative, debt was considered to be unsustainable when (1) the ratio of the PV of debt stock-to-exports exceeded 200-250% or

(2) the ratio of PV of debt-to-budget revenue was above 280%⁵ (Cassimon and Essers, 2013; Gamarra et al, 2009; Gueye et al., 2007).⁶

The implementation of HIPC consisted of two phases. After successfully implementing reforms through IMF- and IDA-supported programmes for a period of three years, eligible HIPCs reached the end of a first phase, the 'decision point', at which the IMF and World Bank decided on the total amount of debt relief needed (through a debt sustainability analysis (DSA) and taking into account stock treatment on Naples terms). Following a second three-year period, in which country-specific 'triggers' (in areas such as macroeconomic stability, public finance management, debt management and social sector reforms) needed to be met, the debtor country reached 'completion point', resulting in full and irrevocable debt relief to bring down debt to HIPC Initiative thresholds (Cassimon and Essers, 2013; Gueye, 2007).

In September 1999, following a comprehensive review and consultation process and under growing pressure of civil society organisations, HIPC was enhanced. Four important modifications were made to the original framework (Cassimon and Essers, 2013; Gautam, 2003; Gueye et al., 2007):

1. The threshold indicators were lowered, enabling a broader group of countries to qualify and larger volumes of debt relief to be provided. The threshold of debt stock-to-exports was lowered to 150% and the ratio of debt stock-to-revenue to 250%. To reach the required amounts of debt relief, Paris Club creditors again augmented their PV debt relief threshold up to 90%, under the Cologne terms.
2. A floating completion point was introduced, replacing the fixed three-year period, which would be reached after realizing the agreed country-specific triggers. This was meant to provide incentives to speed up the process and increase country ownership.
3. A number of creditors, including the main multilaterals and most Paris Club members, started to provide debt relief earlier in the form of interim debt service relief to countries that reached HIPC decision point.
4. Most importantly, the poverty-reducing focus of the resources freed by debt relief was strengthened by linking the HIPC process to the preparation and implementation of a Poverty Reduction Strategy Paper (PRSP). The preparation of a (interim) PRSP was introduced as a condition for reaching decision point. Completion point became conditional on the adoption of a full PRSP and implementation of its policies for at least one year.

⁵ The debt-to-budget revenue criteria only applied to countries with sufficiently open economies, as defined by an exports-to-GDP ratio of at least 30% and a government revenue-to-GDP ratio of at least 15%.

⁶ The HIPC Initiative also used targets for indicators related to debt service (20-25% in the original framework, 15-20% in the Enhanced framework; see further), but these were merely indicative targets (Cassimon et al., 2007).

2.1.2 Additional debt relief provided to HIPCs

Both bilateral and multilateral creditors have taken steps to provide additional debt relief, beyond the HIPC Initiative. Within the Paris Club, most members voluntarily decided to provide full (100%) debt relief on eligible debt titles once a country reached completion point. One specificity that deserves mentioning here are the French *Contrats de Désendettement et de Développement (C2D)*. For its additional debt relief, France has reverted back to earmarking the use of freed-up funds to a set of jointly determined activities in several sectors. In principle the activities spelled out in a C2D are aligned with PRSP priorities, but this is not necessarily the case for all of them.

On the multilateral side the European Commission decided in 2001 to provide full relief on special loans of eligible least developed country (LDC) HIPCs, through its LDC Initiative. In July 2005, following the G8 summit in Gleneagles, three more multilateral creditors (IMF, World Bank and the African Development Fund (AfDf)) supplemented the HIPC Initiative with the Multilateral Debt Relief Initiative (MDRI), in which all remaining claims (disbursed before a certain cut-off date: end-2004 for IMF, AfDF and IaDB and end-2003 for IDA) would be cancelled for countries reaching completion point. Unlike the HIPC Initiative, MDRI was not primarily concerned with alleviating debt sustainability concerns, a goal which should already have been reached by HIPC, but built on the willingness of donor-creditors to provide HIPCs with additional financial resources to support their progress towards the Millennium Development Goals (MDGs). Indeed, because of its ‘topping-up’ nature, MDRI (and other beyond-HIPC) debt relief could be expected to provide the beneficiary countries with much more real additional ‘fiscal space’ (Heller, 2005) than the HIPC Initiative itself (which extinguished a lot of debt that was very unlikely to be ever repaid). Furthermore, the MDRI was, in contrast to HIPC, not comprehensive in its creditor coverage; it did not prescribe parallel debt relief by bilateral, commercial or other multilateral creditors. Additional debt relief by non-Paris Club bilateral donors or commercial donors remained therefore very much ad hoc. The Inter-American Development Bank (IaDB) joined the MDRI in 2007 (Cassimon and Essers, 2013 and Gamarra, 2009).

Typically, no extra conditionalities have been attached to the provision of this additional debt relief. MDRI debt relief is provided automatically when a country reaches completion point. Countries which ran through the whole HIPC Initiative before 2006 had to pass a short assessment to assure that they would still satisfy the HIPC completion point conditionalities before being granted MDRI relief.

2.1.3 The HIPC sample

The original group of 41 HIPCs was established for analytical purposes in the work leading up to the HIPC Initiative. It included 32 countries which were classified as severely indebted low-income

countries (SILICs)⁷ according to the World Debt Tables of 1994-1995, plus seven countries which had received concessional treatment from the Paris Club⁸ and two lower middle-income countries which had recently become IDA-only countries⁹ (Claessens et al., 1997). For the HIPC Initiative itself Nigeria was excluded from this list, as it was not a IDA-only country.

From the start onwards, the HIPC Initiative was not meant to become a permanent mechanism to relief the external debt of LICs. To provide potentially eligible countries an incentive to encourage early implementation of IDA- and IMF-supported programs of reform, a 'sunset clause' was included from the beginning, setting a final date at which debtor countries had to fulfil the eligibility requirements. This date would also be used to delineate the debt which could be treated under the HIPC Initiative, in order to limit debt relief mainly to debt predating the initiative and hence avoid moral hazard. This sunset clause, which was originally set at end-1998, has been extended four times (to 2000, 2002, 2004 and 2006). Since certain countries still did not fulfil the entry criteria after all these extensions, being in the middle or emerging from conflict, it was decided to change the selection policy. Based on end-2004 income and indebtedness data, the list of countries which could become eligible for the Initiative was finalized. In April 2006, the Boards of the IMF and IDA subsequently endorsed and closed the list of countries (IMF and IDA, 2006a).

In the meantime, three countries have been added to the initiative as they expressed interest to be included and their debt stocks appeared to be unsustainable. The table below gives a complete list of all countries which have been considered for HIPC along the road, their current status and their history of Paris Club debt treatments.

⁷ Burundi, Central African Republic, Côte d'Ivoire, Equatorial Guinea, Ethiopia, Ghana, Guinea, Guinea-Bissau, Guyana, Honduras, Kenya, Lao PDR, Liberia, Madagascar, Mali, Mauritania, Mozambique, Myanmar, Nicaragua, Niger, Nigeria, Rwanda, Sao Tome and Principe, Sierra Leone, Somalia, Sudan, Tanzania, Uganda, Yemen, Vietnam, Zaire (currently DRC) and Zambia (World Bank, 1994).

⁸ Benin, Bolivia, Burkina Faso, Cameroon, Chad, Senegal, Togo (Claessens et al., 1997).

⁹ Angola and the Republic of Congo, which were classified as severely indebted middle-income Countries (SIMICs) in the World Debt Tables 1994-1995 (World Bank, 1994).

TABLE 3: LIST OF HIPC COUNTRIES AND COUNTRIES CONSIDERED FOR HIPC

Original list of HIPCs (41)	Current status/reason for exclusion	If not HIPC, Paris Club agreements?
Benin, Bolivia, Burkina Faso, Burundi, Cameroon, Central African Republic, Republic of Congo, Côte d'Ivoire, Ethiopia, Ghana, Guinea, Guinea-Bissau, Guyana, Honduras, Liberia, Madagascar, Mali, Mauritania, Mozambique, Nicaragua, Niger, Rwanda, Sao Tome and Principe, Senegal, Sierra Leone, Tanzania, Togo, Uganda, Zaire (currently DRC) and Zambia	HIPC completion point	
Chad	HIPC decision point	
Somalia, Sudan	Pre-decision point HIPC	
Myanmar	Low risk of debt distress, not eligible for HIPC	Paris Club agreements: 2013 (ad hoc, active)
Angola	Debts expected to be sustainable without HIPC debt relief	Paris Club agreements: 1989 (classic, fully repaid)
Kenya	Debts expected to be sustainable without HIPC debt relief	Paris Club agreements: 1994 (ad hoc, fully repaid), 2000 (ad hoc, active), 2004 (Houston, active)
Vietnam	Debt expected to be sustainable without HIPC debt relief	Paris Club agreements: 1993 (London, active)
Equatorial Guinea	Did not fulfil the criteria: not IDA-only	Paris Club agreements: 1985 (Classic, fully repaid), 1989 (Toronto, active), 1992 (London, active), 1994 (London, active)
Lao PDR	Did not fulfil the criteria: did not meet the indebtedness criteria at end-2010 and was excluded from the list of HIPC eligible countries in 2011	No Paris Club agreements
Nigeria	Did not fulfil the criteria: not IDA-only and debt would not exceed the HIPC thresholds after the full use of traditional debt relief	Paris Club agreements: 1986 (Classic, fully repaid), 1989 (Classic, fully repaid), 1991 (Houston, fully repaid), 2000 (Houston, fully repaid), 2005 (Ad hoc, fully repaid)
Yemen	Debt expected to be sustainable without HIPC debt relief	Paris Club agreements: 1996 (Naples, active), 1997 (Naples, active), 2001 (Naples, active)
Added to the list of countries along the road (3)		
The Comoros	Added to the list of HIPCs as debt appeared to be unsustainable and they have expressed interest in seeking relief under the enhanced HIPC	

Gambia	Initiative. HIPC completion point Added to the list of HIPCs in 2000 as debt appeared to be unsustainable. HIPC Completion Point	
Malawi	Added to the list of HIPCs in 2000 as debt appeared to be unsustainable. HIPC Completion Point	
Taken into consideration based on end-2003 and end-2004 data (13)		
Afghanistan, Haiti	HIPC Completion point	
Nepal	Potentially eligible, but government indicated that it does not wish to avail itself to the HIPC Initiative.	No Paris Club agreements
Eritrea	Pre-decision point HIPC	No Paris Club agreements
Tonga	Debt below thresholds	No Paris Club agreements
Bangladesh	Debt below thresholds	No Paris Club agreements
the Kyrgyz Republic	Did not meet the indebtedness criteria at end-2010 and was excluded from the list of HIPC eligible countries in 2011. Government later indicated that it did not wish to avail itself of assistance under the HIPC Initiative.	Paris Club agreements: 2002 (Houston, fully repaid), 2005 (ad hoc, active)
Bhutan	Did not meet the indebtedness criteria at end-2010 and was excluded from the list of HIPC eligible countries in 2011.	No Paris Club agreements
Sri Lanka	Government indicated it does not wish to avail itself to the initiative	Paris Club agreements: 2005 (ad hoc, fully repaid)
Cape Verde	Debt below thresholds	No Paris Club agreements
Tajikistan	Debt below thresholds The country however received MDRI assistance from IMF as its annual income per capita was below US\$380.	No Paris Club agreements
Moldova	Debt below thresholds	Paris Club agreements: 2006 (Houston, active)

Georgia	Debt below thresholds	Paris Club agreements: 2001 (ad hoc, active), 2004 (Houston, active)
Special cases (2)		
Zimbabwe Cambodia	Potential eligibility remains unclear Debt appeared to be sustainable after assessment. The country however received MDRI assistance from IMF as its annual income per capita was below US\$380.	Paris Club agreements: 1972 (Classic, fully repaid), 1972 (Classic, fully repaid), 1995 (Naples, active)

Source: For completion point, decision point, pre-decision point and potentially eligible HIPCs: IMF (2014a); for Angola, Kenya, Yemen and Vietnam: IMF and IDA (2005a); for the Comoros, Equatorial Guinea, Gambia, Malawi and Nigeria: IMF and IDA (2002); for Bhutan, Kyrgyz Republic, and Lao PDR: IMF (2013a); for The Comoros: IMF and IDA (2001); for Cambodia and Gambia: World Bank and IMF (2000); for Bangladesh and Tonga: World Bank and IMF (2006); for Kyrgyz Republic and Sri Lanka: IMF and IDA (2011); for Cape Verde, Georgia, Moldova and Tajikistan: IMF and IDA (2005b); for Cambodia and Tajikistan: IMF and IDA (2007); for Myanmar: IMF (2014d)

As of March 2015, the HIPC Initiative is nearly completed. Out of the 39 countries that have been eligible under the Initiative, 35¹⁰ reached completion point. The other four countries are still in the process:

- Interim countries (between decision and completion point):
 - Chad could achieve its HIPC completion point in the first half of 2015 if performance in the first review of its IMF-supported ECF program (based on end-2014 data) is deemed satisfactory (IMF, 2014b). With respect to the other triggers good progress has been made and an annual progress report on the implementation of the PRSP has been finalized by the authorities (IMF, 2014a).
- Pre-decision point countries:
 - The last Article IV consultation with Eritrea took place in 2009 and there has been no discussion since then. The political situation remains fragile (IMF, 2014a).
 - Somalia has been re-initiated as an active member state of the World Bank and IMF but it remains ineligible for financial assistance due to protracted arrears to both institutions. The last Article IV consultation took place in 1989. The main development partners (World Bank, IMF, AfDB, EU, DFID) are working together to reconcile the country's external debt data. Furthermore, some basic data and rudimentary central bank operations need to be in place to build the macroeconomic framework for surveillance and Staff-Monitored Program (SMP) purposes (IMF, 2014a).
 - After South Sudan's secession from the North (now Sudan), both countries in September 2012 came to a so-called 'zero option' agreement. Under this agreement Sudan would retain all external debt liabilities, provided that it would obtain debt relief through the HIPC Initiative within two years. Absent such a commitment, Sudan's external debt would be apportioned based on a formula yet to be determined. How such a debt division could look like is illustrated in Leo (2010), based on prior experiences in Yugoslavia and Pakistan. Three main debt division mechanisms have been applied in previous cases: (1) the final beneficiary principle divides debt based according to the geographic region(s) that benefited most from the original loans, (2) population-weighted division and (3) GDP-weighted division. Depending on the method used, between 79-98% of the Sudanese debt would be

¹⁰ Afghanistan, Benin, Bolivia, Burkina Faso, Burundi, Cameroon, Central African Republic, Republic of Congo, Democratic Republic of the Congo, Comoros, Côte d'Ivoire, Ethiopia, The Gambia, Ghana, Guinea, Guinea-Bissau, Guyana, Haiti, Honduras, Liberia, Madagascar, Malawi, Mali, Mauritania, Mozambique, Nicaragua, Niger, Rwanda, Sao Tomé and Príncipe, Senegal, Sierra Leone, Tanzania, Togo, Uganda and Zambia.

allocated to Sudan. After the recent passing of the deadline of the 'zero option', both countries agreed to extend it to October 2016 (IMF, 2014c).

Very recently Sudan concluded a third review of its SMP with the IMF, one important building block towards attaining the HIPC decision point. The review identified the unsustainable debt burden as a challenge for the implementation of the government's medium-term program, which is highly dependent on international oil prices. The country also made some progress towards meeting the requirements for debt relief.

The recent DSA of South Sudan shows a moderate risk of debt distress. While external debt is very low and there are no arrears, caution is required given the country's fragility and heavy dependence on oil revenues (IMF, 2014c).

Two countries are still potentially eligible for HIPC:

- Coming out of a period of long isolation, Myanmar had built up a substantial amount of debt arrears by 2012. After initial political reforms and an agreement with the IMF on a 12-month SMP for 2013 in support of its economic reform efforts, the way was paved for a solution to handle existing arrears and stop further accumulation of new arrears. The agreements concluded in January 2013 foresaw a refinancing of arrears owed to the World Bank and the Asian Development Bank; a cancellation of Japanese debt of at least 60% (negotiated bilaterally outside the Paris Club); a 100% cancellation of Norwegian loans (following a 1998 Norwegian debt relief plan on cancelling odious debt); and an debt treatment on London Terms with the remaining Paris Club creditors (Austria, Canada, Denmark, Finland, France, Germany, Italy, the Netherlands and the UK), clearing US\$10 billion of its arrears (UN, 2014a). While an agreement had to be reached to solve the problem of Myanmar's arrears, it was less obvious that debt reduction, instead of just refinancing, was an appropriate decision at the time. By cancelling large parts of Myanmar's debt stock, donor-creditors conceded bargaining power in their mission to spur further reforms in Myanmar (Roodman, 2013). Following these arrangements, a recent DSA considered the risk of debt distress to be low and concluded that the country would not be eligible for HIPC (IMF, 2014d).
- Zimbabwean eligibility for HIPC is still subject to a number of hurdles which need to be taken first: (1) debt data are unclear, making it difficult to determine eligibility; (2) the country is still in arrears, making it impossible for multilaterals to start providing debt relief; (3) the country did not meet the World Bank's income criterion at end-2004; and (4) accurate fiscal and macroeconomic data are not readily available either. Based on provisional end-2013

debt-to-export data the Bretton-Woods institutions concluded that the country would not qualify for HIPC debt relief (IMF, 2013a; 2014a).

2.1.4 Delivery of HIPC debt relief

According to the latest estimates available, the total cost of the HIPC debt relief to creditors is estimated at US\$75 billion in end-2013 PV terms. Relief from multilateral creditors accounts for 44.4% of the total, with the remaining debt relief to be granted by bilateral and commercial creditors. For MDRI, the total cost for the four participating multilateral creditors is estimated at an additional US\$39.2 billion in end-2013 PV terms (IMF, 2014a).

The delivery of this assistance is however not uniform among the different creditor groups. Bilateral donor-creditors of the Paris Club and the four largest multilaterals (IDA, IMF, AfDB and IaDB), who together account for about 73.6% of the total calculated cost under the HIPC Initiative, have provided almost their full share of HIPC debt relief. Overall participation by non-Paris Club bilateral creditors (representing an estimated 13% of the total cost) remains however much lower, at 47%. Within this group there is a wide variety in participation, with some having (nearly) fulfilled their share of HIPC debt relief (e.g., China 84%, Guatemala 99%, Algeria 92%), some a significant share (e.g., India 44%, Brazil 76%, Kuwait 79%, Saudi Arabia 69%), some a minor part (e.g., United Arab Emirates 11%, Portugal 7%), and others not participating at all (e.g., Costa Rica, Taiwan) (IMF, 2014a).

Finally, for smaller multilateral creditors and commercial creditors voluntary participation in HIPC, on which the initiative is based, was most difficult to accomplish. To maximize the impact of HIPC debt relief and to ensure equal participation of all creditors, a number of mechanisms have been set up.

Within the group of smaller multilateral creditors, which together account for 7.2% of the debt relief costs under the HIPC Initiative, 20 have committed to deliver debt relief, while eight have not yet indicated their intention to do so. Although the exact data are missing, estimates suggest that little more than half of the debt relief to be provided by these creditors has been delivered (IMF and IDA, 2011). To maximize participation of these creditors, while guaranteeing their own financial sustainability, some of the smaller multilateral creditors¹¹ receive support from the Debt Relief Trust Fund (DRTF) to fulfil their share of HIPC debt relief.

Commercial creditors account for 6.1% of the total debt relief to be provided through HIPC. While this average is low, it masks large differences between HIPC countries, ranging from zero

¹¹ West African Development Bank (BOAD), Central American Bank for Economic Integration (CABEI), Caribbean Development Bank (CDB), Caricom Multilateral Clearing Facility (CMCF), East African Development Bank (EADB), Fund for the Financial Development of the River Plate Basin (FONPLATA), International Bank for Reconstruction and Development (IBRD) (which is a minor creditor for HIPCs), International Fund for Agricultural Development (IFAD) and Nordic Development Fund (NDF)

(Afghanistan, Burkina Faso, the Gambia, Haiti and Mauritania) to 35% (Republic of Congo) (IMF and IDA, 2007). Of this group only very few creditors have agreed to provide even limited debt relief (5.5% of all commercial debt for 29 post-decision point countries in 2006 (IMF and IDA, 2006b)). Debt relief from commercial creditors therefore requires particular efforts (IMF and IDA, 2002; 2004a).

The main mechanisms used for the implementation of commercial debt reduction are debt buy-backs and debt restructurings. To help HIPC countries set up these mechanisms, the World Bank's IDA developed a Debt Reduction Facility (DRF), supported with donor funding, which provides grants and technical assistance to negotiate and finance these operations. Since 1989, the DRF has provided support to 18 HIPC countries (World Bank, 2012). Similar operations have also been financed by other IDA sources or donor financing. Under certain circumstances, HIPC countries have chosen to pay commercial creditors in full because of the threat of litigation, the desire to avoid disrupting a commercial relationship, or the fear of loss of collateral in the case of collateralized commercial loans (IMF and IDA, 2001,2002).

One particular concern for the implementation of commercial creditor debt relief have been the legal actions undertaken by commercial creditors¹² to recover their assets. These litigations, and particularly those of so-called 'vulture funds', who are not the original holders of the concerned debt titles but bought these on the secondary market from commercial creditors at a significant discount rate only with the purpose of trying to recover the full value through litigation, have been an additional concern for the delivery of the HIPC Initiative, because of the risk of free-riding. Since 2002, the IMF and the World Bank have therefore monitored creditor litigations through periodic surveys. At its peak, in 2008, IMF and IDA listed 54 cases¹³ (IMF and IDA, 2008).

While the overall number of cases might not seem large, taking into account the number of HIPC countries, their impact on the HIPC Initiative is potentially important and disrupting, certainly in particular countries with large commercial debts. IMF and IDA (2006b) found, for example, that claims reported by creditor countries amounted to about US\$1.9 billion, about 22% higher than the total HIPC debt relief to be provided by commercial creditors. At individual country level the burden for some countries might be high in terms of number of cases (with Nicaragua reporting nine cases and the Republic of Congo eight cases (IMF and IDA, 2007)). As lawsuits are most frequently filed in industrial country courts (New York, London, Paris), the burden on HIPC countries might also be high in terms of lengthy

¹² In the past, a number of non-Paris Club bilateral creditors have been mentioned as involved in litigations against HIPC countries. Burundi however suspended its court claim (IMF and IDA, 2002), the government of Iraq has denied having given authorization to any group to recover a debt to Uganda (IMF and IDA, 2011), and other creditors have only threatened with litigation (e.g. Côte d'Ivoire against Burkina Faso; see IMF and IDA, 2004a). Also one multilateral development Bank (Shelter Afrique) initiated a case against Uganda which has been settled out of court.

¹³ Of the 40 HIPC surveyed in June 2008, 28 countries responded.

court proceedings requiring substantial inputs in terms of budget and institutional resources. For other countries litigation might be costly in terms of the size of claims under litigation (more than 15% of GDP in the case of the Republic of Congo). In a large majority of the cases filed against HIPC, the creditor obtained a judgment against the HIPC. The amounts awarded to the litigating creditors are often substantial compared to the HIPC's economy or the debt relief provided by HIPC. Court judgments awarded against Liberia, for example, amount to 49% of the country's GDP (IMF and IDA, 2008) and the creditors litigating against Nicaragua were awarded judgements four times the amount of debt relief that should have been provided by commercial creditors (IMF and IDA, 2006b).

While winning lawsuits is one thing, obtaining payments from sovereigns is generally another. Debtors have often refused to make the full payment and enforcement of the judgment for payment has shown to be very difficult. Over time, through negotiations, most cases have been solved by other means (Council of the European Union, 2008; IIF-EMTA, 2009; IMF and IDA 2002, 2007, 2008, 2009, 2010, 2011; Paris Club, 2007):

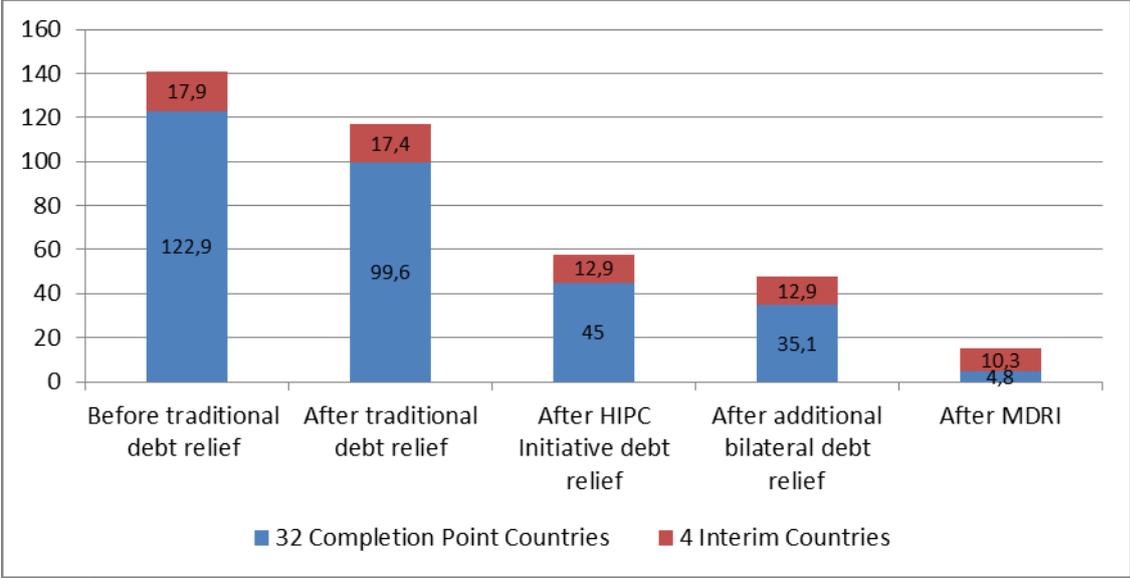
- Many court judgments against HIPCs have been settled through DRF-supported buy-backs at significant discounts (e.g., in the cases of Nicaragua and Liberia) or an agreement in the London Club (e.g., Côte d'Ivoire, even beyond expected HIPC debt relief, or Republic of Congo).
- Other creditors have dropped their litigation, often following pressure from public opinion (e.g., Nicaragua).
- Smaller numbers of individual cases have been agreed through out-of-court settlements (e.g., Cameroon, Guyana, Sierra Leone, Uganda) or international commercial arbitration at significant discount rates.
- On the input side, early engagement with commercial creditors and their engagement in IDA's DRF has reduced the number of new cases.
- Also, Paris club creditors and European Union countries have agreed not to sell their claims on HIPCs to creditors who do not intend to provide debt relief under the HIPC Initiative.
- At the creditor level, a number of initiatives have tried to respond to the threats of litigation (e.g., anti-vulture fund legislation passed in the UK and Belgium).
- Finally, a number of organizations have started to provide technical and legal support to HIPCs, including the HIPC Legal Clinic of the Commonwealth secretariat and the African Legal Support Facility of the African Development Bank.

As a result of these different solutions, the number of cases has declined after 2008 but flattened out over the last years. According to the latest surveys available, the number of litigation cases being

pursued against HIPCs has stabilized at around 18 cases, with the Republic of Congo and the Democratic Republic of Congo being most targeted (IMF, 2014a).

As a result of the debt relief provided through the various initiatives (traditional debt relief, HIPC, and additional debt relief) the debt burden of the 36 post-decision point HIPCs is expected to be reduced by US\$125.7 billion, or nearly 90% (see Figure 2).

FIGURE 2: POST-DECISION-POINT HIPCS’ DEBT STOCK AT DIFFERENT DEBT RELIEF STAGES (IN US\$ BILLIONS, END-2010 PV TERMS)



Source¹⁴: IMF and IDA, 2011

2.2 Debt relief towards non-HIPC countries

Meanwhile, the Paris Club has also sought a more tailored response to the debt situation of middle-income countries and other non-HIPCs. Under the Evian approach, adopted in 2003, Paris Club creditors agreed to take into account issues of debt sustainability of non-HIPCs (based on IMF analyses but with discrete decision power resting with bilateral creditors). Based on an IMF DSA it should be determined whether the debtor country suffers from a liquidity problem or a debt sustainability problem. In case of the former, debt rescheduling continues to be implemented under Classic terms, Houston terms or an heterogeneous middle way.

If the IMF would determine that the country also suffers from a debt sustainability problem, debt cancellation is agreed upon on a case-by-case basis and executed through a multi-year three-stage process in close alignment with an IMF adjustment program. While the Paris Club itself does not list any particular deal under the Evian approach, the large-scale Paris Club debt treatments of Iraq and Nigeria could be seen as belonging to this category, although undoubtedly political factors played an

¹⁴ In the meantime, three of the interim HIPCs have reached completion point (Comoros, Côte d’Ivoire and Guinea). Because of a lack of more recent data on (the PV of) debt relief at the country level, Figure 2 could not be updated.

important role too (Cosio-Pascal, 2008; Weiss, 2013). The recent case of Myanmar could be another, again politically motivated example.

The debt of non-HIPCs (and non-eligible debt titles of HIPCs; mostly post-cut off debt) has furthermore been subject to a new wave of bilateral debt-for-development swap operations between Paris Club members and their debtors. These include, among many others, debt for-nature swaps enacted under the US Tropical Forest Conservation Act (TFCA), debt-for-health swaps under the Debt2Health Scheme of the Global Fund to Fight AIDS, Tuberculosis and Malaria, and debt-for-education swaps. Since the introduction of a new law in 2006, Spain has also used debt swaps as an instrument to top up its relief to various African HIPCs (Burkina Faso, Cameroon, Ethiopia, Ghana, Mauritania, Mozambique, Senegal, Tanzania and Uganda).

3 Evaluation of debt relief operations¹⁵

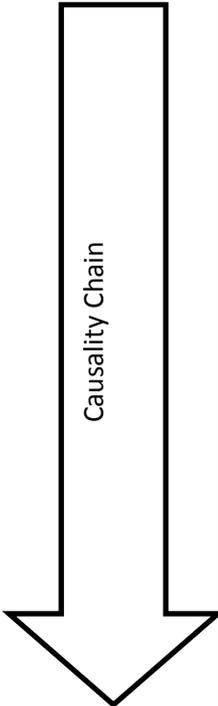
3.1 Evaluation framework

The empirical ex post evaluation literature on international debt relief is growing but still much more limited than the body of analytical work. Due to the paucity and fragmented nature of data on the amounts of debt relief granted outside the HIPC framework, focus in this empirical literature is almost exclusively on HIPCs. Therefore this subsection will adopt a similar focus.

To evaluate the effects of HIPC debt relief, we make use of an evaluation framework developed by Dijkstra (2003). The logical framework of Table 4 presents the different expected effects of debt relief on the vertical axis, while the indicators used to assess each of these effects are listed horizontally.

¹⁵ This section draws liberally on but updates Cassimon and Essers (2013).

TABLE 4: LOGICAL ASSESSMENT FRAMEWORK



objectives-means	indicators
<i>inputs</i>	
- debt relief expenditures and modalities - policy dialogue and conditionalities attached	- amounts spent, assigned and contributed - conditions used
<i>Effectiveness at output level</i>	
- reduction of debt and debt service, increased net fiscal space - improved governance	- debt stock and debt service evolution, government accounts - quality of governance scores
<i>Effectiveness at outcome level</i>	
- debt sustainability - elimination of debt overhang/improved creditworthiness - increased pro-poor spending	- DSA/DSF indicators and analysis - international credit ratings, increased investments - increase in pro-poor spending in government budget
<i>Relevance at impact level</i>	
- economic growth - poverty reduction	- change in GDP - change in poverty indicators

Source: Dijkstra, 2003

At the input level the framework identifies the financial resources granted and modalities used by donors, as well as the type of policy dialogue and other conditionalities attached. The direct results of these inputs, i.e. the outputs, are reduced debt stocks and debt service, which should subsequently result in an increase of net resources available in the government budget (fiscal space). Another, more indirect output of the HIPC Initiative is improved governance resulting from the policy dialogue and conditionalities attached to debt relief. At outcome level, the HIPC Initiative and its supplementary bi- and multilateral debt relief initiatives, in contrast to previous relief operations, explicitly aimed to have three effects: first, clean the debt slate of the country and make it regain debt sustainability; second, eliminate debt overhang and improve creditworthiness; and third, increase the amount (and quality) of poverty-reducing spending. Finally, the ultimate impact of this causality chain should be economic growth and poverty reduction (Dijkstra, 2003).

3.2 Pre- and early HIPC debt relief

Judging by Dijkstra's own analysis of eight country cases (Bolivia, Jamaica, Mozambique, Nicaragua, Peru, Tanzania, Uganda and Zambia), international debt relief during the 1990s performed rather poorly along the different levels of the logical framework¹⁶ (Dijkstra, 2003). Econometric analysis by Hernández and Katada (1996) on a sample of 32 low-income African countries for the period 1984-

¹⁶ Dijkstra herself uses the term 'efficiency' for what we indicate with 'effectiveness at output level'. Because in the evaluation literature 'efficiency' generally refers to achieving certain goals at the lowest possible cost, we think it is somewhat of a misnomer in this context.

1993 also indicates that, unlike aid grants, bilateral ODA debt relief (from 1989 onwards) did not reduce the total indebtedness of the countries or solve their debt overhang problems.

In retrospect the dismal performance of pre-HIPC and early HIPC debt relief during the 1990s should not come as a surprise. These sorts of debt relief very much resembled old-style project aid and balance-of-payment support disbursed during the heydays of structural adjustment, which had limited cash flow effects and have been criticized by donors organisations themselves for failing to bring about the promised development results. Debt relief that imitates these forms of aid can evidently not be expected to do much better (Cassimon and Essers, 2013). Empirical evidence on international debt relief into the new millennium looks, in some aspects, more encouraging.

3.3 Enhanced HIPC debt relief

3.3.1 HIPC debt relief effectiveness at output level

At output level there seems to be convincing proof of HIPC debt relief effectiveness. As indicated earlier, when HIPC and 'beyond-HIPC' debt relief will be fully executed, total (external) debt stocks of the current 36 post-decision point HIPCs will be almost 90% lower in end-2010 PV terms than before traditional (pre-HIPC) debt relief (IMF and IDA, 2011; see Figure 2). For a subset of 25 African HIPCs, Merotto et al. (2014) show a decrease of nominal debt to GDP from 146% at decision point to 31% following MDRI. Over the same period, the PV of external debt to GDP decreased from 48% to 15%. These last trends do not even take into account pre-HIPC debt relief.

Debt service payments of the 36 post-decision point HIPCs have come down by almost two percentage points of GDP, on average, between 2001 and 2012 (IMF, 2014a).

Using econometric analysis, Cassimon and Van Campenhout (2007, 2008) show that HIPC debt relief (up to the mid-2000s) has on average reduced domestic borrowing and increased government recurrent primary spending for different samples of HIPCs. In fact, they find that the fiscal response effects of HIPC debt (service) relief are most similar to those of programme grants (such as sector and general budget support). Merotto et al. (2014) look at a set of 31 African countries, including HIPCs and non-HIPC recipients of Paris Club debt relief (Kenya and Nigeria), and the importance of domestic debt following HIPC and MDRI (2003-2005). They show that the importance of domestic debt has remained constant in the wake of these initiatives, concluding that HIPCs haven't made disproportionate use of domestic borrowing.

On the crucial question of whether debt relief crowds out traditional aid, Powell and Bird (2010) show that, at least in Sub-Saharan Africa, the donor community has treated post-2000 debt relief as a complement rather than a substitute for other aid interventions (see also Cassimon and Van

Campenhout, 2008). Dömeland and Kharas (2009) are more reticent in their claims; by comparing resources provided to HIPCs and non-HIPCs they conclude that there are no significant differences but that the HIPC Initiative may have simply prevented a decline in net transfers to HIPCs. Overall, the available evidence seems to suggest that HIPC and beyond-HIPC debt relief have created real fiscal space (compared to a counterfactual situation where there had been no such debt relief, at the minimum).

Finally, several studies have found recent debt relief to be positively associated with improvements in recipient countries' governance quality (see e.g., Depetris Chauvin and Kraay, 2007; Freytag and Pehnelt, 2009). Causality is however difficult to establish (Presbitero, 2009).

3.3.2 HIPC debt relief effectiveness at outcome level

At outcome level, Beddies et al. (2009) indicate that, at end-2007, post-completion point HIPCs had a rosier debt outlook and lower risk of debt distress than other HIPCs and non-HIPC low-income countries. The global financial and economic crisis did not translate into new systemic debt sustainability problems for HIPCs according to the IMF and World Bank (2010). Hernández and Gamarra (2011) claimed that an intensified and protracted global crisis, coupled with more stringent financing conditions, might nevertheless lead to renewed debt distress in the not-too-distant future, even for African post-completion HIPCs.

Cassimon and Van Campenhout (2007, 2008) uncover a positive trend in HIPC government investments in the years following debt forgiveness (albeit with a certain lag), in accordance with debt overhang theory. Recent work, which extends the study period up to 2011, confirms the positive results HIPC debt relief has had on public investment, but fails to find an equally strong impact for the MDRI (Cassimon et al., 2013a). More indirect evidence supporting the argument that concerted debt relief can eliminate debt overhang comes from Raddatz (2011). By employing an event study methodology he shows that stock market prices of South African multinationals with subsidiaries in African HIPCs react positively to announcements about major debt relief initiatives. Conform expectations, the price effects are greater for announcements about the MDRI and enhanced HIPC (which provide deeper and broader relief) than for news on the original HIPC Initiative.

Finally, for what concerns pro-poor spending, IMF (2014a) allege that, over the 2001-2012 period, poverty-reducing expenditures by post-decision point HIPCs (as defined in their respective PRSPs) have risen by more than two percentage points of GDP, more than the decline in debt service over that period. There is however great heterogeneity of such expenditures at the country level, with some interim- and post-completion HIPCs seriously lagging behind (Presbitero, 2009). Moreover,

most econometric studies find the effect of HIPC debt relief on government spending in the education and health sector not to be significant when controlling for other factors (Crespo Cuaresma and Vincelette, 2008; Depetris Chauvin and Kraay, 2005; Schmid, 2009), or to be significant only when accompanied by positive institutional change (Dessy and Vencatachellum, 2007). So, whereas in the past decade government spending on poverty reduction purposes has definitely increased for some (if not most) HIPCs, debt relief may not necessarily have played an important role.

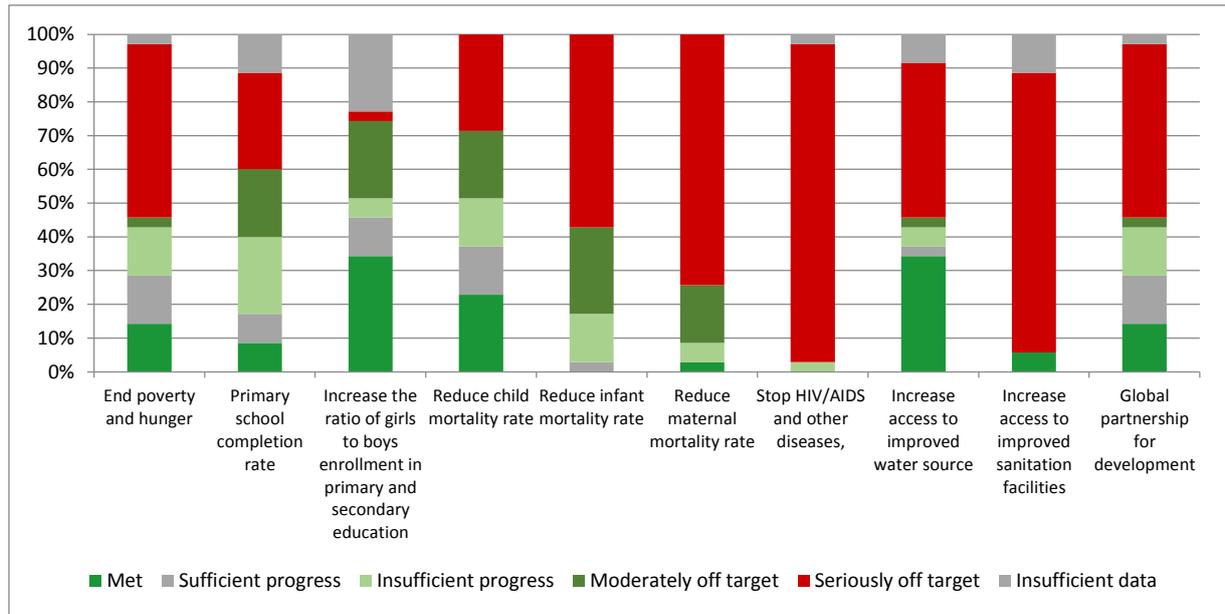
3.3.3 HIPC debt relief relevance at impact level

Third and last, the evidence on the potential of debt relief to eventually generate economic growth and reduce poverty in recipient countries is still inconclusive. Taken together, the results of Depetris Chauvin and Kraay (2005), Presbitero (2009) and Johansson (2010) seem to suggest that a debt relief-growth nexus, if it exists, is certainly not omnipresent and may exhibit non-linear characteristics.

Probably even more difficult to verify is the causal link between debt relief and poverty reduction. Looking at the progress of the 35 post-completion HIPCs towards achieving the MDGs, it appears that most of them will likely miss many of the goals set by 2015. All but two HIPCs¹⁷ are 'seriously off target' in halting HIV/aids and other diseases. Countries are also lagging behind to meet the MDGs in areas of increased access to improved sanitation facilities and a reduction of maternal mortality rates. HIPCs score better in increasing their population's access to improved water sources, improving the ratio of girls to boys enrolment in primary and secondary education and reducing child mortality. On these MDGs, nearly a third of the HIPCs have met the target or have made sufficient progress. The IMF (2014a) argues that, overall, most HIPCs have exhibited significant progress on the MDGs, taking into account the position they started from.

¹⁷ The remaining two are the Central African Republic (insufficient data) and the Comoros (insufficient progress).

FIGURE 3: PROGRESS MADE BY HIPCS ON THE MDGS



Source: IMF, 2014a

These findings are in line with Crespo et al. (2008) and Schmid (2009) who find seemingly robust evidence of HIPC debt relief lowering primary school drop-outs and reducing infant mortality rates, respectively. HIPC conditionality, which induces economic and political reforms and strengthens the links between debt relief, poverty reduction and social service delivery, is advanced as a possible explanatory factor. This hypothesis asks for further scrutiny, however.

Taking all the evidence at the different levels together, one could cautiously conclude that the HIPC debt relief has been more successful than previous debt relief operations. In contrast to pre-HIPC and early HIPC debt relief, more recent operations under the enhanced HIPC Initiative and MDRI have, on average, succeeded in making debt stocks and service sustainable and generating real fiscal space. Part of the differences in assessment can be attributed to debt relief's equivalence with certain aid modalities in terms of conditionality sets and cash flow effects (see Cassimon and Essers, 2013). The direct impact of HIPC/MDRI relief on governance, pro-poor spending and, ultimately, growth and poverty reduction is perhaps more elusive (which is not very different from what evaluations of direct budget support find; see e.g., IDD and Associates, 2006). Rigorous empirical study of these and other potential effects of debt relief should be seen as an ongoing research programme. Nevertheless, one needs to keep 'expectations... modest and time horizons long' (Moss, 2006, p. 293).

3.4 Post-HIPC Debt Relief

3.4.1 Evian approach

With the introduction of the Evian approach in 2003, Paris Club creditors have sought to provide an answer to the debt problems of non-HIPC countries for whom the traditional debt relief approaches were not sufficient and, as a result, came back repetitively to the Paris Club (see before).

Some have argued that the Evian approach is unfair and leaves the door open for politically motivated debt relief. While the case for debt relief to Iraq, for example, was compelling, the same argument could be applied to many other countries which emerged from conflict (Siegle, 2004). That notwithstanding, Singh and Andritzky (in Weiss, 2013) argue that the political debt deal with Iraq would not have passed if it could not have been fit within the Evian approach.

To determine debt sustainability, the Paris Club relies on the DSAs carried out by the IMF. However, the bilateral creditors themselves draw their own conclusions out of these DSAs to decide on the appropriate levels of debt relief (Cosio-Pascal, 2008).

One of the foundations of the Evian approach was the lack of comprehensive treatment of all creditors. This allowed non-participating creditors, like commercial or non-Paris Club creditors, to free ride and increase the likelihood of being repaid. Within the approach, the Paris Club, together with the debtor country, commits to push hard for comparable debt treatments by other creditors. But as the HIPC Initiative has shown, this does not provide any guarantee. Commercial creditors in particular are hard to convince and seem to have incentives to free ride on other creditors' relief efforts.

In sum, the Evian approach has been an honourable attempt by Paris Club creditors to assist non-HIPCs in keeping their debts sustainable. However, implementation of the Evian approach is perhaps too ad hoc, which risks (mis)using it for political purposes and resulting in an unequal treatment of countries.

While the Evian approach has not been the subject of any comprehensive evaluation up to now, country-level evaluations of specific deals exist. In the case of Nigeria, for example, Dijkstra (2013) concludes that the 2005 debt relief deal played a key role in improving the country's economic performance. Of the three possible impact channels of debt relief she studies, i.e., the flow channel (reduced debt service), the stock channel (removal of debt overhang) and the conditionality channel, the last one seems to have been the most influential as the anticipation of debt relief unlocked political reforms which had been blocked for a long time.

3.4.2 Debt swaps

As indicated before, debt-for-development swaps have again gained some importance in financing projects in health, education, conservation and other sectors. Even when focusing only on debtor countries or debt titles outside the HIPC and MDRI Initiatives, these swaps may seem like an unfortunate anachronism by returning to the practice of micro-earmarking (mimicking old-style project aid), contrary to the principles advocated under the new aid approach.¹⁸

Elsewhere we have critically examined recent individual cases of debt-for-development swaps, in a variety of sectors (see Cassimon et al., 2008, 2011b, 2011c). Overall and unsurprisingly so, these case studies hint at low debt relief effectiveness at output and outcome levels. Of course, in principle, debt-for-development swap operations could be ‘engineered’ to better accommodate potential problems.

First, to generate and maximize the net cash flows for the recipient, swaps should preferably target non-concessional debt titles (whose relief implies larger and quicker gains) that are likely to be serviced. Also, to create fiscal space (or at least to not destroy it) and to ease budgetary pressures on the debtor country government, counterpart payments should incorporate a discount, reflecting the possibility of non-repayment of the original obligations (if any), and reflect as closely as possible the repayment schedule of the original debt.

Second, debt-for-development swaps should respect principles of additionality, complementing rather than substituting for other forms of donor support.

Third, and in line with commitments made in Paris, Accra and Busan, the support freed up by swaps should be policy-aligned with debtor country national development strategies (as detailed in their PRSPs) and, where feasible, system-aligned with the country’s own existing (government) systems and institutions. Such alignment, making swaps behave like new-style project aid, would greatly enhance country ownership, reduce transaction costs and contribute to capacity building.

Fourth, current debt-for-development swaps are often piecemeal operations typically well below US\$100 million each. Only if they were large enough, swaps could be expected to induce more indirect effects down the causality chain such as debt overhang elimination in recipient countries. One promising avenue, at least for a limited selection of non-HIPC countries, may be to convince creditors that are favourable towards debt swaps to pool the resources generated by the relief given on their claims into one single fund, managed by (or at least in close cooperation with) the debtor country itself (or, if possible, directly into the country’s budget). Debt-for-development swaps would

¹⁸ However, if one takes into account the amount of off-budget aid and parallel PIUs that still exist today, in spite of donor commitments made under the Paris Declaration, Accra Agenda for Action and Busan Partnership for Effective Development Cooperation, debt swaps may not be that much of an anachronism altogether.

then move closer towards a HIPC/MDRI-type of setup, initiatives with greater potential because of their sheer size and more appropriate forms of conditionality.

4 Debt relief and longer-term debt sustainability

4.1 Debt sustainability off the radar?

As the HIPC Initiative is nearly finished, international attention to debt sustainability issues in developing countries seems to have somewhat diminished. In the wake of the global economic and financial crisis, debt sustainability concerns have shifted from developing to more advanced economies, especially countries in the European periphery but also Argentina (IMF, 2014e). The change in focus is also noticeable in NGOs that originated from lobby work around developing country debt crises and debt relief, such as the Jubilee Debt Coalition or Eurodad.¹⁹

4.2 Evolution of post-HIPC debt ratios

Following the enhanced HIPC Initiative in 1999, the problem of high debt service was tackled at decision point. The impact of the initiative on debt service is therefore best compared before and after HIPC decision point, as we do in Table 5 and Figure 4. Both clearly show that debt service ratios of post-decision point HIPCs have decreased over time and that variation in these ratios has shrunk.

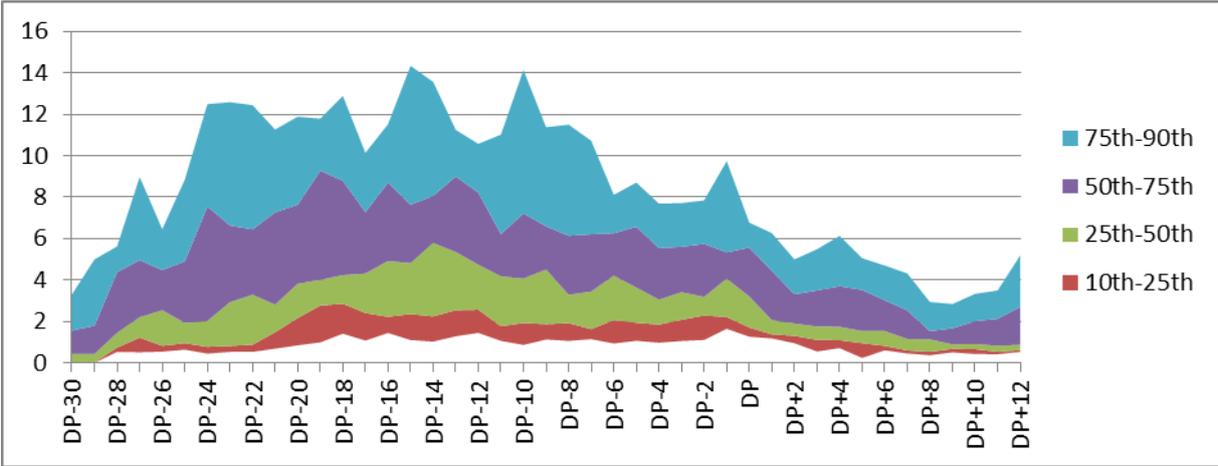
TABLE 5: TOTAL DEBT SERVICE (% OF GNI) FOR 36 POST-DECISION POINT HIPCS

	DP-15 (30)	DP-10 (33)	DP-5 (33)	DP-1 (35)	DP (35)	DP+1 (36)	DP+5 (32)	DP+10 (26)
max	19,04	107,47	80,76	109,97	135,38	7,18	5,88	6,72
min	0,41	0,27	0,12	0,15	0,06	0,08	0,07	0,27
median	4,81	4,07	3,64	4,07	3,21	2,06	1,54	0,91
average	6,09	8,63	6,98	7,42	7,43	2,98	2,26	1,54

Source: World Development Indicators. Note: Due to limited data availability and the recent attainment of HIPC decision point by certain countries, data in the table are not necessarily based on all post-DP-HIPCs. In brackets therefore the number of countries for which data was available.

¹⁹ See <http://jubileedebt.org.uk> and <http://www.eurodad.org>.

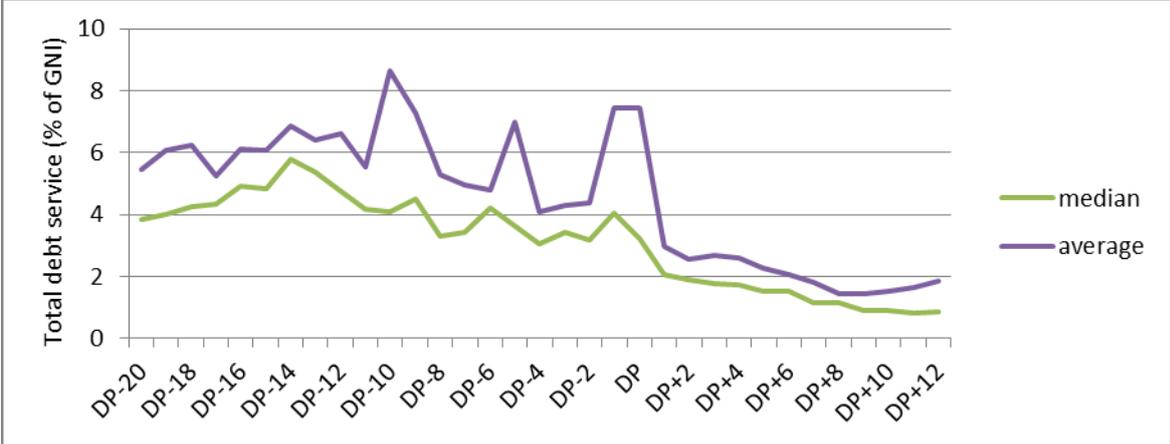
FIGURE 4: TOTAL DEBT SERVICE (% OF GNI) FOR 36 POST-DECISION POINT HIPCS, WITH PERCENTILE RANGES.



Source: World Development Indicators. Note: Due to limited data availability and the recent attainment of HIPC decision point by certain countries, data in the table are not necessarily based on all post-DP-HIPCs. Table 5 shows in brackets the number of countries for which data was available.

Figure 5 furthermore illustrates how the debt service of several countries increased just prior to reaching decision point. This could be attributed to the specific set-up of the HIPC Initiative, according to which debtor countries have to clear their arrears to multilateral creditors before they can reach decision point. Helpful bilateral donors therefore often assisted debtor countries with bridge loans. These loans constitute short-term financing to service the multilateral debt in arrears, and are paid back later to the bilateral donor with new financing coming from the multilateral.

FIGURE 5: TOTAL DEBT SERVICE (% OF GNI) FOR 36 POST-DECISION POINT HIPCS



Source: World Development Indicators. Note: Due to limited data availability and the recent attainment of HIPC decision point by certain countries, data in the table are not necessarily based on all post-DP-HIPCs. Table 5 shows in brackets the number of countries for which data was available.

At completion point, debtor countries get irrevocable relief of their debt stock. While the average ratios prior to the HIPC Initiative were greatly above 100% of GNI, they decreased to less than 40% of GNI after countries reached their respective HIPC completion points. Given the use by the initiative

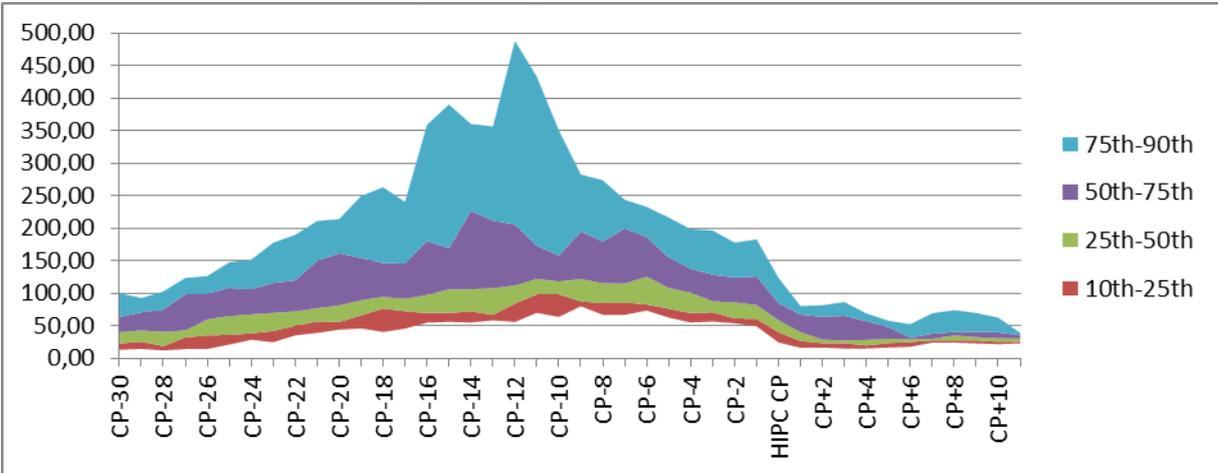
of a threshold level, Table 6 and Figures 6 and 7 show how also external public debt stocks have converged.

TABLE 6: EXTERNAL DEBT STOCK (% OF GNI) FOR 35 POST-COMPLETION POINT HIPCS

	CP-15 (30)	CP-10 (32)	CP-5 (34)	CP-1 (35)	CP (35)	CP+1 (32)	CP+5 (23)	CP+10 (6)
Max	1.218,97	551,74	1.001,67	277,47	210,36	205,00	76,42	82,34
Min	28,04	46,42	35,62	19,78	15,21	14,06	12,29	18,80
Median	105,91	117,93	108,04	81,62	58,09	39,93	29,70	30,79
Average	184,60	166,82	147,31	101,57	66,32	52,92	35,48	38,13

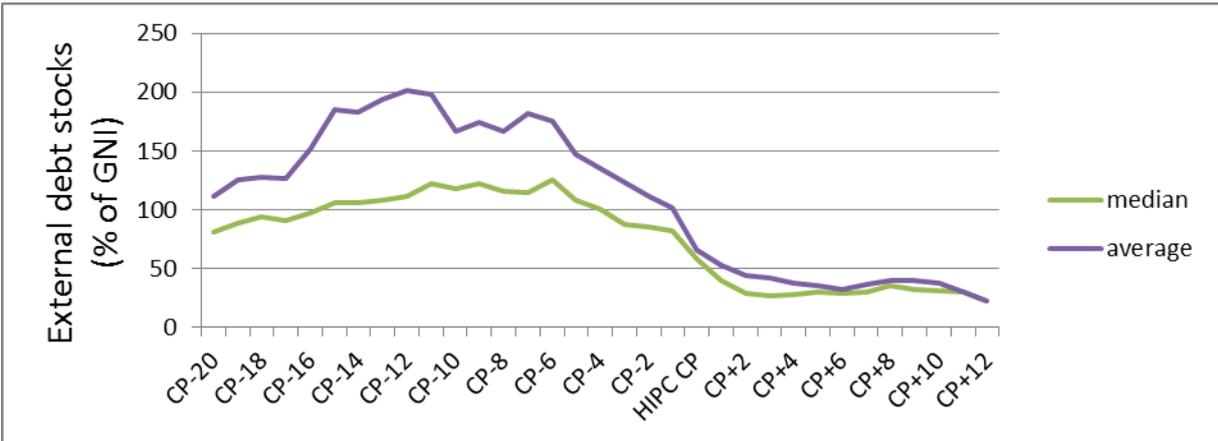
Source: World Development Indicators. Note: Due to limited data availability and the recent attainment of HIPC completion point by certain countries, data in the table are not necessarily based on all post-CP-HIPCs. In brackets therefore the number of countries for which data was available.

FIGURE 6: EXTERNAL DEBT STOCK (% OF GNI) FOR 35 POST-COMPLETION POINT HIPCS



Source: World Development Indicators. Note: Due to limited data availability and the recent attainment of HIPC completion point by certain countries, data in the table are not necessarily based on all post-CP-HIPCs. Table 6 shows in brackets the number of countries for which data was available.

FIGURE 7: EXTERNAL DEBT STOCK (% OF GNI) FOR 35 POST-COMPLETION POINT HIPCS



Source: World Development Indicators. Note: Due to limited data availability and the recent attainment of HIPC completion point by certain countries, data in the table are not necessarily based on all post-CP-HIPCs. Table 6 shows in brackets the number of countries for which data was available.

Using GDP-weighted averages, Merotto et al. (2013) show a decrease of HIPC nominal public debt from 104% of GDP before debt relief to 27% after irrevocable debt relief. By 2011 the ratio had only risen to 34%.

4.3 The current Debt Sustainability Framework of the IMF and World Bank

While the HIPC Initiative reduced external debt stocks and debt service substantially, as a consequence of which countries regained debt sustainability, graduation from the HIPC Initiative does not by itself ensure long-term debt sustainability. Confronted with huge needs, governments of low-income countries face the difficult task of balancing public spending, taxation and borrowing decisions, often in the presence of limited absorptive capacity. To monitor and ensure that a country's indebtedness be kept in line with its ability to repay, different ways to define and measure debt sustainability have been proposed (Cassimon et al., 2007).

The most elaborated and widely used framework to monitor debt sustainability is the Debt Sustainability Framework (DSF) of the World Bank and IMF, a standardized framework for conducting public and external debt sustainability analyses (DSAs). For low-income countries (LICs) the two institutions have jointly conducted these assessments since 2005. For countries with access to international financial markets and emerging economies, the IMF launched a separate assessment tool, the Market Access Countries DSA (MAC DSA), in 2013. The LIC DSAs assess the sustainability of countries' debt by looking at solvency (debt stock indicators) and liquidity ratios (debt service indicators) taking into account composition and concessionality of debts (PV calculations) and different proxies of repayment capacity (exports, revenue, GDP). This is in line with the indicators used under the HIPC Initiative.

To estimate at what point the build-up of debt might become unsustainable, the IMF and IDA (2004b) and World Bank and IMF (2012) listed countries that experienced debt crises in the past and looked at these countries' debt indicators one year prior to the outbreak of such a crisis. This approach resulted in the median ratios presented in Table 7, which could be considered as first estimates of threshold levels for potential debt distress.

TABLE 7: MEDIAN DEBT RATIOS PRIOR TO DEBT DISTRESS

		PV OF DEBT IN PERCENTAGE OF			DEBT SERVICE IN PERCENTAGE OF	
		GDP	exports	revenue	exports	revenue
Median debt ratios prior to debt distress	IMF and IDA (2004b)	43%	192%	288%	15%	13%
	WB & IMF (2012)	30%	119%	159%	23.2%	19.8%
HIPC Thresholds	1996		200-250%	280%		
	1999		150%	250% ²⁰		

Source: IMF and IDA, 2004b; World Bank and IMF, 2012.

²⁰ The fiscal revenue threshold only applies if the ratios of exports of goods and services to GDP and fiscal revenue to GDP are above 30% and 15%, respectively.

Table 7 shows that the figures these studies put forward are similar to the HIPC thresholds, which were based on a similar exercise in the 1990s (Cohen, 1996).

However, while these threshold levels were useful to provide similar, non-discriminatory debt relief to all HIPCs, they do not adequately take into account country characteristics which might worsen or lessen the risk of debt distress, such as the policies countries employ and existing institutions. Countries with a weak policy and institutional environment are generally thought to be more prone to misuse, or less productively use government funds, which makes them vulnerable to debt distress at much lower levels of debt than ‘better-governed’ countries.

Further empirical work by Kraay and Nehru (2003, 2006) and IMF and IDA (2004b) shows that, indeed, the quality of policies and institutions is an important determinant of the level of debt a country can sustain. Kraay and Nehru (2003), for example, find that the probability of debt distress for a country with an overall Country Policy and Institutional Assessment (CPIA) score (a composite measure constructed by the World Bank) at the 25th percentile is 26%, while it is only 9% for a country with a 75th percentile CPIA score. Holding the probability of debt distress constant, both studies indicate that threshold levels for debt distress vary significantly for countries with weak (a CPIA of 3.25 or less), medium (3.5) or strong (3.75) policy and institutional performance.

In line with these findings, and in contrast to the uniform HIPC thresholds, the LIC DSA differentiates debt sustainability thresholds according to the CPIA scores of the debtor country.

TABLE 8: POLICY PERFORMANCE AND DEBT SUSTAINABILITY THRESHOLDS

		DEBT BURDEN THRESHOLDS				
		PV of debt in percentage of			Debt service in percentage of	
		GDP	Exports	Revenue	Exports	Revenue
HIPC thresholds			150	250		
LIC DSA thresholds						
CPIA SCORE	POLICY PERFORMANCE					
CPIA ≤ 3.25	Weak	30	100	200	15	25
3.25 < CPIA ≤ 3.75	Medium	40	150	250	20	30
CPIA > 3.75	Strong	50	200	300	25	35

Source: IMF and IDA, 2005c

Table 8 shows that HIPC thresholds equal the ones used by the LIC DSA for countries with ‘medium’ CPIA scores. As a result, the debts of institutionally weak countries could still be above the policy-dependent LIC DSA thresholds after HIPC debt relief. Such countries could thus exit the HIPC Initiative with an ‘unsustainable’ debt burden.

Recently, the main findings of the just-described studies were updated, taking into account several technical differences between them and aligning methodology and definitions. This update largely

corroborated the original thresholds, but proposed to lower the threshold for debt service-to-revenue ratios to 18%, 20% and 22% depending on the policy performance (World Bank and IMF, 2012; IMF and IDA, 2013).

As of now, forward-looking debt sustainability assessments are conducted for all low-income countries. They involve four basic steps (Cassimon et al., 2007):

1. Deciding on the appropriate debt sustainability concepts and indicators;
2. Conducting consistent forward-looking analyses of the debt dynamics under a most-likely benchmark scenario, over the medium- and longer term.
3. Running stress tests using detailed alternative scenarios, tailored to relevant country vulnerabilities;
4. Translating debt sustainability assessments into policies for new borrowing, including minimum levels of concessionality.

4.4 How do the HIPC's score on the DSA?

Over the past 14 years, 35 countries have reached HIPC completion point. Table 9 compares the risk of debt distress²¹ of these countries according to their first DSA after completion point with that of their latest DSA.

²¹ The IMF and World Bank define four levels of debt distress: (1) low risk: all debt indicators are below their relevant thresholds, including under stress tests; (2) moderate risk: although the baseline scenario does not lead to breaches of thresholds, stress tests result in one or more breaches; (3) high risk: the baseline scenario results in a breach of one or more thresholds, but the country does not currently face any payment difficulties. (4) in debt distress: current debt and debt service ratios are in significant or sustained breach of thresholds. Actual or impending debt restructuring negotiations, or the existence of arrears, would generally suggest that a country is in debt distress. (IMF and IDA, 2013).

TABLE 9: COMPARISON OF THE RISK OF DEBT DISTRESS FOLLOWING COMPLETION POINT WITH THE LATEST DSA

2013-2014	Low	Rwanda	Benin, Republic of Congo, Ethiopia, Madagascar, Senegal, Tanzania, Uganda	Bolivia, Liberia, Zambia
	Moderate	Democratic Republic of the Congo, Gambia, Guinea-Bissau, Niger,	Burkina Faso, Côte d'Ivoire, Ghana, Guinea, Guyana, Honduras, Malawi, Mali, Mauritania, Nicaragua, Sierra Leone, Togo	Cameroon, Mozambique
	High	Afghanistan, Burundi, Comoros, Haiti	Central African Republic, Sao Tome and Principe,	
		High	Moderate	Low
		DSA at completion point or first DSA thereafter		

Source: Latest DSAs, available at: <https://www.imf.org/external/pubs/ft/dsa/lic.aspx>. Note that some countries reached completion point years before their first DSA.

Overall, only 11 post-completion point HIPC are currently classified as having a low risk of debt distress, according to their latest LIC DSA; 18 are classified as having a moderate risk and six are, even after HIPC, still considered at high risk. In this last category, some came even out of the HIPC Initiative with high risk, partly due to the difference in thresholds between HIPC and the LIC DSA and partly due to a new build-up of debt during the interim period (as HIPC calculates debt relief based on decision point data). While debt sustainability outlooks are much better than would have been the case without HIPC, this evidence suggests that some structural weaknesses remain and have to be addressed and that the build-up of new debt needs to be cautiously monitored in order to avoid a return to debt distress.

Table 10 looks beyond HIPCs, at all countries that are eligible for concessional assistance from the IMF's Poverty Reduction and Growth Trust (PRGT).

TABLE 10 : DSA RATING OF PRGT-ELIGIBLE COUNTRIES (MOST RECENT DSA AVAILABLE)

DSA RATING				
Low risk	Moderate risk	High risk	In debt dist.	No rating
<i>Post-CP HIPC</i>				
Benin, Bolivia, Republic of Congo, Ethiopia, Liberia, Madagascar, Rwanda, Senegal, Tanzania, Uganda, Zambia	Burkina Faso, Cameroon, Democratic Republic of the Congo, Côte d'Ivoire, The Gambia, Ghana, Guinea, Guinea-Bissau, Guyana, Honduras, Malawi, Mali, Mauritania, Mozambique, Nicaragua, Niger, Sierra Leone, Togo	Afghanistan, Burundi, Central African Republic, Comoros, Haiti, São Tomé and Príncipe		
<i>Interim HIPC</i>				
		Chad		
<i>Pre-DP HIPC</i>				
			Sudan	Eritrea, Somalia
<i>Non HIPC</i>				
Bangladesh, Cambodia, Kenya, Moldova, Myanmar, Nepal, Nigeria, Papua New Guinea, Timor Leste, Vanuatu, Vietnam	Bhutan, Dominica, Kyrgyz Republic, Lao PDR, Lesotho, Mongolia, Solomon Islands, St Lucia, St Vincent and the Grenadines, Tonga, Yemen	Djibouti, Grenada, Kiribati, Maldives, Marshall Islands, Samoa, Tajikistan,	Zimbabwe	Cape Verde,

Source: Latest DSAs, available at: <https://www.imf.org/external/pubs/ft/dsa/lic.aspx> .

The broader group of PRGT countries includes nearly all countries which were considered for HIPC debt relief in the past, except for Angola, Equatorial Guinea, Sri Lanka and Georgia, which do not face considerable debt sustainability problems (for Angola: IMF,2014f, p.40; for Equatorial Guinea: IMF,2013b, p.10); for Sri Lanka: IMF,2014g; for Georgia: IMF,2015).

Based on these DSAs, Baduel and Price (2012) conclude that debt sustainability projections improved prior to the economic crisis. While the crisis has had a strong short-run impact on key debt and debt service ratios due to expansionary fiscal policies, long-term projections tend to converge on average to their pre-crisis levels after the crisis.

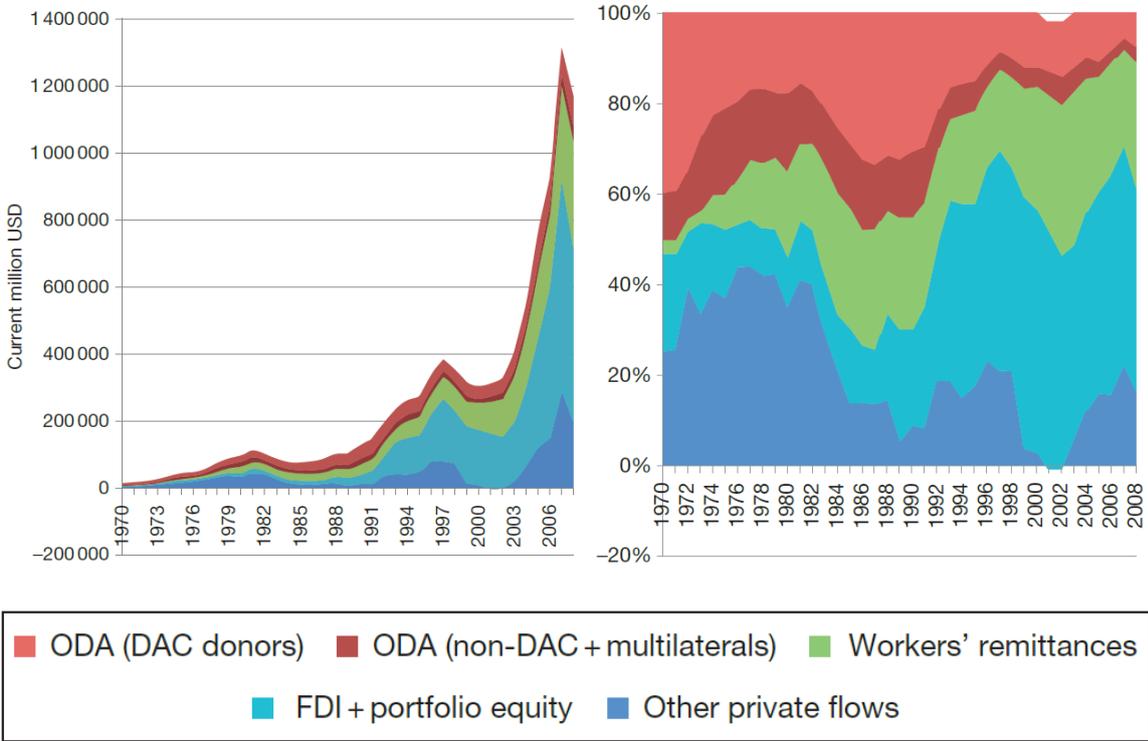
5 Current risks to debt sustainability

5.1 Changes in the development landscape

While the theme of financing for development was already high on the donor agenda in 2002, at the time of the Monterrey Financing for Development Summit, a range of new issues have drastically changed the landscape, both in terms of financing actors, with their own motives, as in terms of recipient countries.

On the one side, financial resources to developing countries have grown exponentially and have become more diversified over the past decades. Figure 8 shows the importance of selected net resource flows to developing countries²². Five categories of resource flows are considered: ODA flows from OECD-DAC members; ODA flows from non-DAC bilaterals and multilateral organisations; workers’ remittances, compensation of employees and migrants’ transfers; foreign direct investment and portfolio equity flows (mainly stock market investment); and other private medium-and long-term flows, defined as the sum of international bond investment (so-called portfolio debt) and international bank and other commercial lending.

FIGURE 8: NET RESOURCE FLOWS TO ALL DEVELOPING COUNTRIES (1970-2008, LEFT: CURRENT US\$ MILLIONS, RIGHT: IN % OF TOTAL)



Source: Cassimon et al. (2013b)

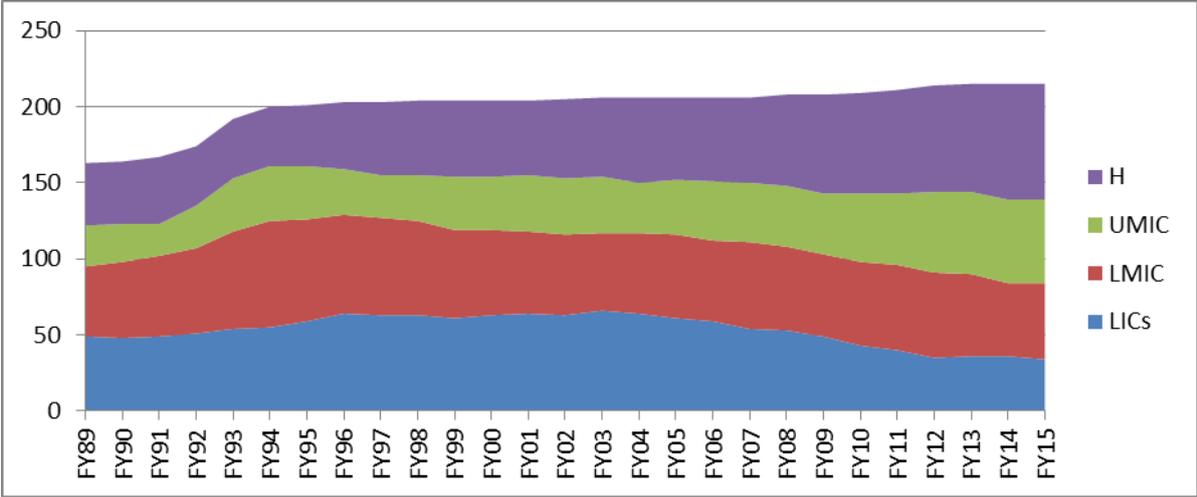
²² Developing countries are defined in line with the definition used by the World Bank : low and middle income countries. In the fiscal year 2015, the upper boundary was set at a GNI per capita of \$12,746.

Looking at Figure 8, one can observe a tripling in resource flows to developing countries over a decade, in nominal terms. Developing countries now clearly have better access to global and regional financial markets (see also DAC, 2013 and further). With respect to the relative importance of the different resource flows, it can be seen that the importance of aid relative to other resource flows, FDI and portfolio equity in particular, has been declining. Whereas during the late 1980s and early 1990s aid flows represented almost 50% of the selected resource flows, they have fallen back to less than 15% in more recent years. Workers’ remittances, on the other hand, seem on the rise, up from less than 5% of the total in the early 1970s to nearly 20% in 2008.

It is clear that developing countries are faced with a growing range of channels and instruments to choose from to finance their development spending. Besides traditional donor financing, countries have now access to resources from non-traditional donors, philanthropic organizations, private sector financing etc. DAC (2013) presents similar trends for the subset of resource flows from DAC countries to developing countries. Despite a real increase of 63% in ODA from DAC donors between 2000 and 2011, its relative importance as a source of finance has diminished. While this evolution is certainly welcome, the debt-creating nature of some of the flows need to be carefully monitored in order to sustain debt sustainability.

At the recipient side, a growing number of developing countries have ‘caught up’. Figure 9 shows the history of income classifications by the World Bank²³:

FIGURE 9: COUNTRY INCOME CLASSIFICATIONS BY THE WORLD BANK: HIGH-(H), UPPER MIDDLE-(UMIC), LOWER MIDDLE-(LMIC) AND LOW-INCOME (LIC)(NUMBER OF COUNTRIES, FY1989-FY2015).



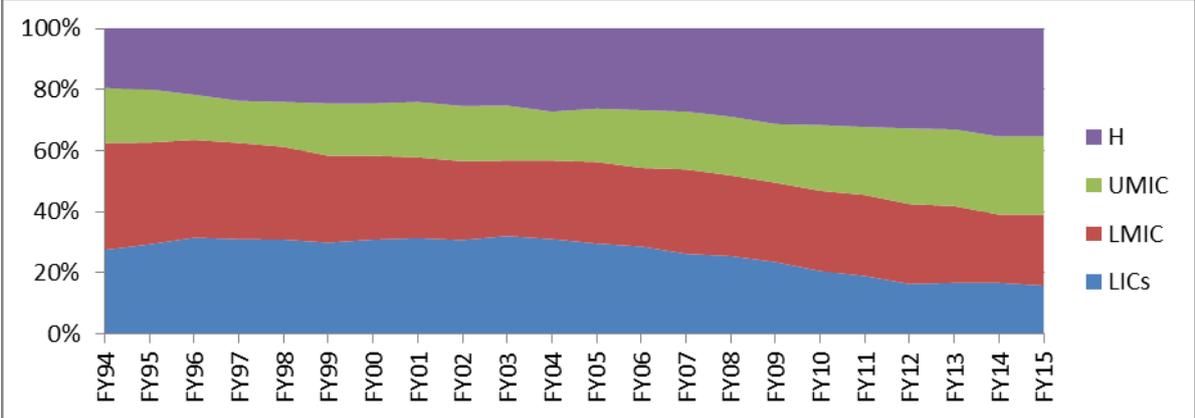
Source: authors’ calculations based on World Bank Country and Lending groups FY 2015.

Figure 9 first indicates that in the early 1990s the number of economies classified by the World Bank increased from 166 in FY1989 to 200 in FY1994 and 215 by FY2015, largely due to the emergence of

²³ The World Bank classifies all its member economies and other economies with populations of more than 30,000 people. Cut-offs between income classifications are annually updated on 1 July by the World Bank.

newly independent states (following the break-up of the USSR and Yugoslavia) and the classification of additional countries not listed before. A second and more important trend is the decreasing share of LIC and LMIC countries. This is also apparent from figure 10, which shows the share of economies classified in the different income groups starting from FY1994 (to limit the impact of newly classified economies).

FIGURE 10: COUNTRY INCOME CLASSIFICATIONS BY THE WORLD BANK: HIGH-, UPPER MIDDLE-, LOWER MIDDLE- AND LOW-INCOME (SHARE PER INCOME GROUP, FY 1989-FY2015)



Source: authors’ calculations based on World Bank Country and Lending groups FY 2015.

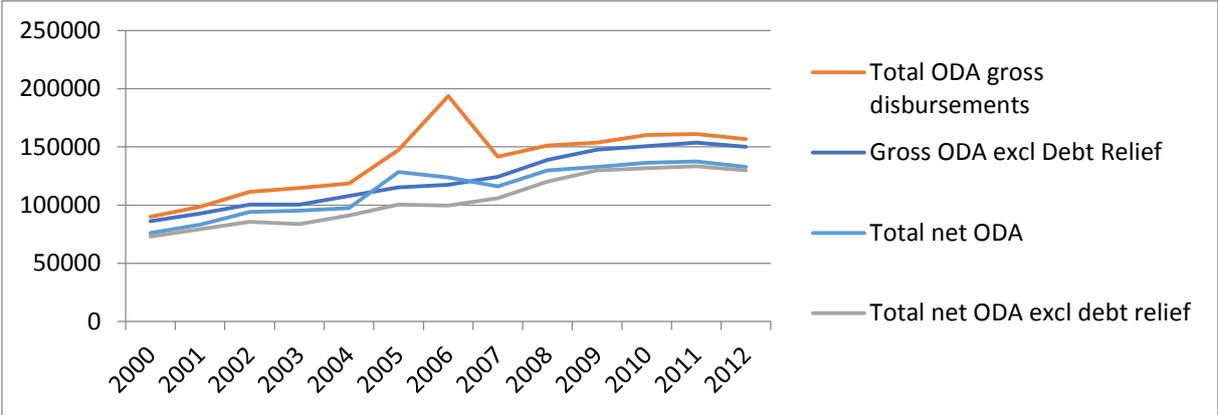
Figure 10 also shows a gradual decrease in the number of LICs from 66 in FY2003 to 34 in FY2015. Simultaneously, the number of LMICs remained at around 50 and the groups of UMICs and HICs increased from 37 in FY2003 to 55 today and from 52 to 76 today, respectively. As projected (per capita) growth rates of most developing countries, remain above those of developed economies, the catching-up process is projected to continue in the following years and decades.

5.2 Changes in aid

5.2.1 Stabilization of aid

Following the global financial and economic crisis, aid towards developing countries has stabilized over the past years. Figure 11 shows the trend in different aggregate ODA measures over the past decade.

FIGURE 11: ODA TO DEVELOPING COUNTRIES (ALL DONORS REPORTING TO DAC, 2000-2012, IN CONSTANT 2012 US\$ MILLIONS)

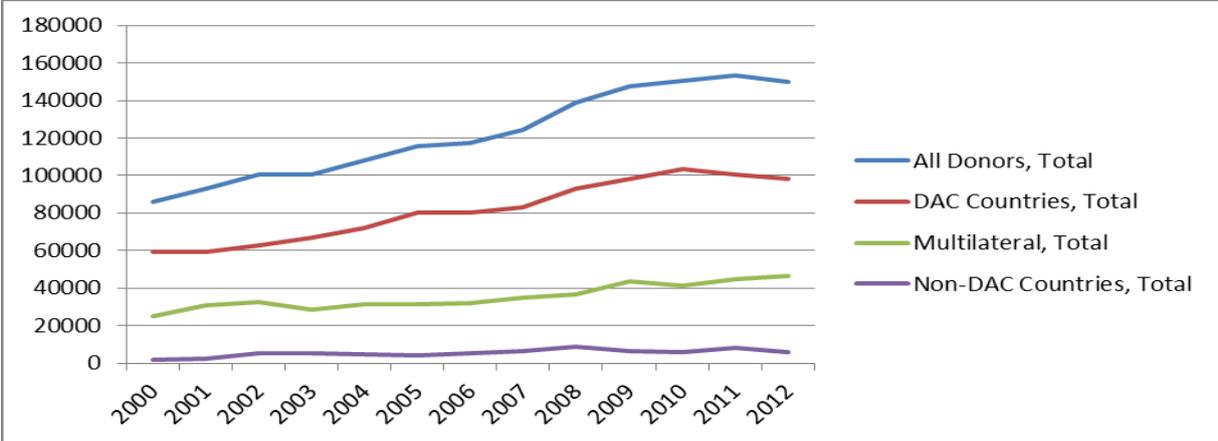


Source: OECD-DAC

While ODA grew steadily from 2000 onwards, a peak was reached in 2010; after which aid fell gradually in 2011 and 2012 as several governments implemented austerity measures and cut their aid budgets. Most recent data from the DAC, which is not yet compatible with Figure 11, show a slight rebound of 6.1% in real terms in 2013. Even after excluding the five new countries that joined the DAC in 2013 (Czech Republic, Iceland, Poland, Slovak Republic and Slovenia) this represents a new all-time high. The annual survey of donors’ spending plans of the DAC suggests that a further (small) increase could be expected for 2014, after which aid would stabilize again.

To examine in greater detail donor and recipient country aid flows, we will continue with the ‘gross ODA excluding debt relief’ measure, as this most closely reflects the (gross) transfer of resources to developing countries by excluding reflows of capital on loans towards donor countries and debt relief. Figure 12 looks at the division of gross ODA excluding debt relief among the different donors reporting to the DAC.

FIGURE 12: GROSS ODA EXCLUDING DEBT RELIEF BY DIFFERENT DONORS (ALL DEVELOPING COUNTRIES, 2000-2012, IN CONSTANT 2012 US\$ MILLIONS)



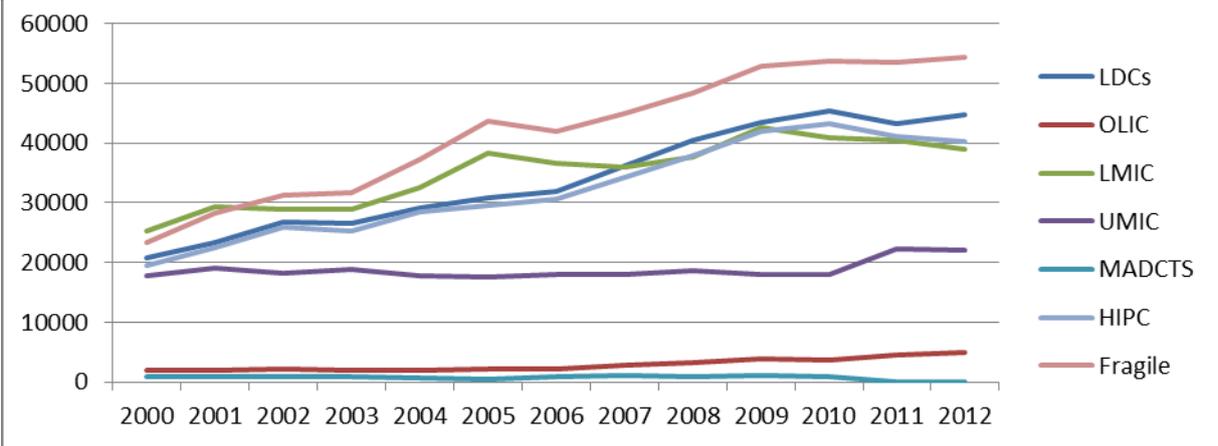
Source: OECD-DAC

We note that mainly bilateral donors have decreased their gross aid over the past few years. Multilaterals, on the other hand, further increased their aid.

5.2.2 Changing country allocation of aid

Figure 13 looks at the division of gross ODA across different country groupings.

FIGURE 13: GROSS ODA EXCLUDING DEBT RELIEF BY RECIPIENT COUNTRY GROUPS (ALL DONORS, 2000-2012, IN CONSTANT 2012 US\$ MILLIONS)²⁴



Source: OECD-DAC

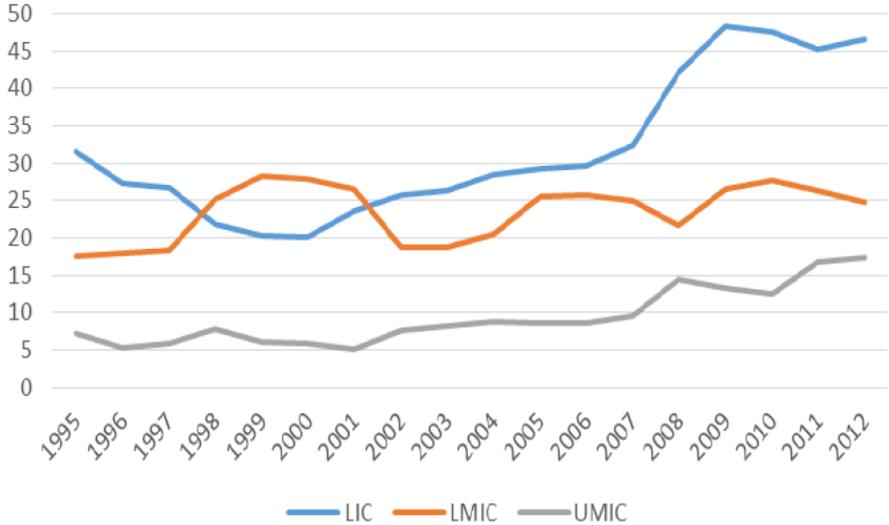
It can be observed that aid towards fragile states, LDCs and other LICs has seen a generally increasing trend over the past decade. Aid towards LMICs and UMICs has stabilized over the past years. Finally, due to its large overlap in countries, aid towards HPCs has closely followed aid towards LDCs but slightly decreased over the past years.

These evolutions are in line with a recent analysis by Rabinowitz (2014), which considers net ODA per capita and takes into account the changing composition of the different income groupings.²⁵

²⁴ LDC: least developed countries, OLICs: other low income countries, LMIC : lower middle income countries, UMIC : upper middle income countries, MADCTS : More advanced developing countries and territories.

²⁵ China and India are excluded from this analysis as their population size skews the results of their income groupings downward.

FIGURE 14: NET ODA PER CAPITA (1995-2012, IN CONSTANT 2012 US\$)



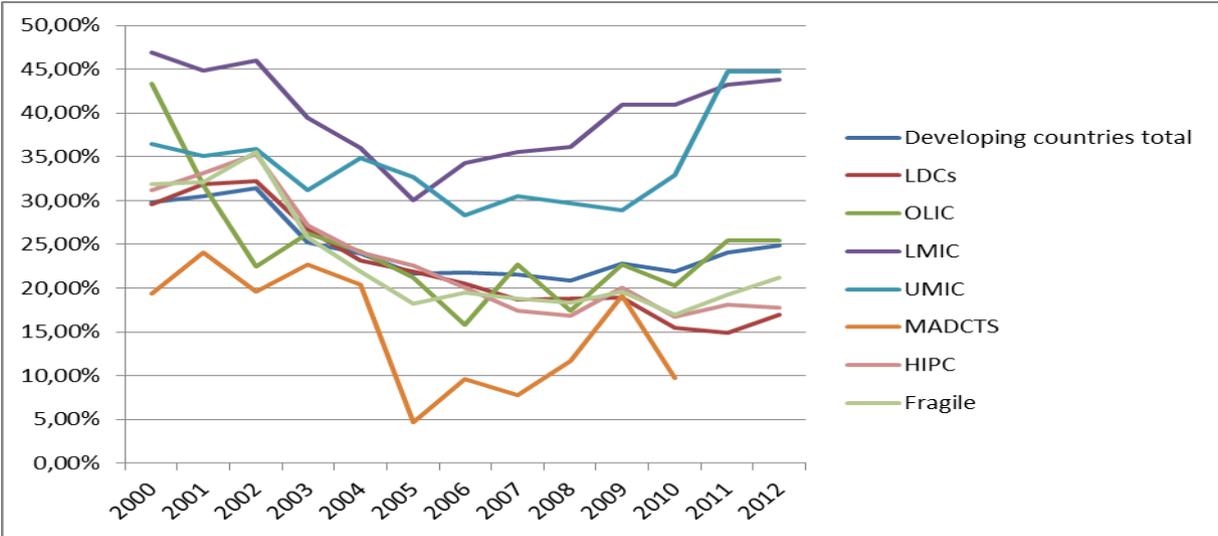
Source: Rabinowitz, 2014

Rabinowitz (2014) shows that net ODA per capita to LICs increased significantly from about US\$20 in 2000 to more than US\$45 in 2010, after which it fluctuated around US\$45-50. For LMICs, net ODA per capita fell sharply in the early 2000s to less than US\$20 per capita, after which it slightly increased again and continued to hover around US\$25. Finally, for UMICs, aid per capita increased from US\$5 in 2000 to US\$10 in 2007. It further increased to more than US\$15 by 2012.

5.2.3 Changing composition of aid

While aid has more or less stabilized over the past years, its composition has changed in an important way. Figure 15 shows the share of loans in gross ODA excluding debt relief, again for different income groups.

FIGURE 15: SHARE OF LOANS IN GROSS ODA EXCLUDING DEBT RELIEF ACROSS DIFFERENT INCOME GROUPS (ALL DONORS, 2000-2012)



Source: OECD-DAC

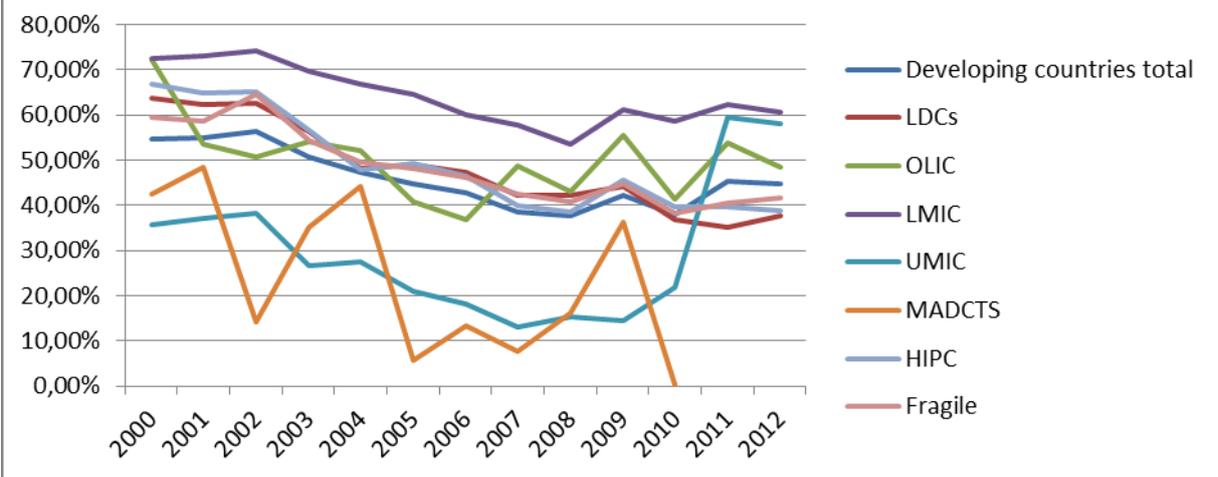
The share of loans in ODA has recently increased. While this trend is most apparent in MICs, LDCs and other LICs have also known a slight increase in the share of their aid being delivered through loans. For HIPCs, the share of loans continues to follow its downward trend. These conclusions are in line with Rabinowitz (2014), who shows that the share of grants has increased significantly for LICs, from 51% in 1998 to 85% in 2010 after which it slightly decreased. The grant share for LMICs and especially UMICs has fallen sharply to less than 60%.

All together the figures indicate that between 2000 and 2009 ODA allocations became progressively focused on LDCs, LICs and fragile countries. ODA was also increasingly delivered in the form of grants instead of loans. Over the past few years, however, these trends have slightly reversed. ODA to the poorest and most fragile countries has stabilised and the share of loans has somewhat increased.

5.2.3.1 Multilateral donors

This growing importance of loans is however not a trend which can be observed in all subsets of donors.

FIGURE 16: SHARE OF LOANS IN GROSS ODA EXCLUDING DEBT RELIEF ACROSS DIFFERENT INCOME GROUPS (MULTILATERAL DONORS, 2000-2012)



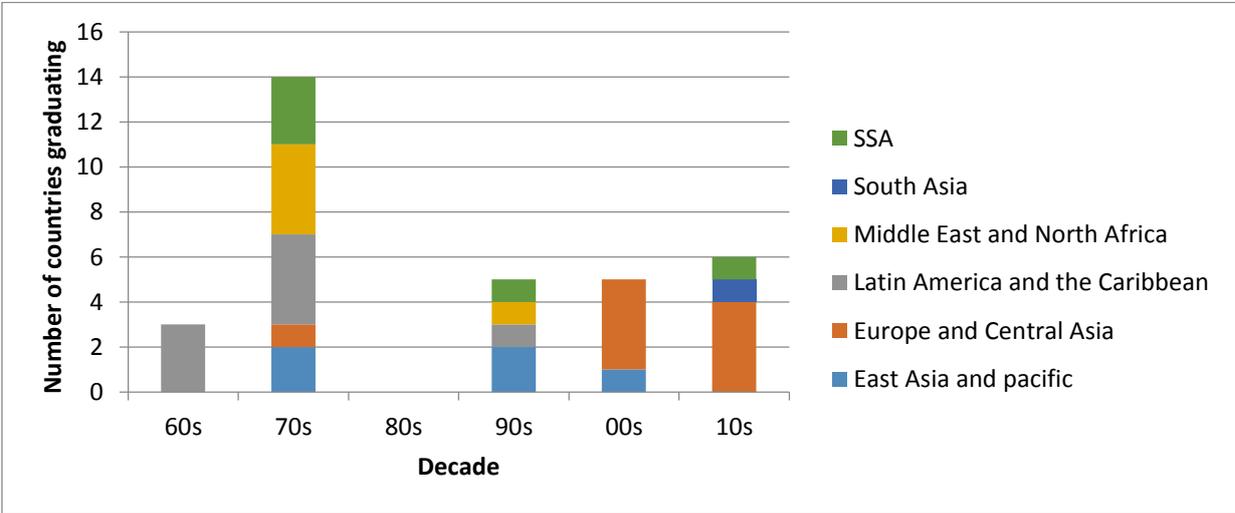
Source: OECD-DAC

Figure 16 shows that the share of loans in aid provided by multilateral donors differs significantly across recipient country income groups. Overall, the share of loans in aid to all developing countries decreased until 2009 but ticked up again thereafter. With respect to specific country groupings, multilateral donors apparently delivered the highest share of loans in their aid to LMICs. Only recently the UMICs have received similar shares of their aid in the form of loans. Fragile countries, HIPCs and LDCs get the smallest loan shares.

Rising per capita income levels will have an impact on the conditions of the financial resources provided by multilateral donors. As countries are developing, they are also approaching the thresholds at which they are no longer eligible for concessional financing from multilateral

development banks. In the case of the World Bank, for example, its concessional arm, the International Development Association (IDA), provides concessional financing and grants only to countries whose GNI is below an annually updated threshold level (US\$1,215 in FY2015) or somewhat richer countries that are not considered creditworthy to borrow from the World Bank’s non-concessional arm, the International Bank for Reconstruction and Development (IBRD) (mostly small island states). With the economic growth rates recently experienced by many developing countries, an increasing number of them is graduating from IDA eligibility. Over its lifespan (1960-2014), 111 countries worldwide have ever been eligible for IDA assistance. Of these countries, 41 have graduated out of IDA, of which 8 fell back below the eligibility threshold. Figure 17 presents the regional composition and the period of graduation for the 33 countries that did not revert.

FIGURE 17: REGIONAL COMPOSITION OF IDA GRADUATES

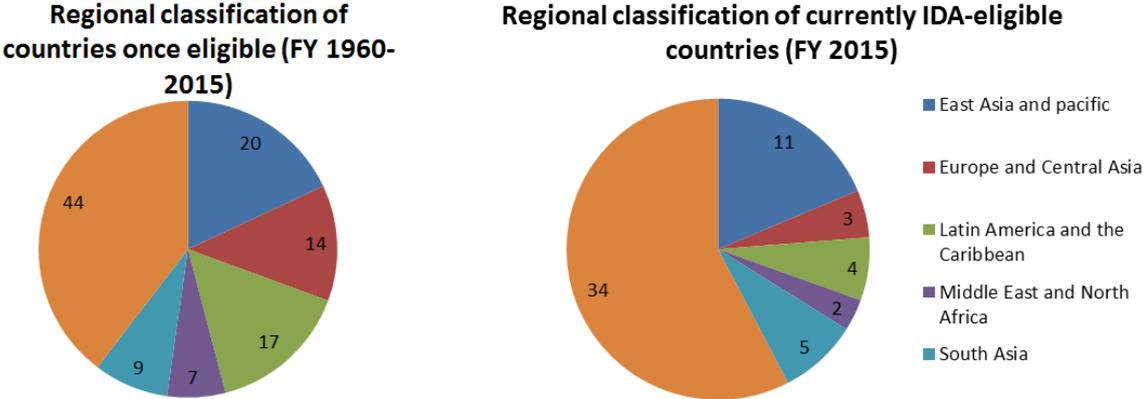


Source: authors’ calculations based on World Bank Country and Lending groups FY 2015.

It is clear from Figure 17 that Latin America was well-represented among the first countries graduating from IDA. More recently, European and Central Asian countries have made up the majority of IDA graduates.

As a result of these graduations, 77 countries are currently eligible for concessional IDA support (FY2015): 59 IDA-only and 18 ‘blend’ countries (which also borrow non-concessional from the IBRD). In addition, India, which graduated in FY2014, is still receiving transitional support. Figure 18 compares the regional composition of all countries which have in the past been eligible for IDA support with that of the current list of IDA-only countries.

FIGURE 18: COMPARISON OVER TIME OF THE REGIONAL CLASSIFICATION OF IDA-ELIGIBLE COUNTRIES (NUMBER OF COUNTRIES)

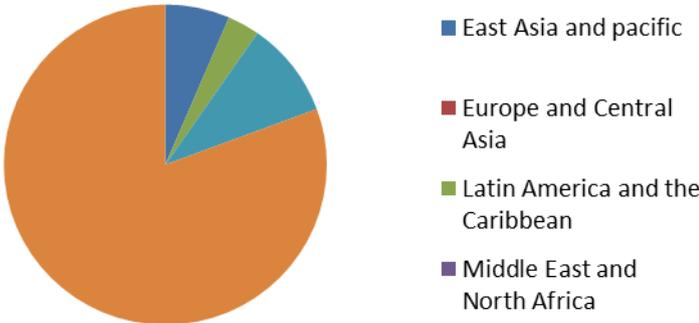


Source: authors’ calculations based on World Bank Country and Lending groups FY 2015.

Figure 18 shows that following the graduations, the regional composition of IDA countries has changed significantly. Currently, more than 75% of the countries are from Sub-Saharan Africa and East Asia and the Pacific.

According to projections from Moss and Leo (2011), these trends are likely to continue. They estimate the number of IDA-only countries to decrease to 31 by 2025. Sub-Saharan African countries will then account for more than 80% of all countries and fragile or post-conflict countries will make up nearly 60% of IDA clients (see Figure 19).

FIGURE 19: PROJECTED REGIONAL CLASSIFICATION OF IDA-ONLY COUNTRIES IN 2025.



Source: Moss and Leo (2011).

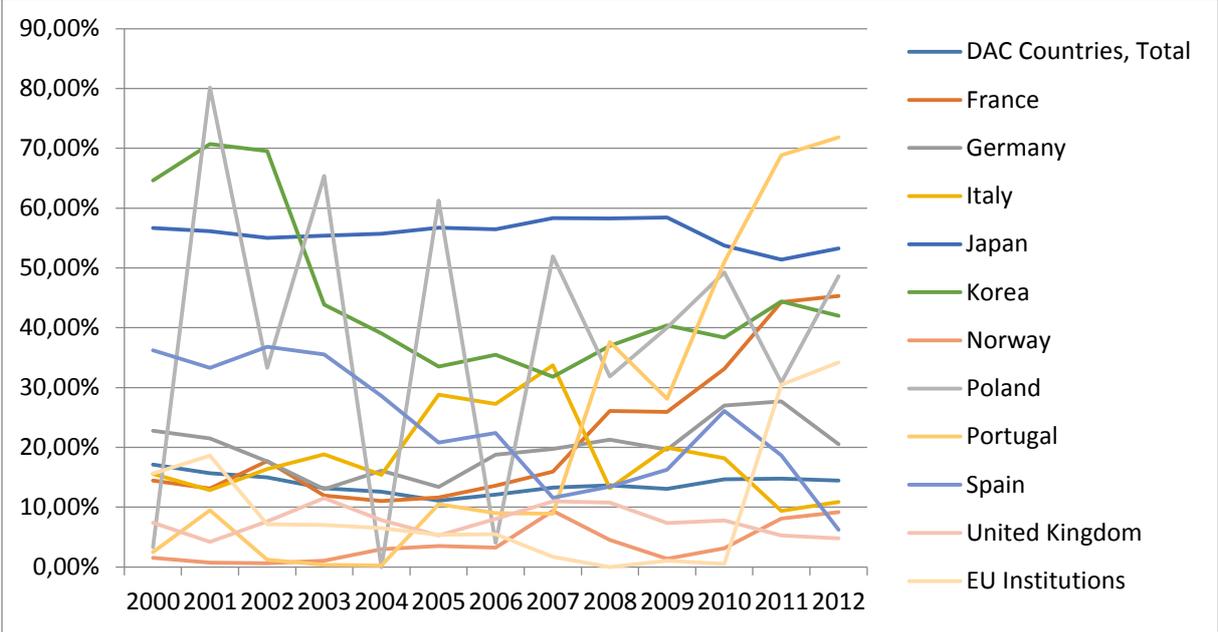
Within the group of (former) HIPC, all countries still have access to IDA financing. Some have, however, reached middle-income status (above US\$1,046 per capita in FY2015: Cameroon, Republic of Congo, Nicaragua) and are approaching the IDA eligibility threshold, whereas others are already classified as blend countries (e.g., Bolivia). According to the projections of Moss and Leo (2011), Bolivia, the Republic of Congo, Guyana and Honduras would be the first countries graduating from IDA.

While a further graduation of developing countries out of IDA is the result of these country’s economic growth and an indication that they are considered creditworthy by international financial markets, this graduation process, first into the blend and later into the IBRD lending category, means that the countries in question will face harder conditions on their future multilateral financing. These prospects will need to be taken into account in discussions about longer-term debt sustainability (Prizzon and Mustapha, 2014).

5.2.3.2 Bilateral donors

Figure 20 looks at the use of loans by bilateral DAC donors.

FIGURE 20: SHARE OF LOANS IN GROSS ODA EXCLUDING DEBT RELIEF FOR 10 DAC DONORS WITH HIGHEST AVERAGE SHARE OF LOANS IN THEIR ODA (ALL RECIPIENTS, 2000-2012)



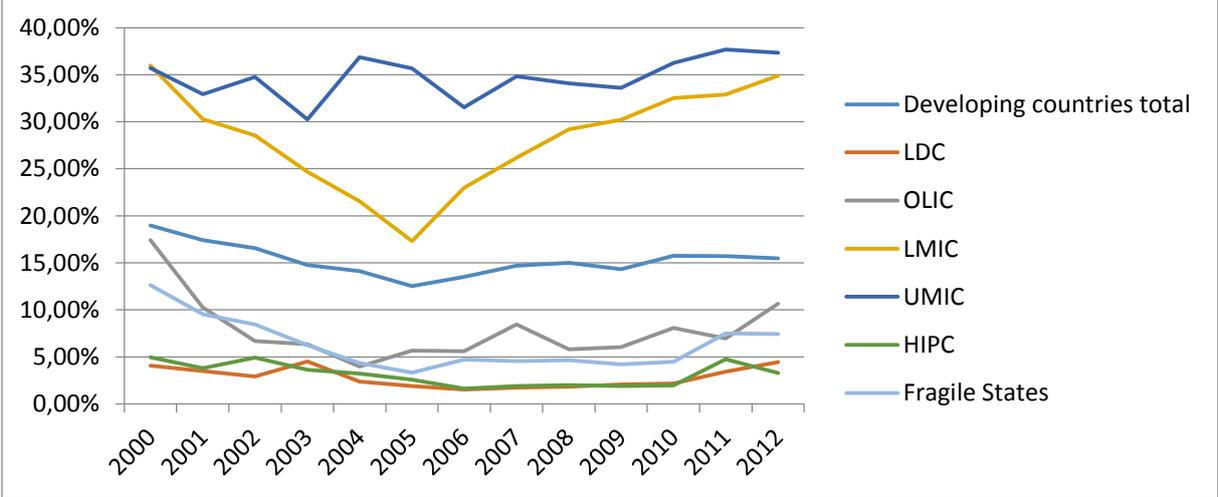
Source: OECD-DAC

It shows that the importance of loans in aid from bilateral DAC donors to developing countries has slightly increased over the past seven years. According to DAC (2013), the main reason is that, in the low-interest environment of recent years, a few large DAC members have taken the opportunity to on-lend funds to developing countries that they themselves raised cheaply on financial markets and reported them as ODA (as, technically, these loans met the ODA grant element test, which uses a fixed 10% discount rate). The reporting of such market-raised funds, which are not necessarily provided to the recipient with an explicit government subsidy, as ODA, has been the subject of a heated debate at the DAC on the rules regulating the reporting of ODA loans²⁶.

²⁶ At the most recent DAC High Level Meeting the members of the organisation agreed to adapt the rules for ODA reporting of loans. See Cassimon et al. (2014) and Roodman (2015) for more details.

Figure 21 further demonstrates some differences between country groupings. While the importance of loans in bilateral DAC aid to UMICs and (much more so) to LMICs, has increased in recent years, the loan share of bilateral DAC aid to LDCs, HIPC, fragile states and other LICs remains limited. This pattern suggests that donors may increasingly provide loans, rather than grants, as countries graduate to MIC status.

FIGURE 21: SHARE OF LOANS IN GROSS ODA EXCLUDING DEBT RELIEF ACROSS DIFFERENT INCOME GROUPS (BILATERAL DAC DONORS, 2000-2012)

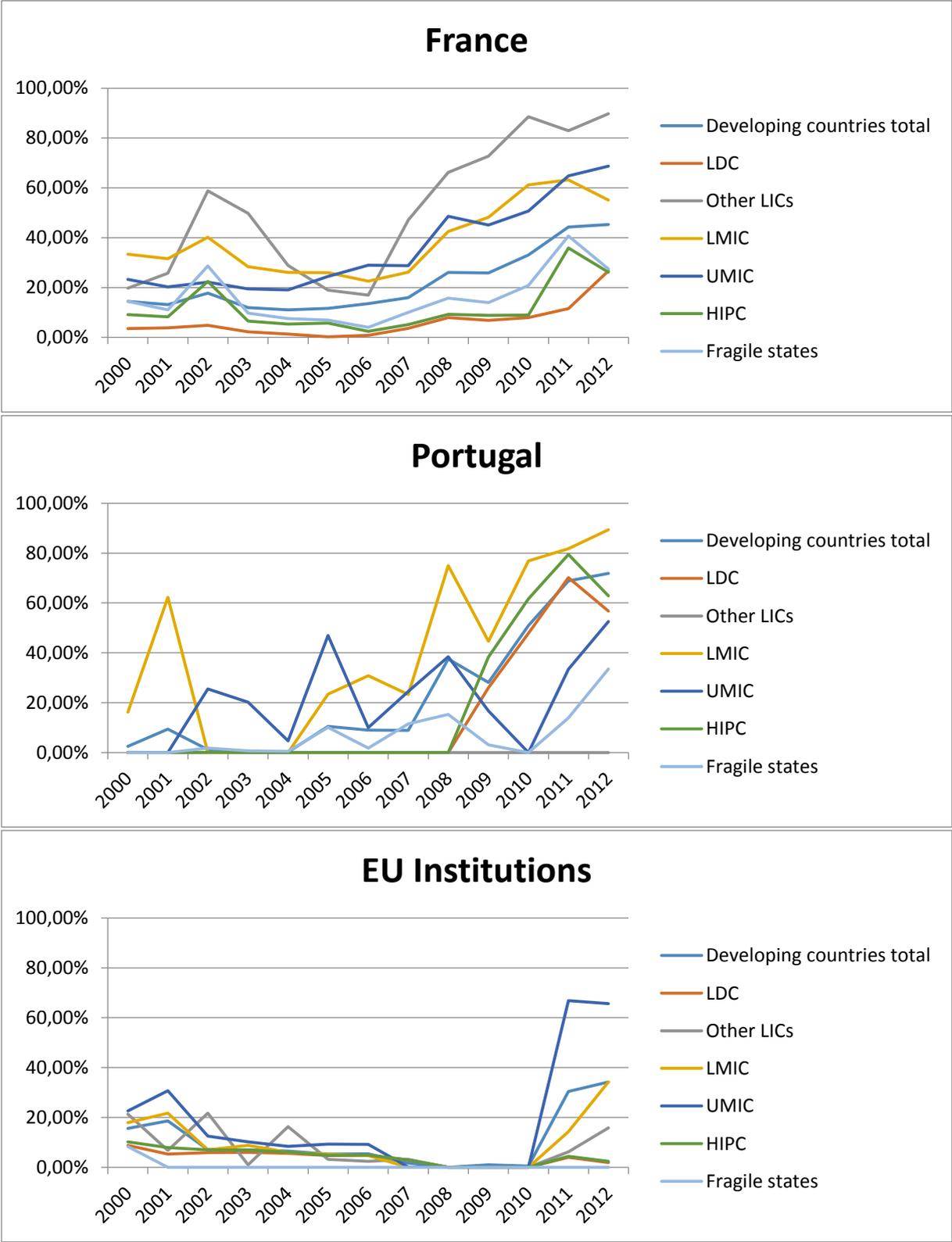


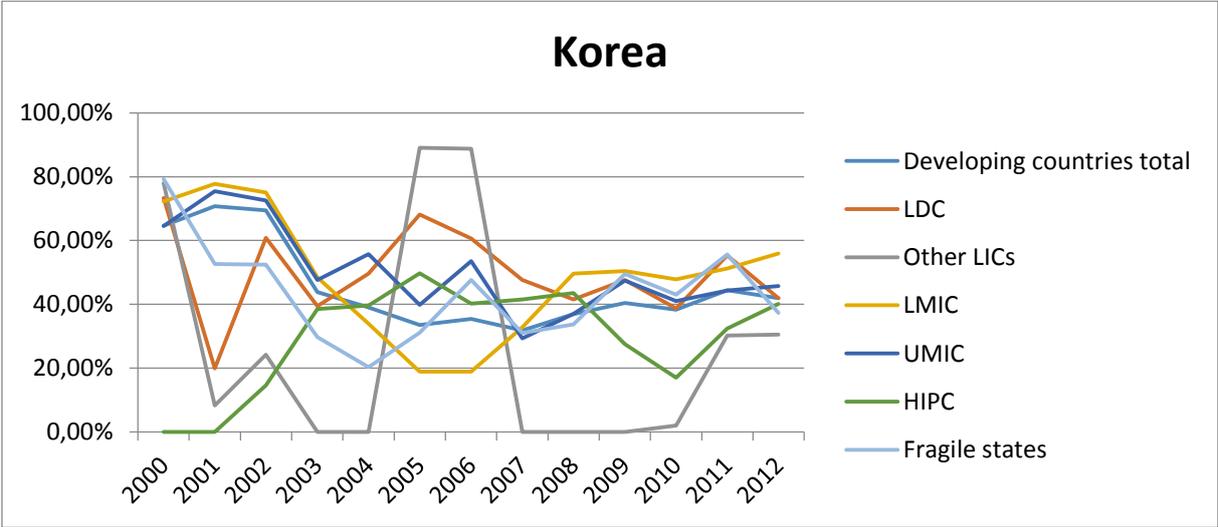
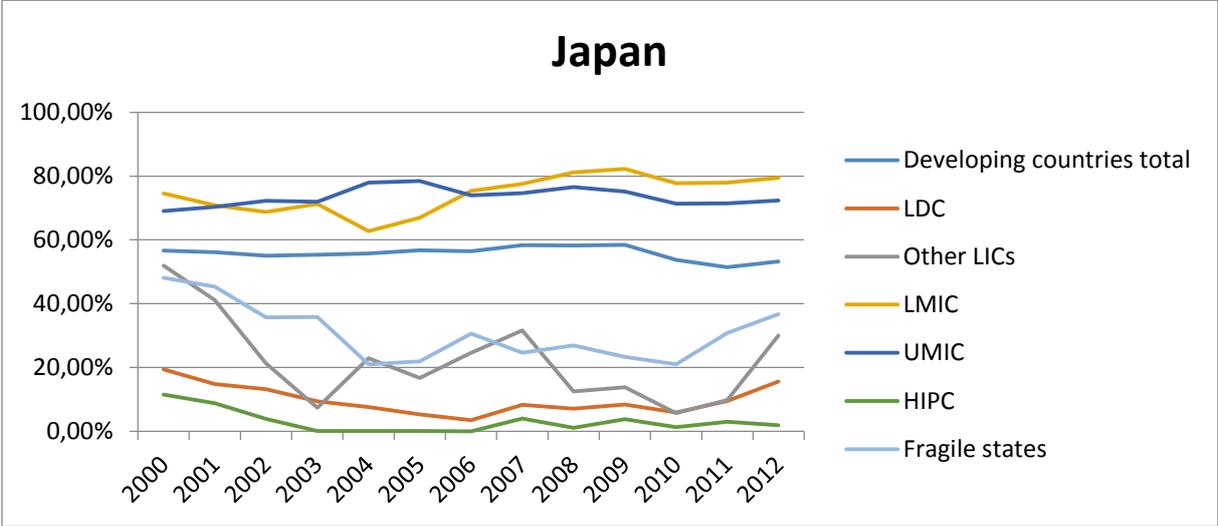
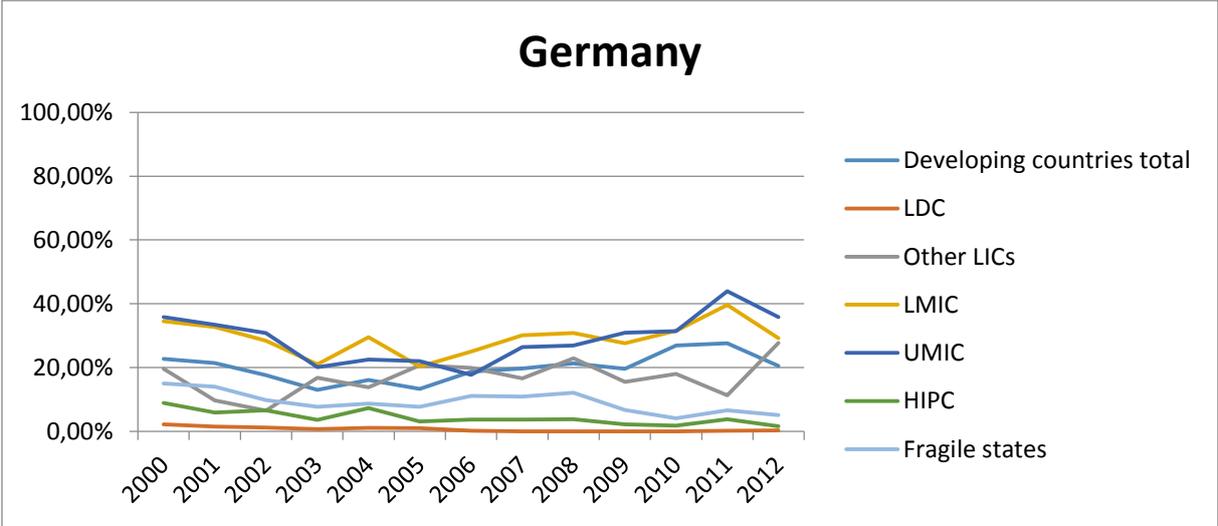
Source: OECD-DAC

Behind the aggregated data of the DAC lies a wide variety of donor practices. While some donors have historically been using loans as a financing instrument (e.g., Japan and Korea), others have only recently started using these instruments more regularly (e.g., France, Portugal and the EU).

Figure 22 further illustrates some of these donor differences. While France, the EU institutions and Portugal have all only recently increased the share of loans in their aid to developing countries, France and Portugal have done so for nearly all countries, including HIPC, LDCs and fragile states, while the EU has mainly done so for MICs. Given its size as a donor and the different concessionality thresholds used by the DAC (25%) and the IMF (35%), which makes a DAC concessional loan not necessarily IMF-concessional, France provides about 10% of the non-concessional financing to a subset of African HIPC which have been borrowing heavily over the past years (Merotto et al., 2014). German aid has seen a smaller increase in the share of loans, with a focus on MICs. Japan and Korea have both employed large loan shares for a much longer period, but Japan has used loans predominantly in its provision of aid to MICs, while Korea has done so for all developing country groups.

FIGURE 22: SHARE OF LOANS IN GROSS ODA EXCLUDING DEBT RELIEF ACROSS DIFFERENT INCOME GROUPS (SELECTED BILATERAL DAC DONORS, 2000-2012)





Source : OECD-DAC

For bilateral DAC donors, the impact of the graduation of developing countries could be twofold. As countries grow richer, the share of their aid provided as loans might increase. Moreover, a growing number of donors might consider the provision of their aid in the form of loans. Currently only a

minority²⁷ of donors make significant use of loans to provide financing to developing countries (DAC, 2014a), of which only a few make significant use of it. However, given increasing budget constraints, bilateral donors might consider a shift of aid modalities, from grants to loans, especially in their aid to countries reaching MIC status.

Finally, the economic development of countries might also have an impact on aid by reducing the number of countries eligible for ODA, as determined by the DAC list of recipient countries. The DAC list of ODA countries basically comprises all low- and middle-income countries, excluding G8 members, EU members and countries with a fixed date of EU accession. Over the past four decades, more than 50 countries have graduated from ODA eligibility. By 2030 an additional 29 might be excluded from the list as their per capita income levels would be considered too high (DAC, 2014b).

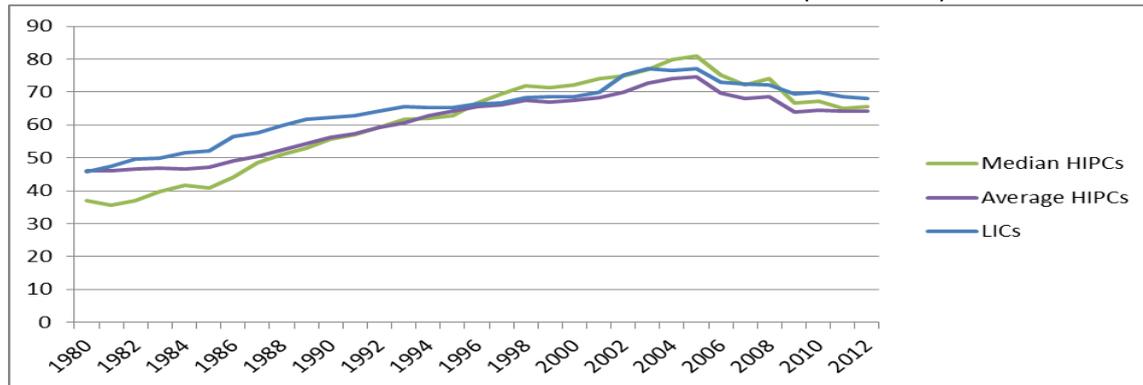
5.3 Changing debt composition: new financing possibilities and risks

5.3.1 Declining shares of concessional financing

While most LIC financing has been highly concessional in the past, many LICs have recently increased their reliance on non-concessional debt. For HIPC, this trend is mainly a result of the HIPC process which reduced countries' debt burden and problems of debt overhang; which in turn made it possible for countries to regain debt sustainability and obtain access to other sources of debt without affecting too much their ability to repay. Furthermore, LICs in general have strengthened their macroeconomic and debt management. Finally, the trend towards more non-concessional debt has been supported by changes in the IMF's borrowing limits policy since 2009. These changes have provided more flexibility to LICs to take on new non-concessional debt based on their DSA results (Baduel and Price, 2012). As of December 2011, there were only seven Sub-Saharan African countries with limited or no room for additional non-concessional borrowing according to Sy (2013).

²⁷ Only France, Germany, Italy, Japan, Korea, Poland, Portugal, Spain, United Kingdom and the EU Institutions provided on average more than 5% of their aid in the form of loans over the period 2000-2012.

FIGURE 23: CONCESSIONAL DEBT AS % OF TOTAL EXTERNAL DEBT (1980-2012)



Source: World Bank International Debt Statistics

While Figure 23 shows the growing relative importance of non-concessional debt in LICs since 2005, this does not necessarily mean that non-concessional borrowing substitutes for concessional borrowing. In fact, for African HIPCs, Merotto et al. (2013) find no crowding out of concessional finance. Of a subset of eight HIPCs which recently increased their non-concessional borrowing significantly, only one (Uganda) did not first use its entire IDA commitment, and the unused balance is very small.

Although the increase in non-concessional borrowing by former HIPCs and other LICs is an illustration of the growing creditworthiness of these countries in the eyes of both donors and international investors and adds to the total resources available for (much-needed) public investments, non-concessional flows also have inherent risks and may endanger debt sustainability over time, if not adequately managed.

5.3.2 Emerging donors

Over the past decade the importance of South-South Development Cooperation (SSDC) has increased considerably. According to data collected by UNDESA, SSDC has doubled between 2006 and 2011 and is estimated at about US\$16 to 19 billion in 2012. Taking into account Chinese and Indian export credit loans, estimates increase to US\$21 billion. As such, SSDC amounts to 7-12% of global development cooperation, a share which could be expected to further increase in the future given the stabilization of aid provided by DAC donors. Most of the SSDC aid is delivered in the form of grants, whereas some larger bilateral partners provide highly concessional loans. Projects are the preferred modality for the delivery of aid, with an estimated 75% of SSDC project-based, mainly focused on infrastructure (55%) (UNDESA, 2014).

Most SSDC partners have a strong regional focus and play a key role in the economic growth, trade and investments in their respective regions. Oil-rich Middle Eastern countries are most active in other Arab countries (e.g., Saudi Arabia in Egypt); Venezuela and Brazil play a similar role in the Latin

American and Caribbean; Turkey in Asia and the Middle East; and China and India also in Asia (see Manning, 2006; Kharas, 2009; Walz and Ramachandran, 2010; Zimmerman and Smith, 2011). Besides, certain partners also target countries which are historically, religiously or linguistically affiliated (much like traditional donors). Brazil has set up cooperation programs with other Lusophone countries (Angola, Mozambique and Equatorial Guinea). Finally, some partners are reaching out globally. Contributions to Africa by China, India, Turkey and Chile, for example, are increasing rapidly (Walz and Ramachandran, 2010, Chinese Information Office of the State Council, 2014).

Although data on SSDC is becoming more and more available, it is still very limited for certain emerging donors. For a first group of 17 countries, including several EU member states and the main Arab donors, detailed data is available as they report their annual ODA statistics to the DAC.

TABLE 11: GROSS ODA DISBURSEMENTS OF NON-DAC BILATERAL DONORS REPORTING TO THE DAC (2004-2013, ALL DEVELOPING COUNTRIES, IN CONSTANT 2012 US\$ MILLIONS)

	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
Bulgaria							42,06	47,23	39,95	49,6
Chinese Taipei	539,09	572,71	594,16	549,7	442,6	431,38	395,61	372,14	304,5	271,51
Cyprus		17,89	30,07	37,25	38,07	47,67	53,14	36,73	25,08	20,38
Estonia	7,32	13,43	18,05	17,05	20,69	18,22	19,37	23,14	23,24	28,76
Hungary	83,53	114,91	174,35	99,92	93,8	113,64	111,95	128,9	118,38	123,43
Israel	114,64	129,36	118,97	135,49	143,94	135,71	148,85	199,15	181,19	184,85
Kuwait (KFAED)	576,72	660,22	541,44	522,2	674,66	554,33	640,61	483,49	451,66	N/A
Latvia	10,14	12,63	13,66	16,88	22,19	22	16,22	18,68	21,11	23,71
Liechtenstein				19,22	24,09	27,52	27,66	30,32	28,6	28,24
Lithuania	11,04	18,4	28,99	50,88	48,64	37,96	38,14	50,44	51,91	50,38
Malta						14,36	14,33	19,48	18,32	18,24
Romania					124,93	159,96	118,63	159,93	142,41	133,79
Russia							578,8	538,72	465,01	688,19
Saudi Arabia	2248,71	1216,78	2450,53	1767,46	5163,99	3403,86	3628,37	5114,26	1436,18	5819,66
Thailand			85,33	71,51	181,44	42,09	47,04	48,84	35,05	N/A
Turkey	486,34	754,4	874,96	631,33	735,4	747,6	938,56	1268,41	2533,3	3316,11
United Arab Emirates	645,67	663,9	982,32	2739,72	1387,5	1088,73	593,04	796,18	1164,67	N/A
TOTAL	4723,2	4174,63	5912,83	6658,61	9101,94	6845,03	7412,38	9336,04	7040,56	10756,85

Source: OECD-DAC

Table 11 indicates that the gross disbursements of these DAC-reporting donors have doubled in less than a decade. While in 2012 the total fell from over US\$9 billion to US\$7 billion, this decrease is driven by a huge decrease in Saudi Arabian ODA. In 2013, with ODA data still missing for three donors, total ODA could be as much as US\$12 billion, about 8% of gross ODA disbursed by traditional DAC donors in 2013. The largest donors in this non-DAC list are Saudi Arabia (with a 2011-2013 average of US\$4 billion of ODA in constant 2012 US\$), Turkey (2011-2013 average of US\$2.4 billion) and the United Arab Emirates (2010-2012 average of US\$850 million).

According to Walz and Ramachandran (2010) these data still underestimate the ODA provided by Arab countries as they do not report their debt forgiveness as ODA. Relative to the size of their economies, Arab donors’ contributions are about 1.5% of GNI (on average, over 1973-2008), more than twice the UN target (Walz and Ramachandran, 2010).

Within this group, most donors provide their aid in the form of grants. Only five DAC-reporting emerging donors have used loans in the past decade (see Table 12)

TABLE 12: SHARE OF LOANS IN GROSS ODA BY NON-DAC DONORS REPORTING TO THE DAC (2004-2012, ALL DEVELOPING COUNTRIES)

	2004	2005	2006	2007	2008	2009	2010	2011	2012	HIPC contribution
Kuwait (KFAED)	93,52%	98,34%	97,38%	98,51%	91,27%	99,08%	95,79%	93,03%	91,12%	79%
Saudi Arabia	8,12%	15,85%	9,19%	12,34%	4,41%	17,43%	11,11%	6,63%	29,16%	69%
Thailand	0,00%	0,00%	79,47%	63,17%	89,96%	30,38%	52,45%	33,71%	29,36%	N/A
Turkey	0,00%	0,00%	0,00%	0,00%	0,00%	0,00%	0,00%	0,00%	20,64%	N/A
United Arab Emirates	17,91%	19,19%	25,29%	19,95%	8,50%	9,12%	23,60%	15,39%	19,84%	10%

Source: OECD-DAC

Kuwait has provided most of its ODA in the form of loans in this group of donors, and so has Thailand in several years. Other donors’ ODA is marked by fluctuating and small shares of loans.

It should further be noted that the SSDC programmes of these donors generally focus much more on infrastructure and other structural bottlenecks than traditional donors (see e.g., for Africa, AfDB et al., 2011), which could positively influence recipients’ repayment capacity. To assess donor willingness to provide debt relief, we have added in the last column of Table 12 the share of HIPC debt relief these emerging donors have provided up to now. It turns out that none of these countries has provided full debt relief, but the largest donor, Saudi Arabia, and the main provider of loans, Kuwait, have provided significant shares of their expected debt relief under the HIPC Initiative.

The exact flows of other non-DAC donors are more difficult to estimate. Some of them do report their aid separately, but not in line with the ODA definitions used by the DAC; while others report only aggregated ‘investment packages’, which pool together ODA with non-ODA flows (Prizzon and Mustapha, 2014). As a result, the aid figures circulating are guesstimates at best. The importance of these donors in the bilateral debt flows to developing countries can, however, not be denied. The latest World Bank International Debt Statistics report notes that non-traditional developing country creditors²⁸, mainly China, Brazil and India, were the main creditors to Sub-Saharan Africa in 2012 (World Bank, 2014). In the following paragraphs, we provide some estimates of Chinese, Brazilian, Indian and South African aid.

²⁸ The World Bank (2014) considers as bilateral creditors’ governments and their agencies, including central banks, aid agencies, official export credit agencies and autonomous agencies’.

Among non-DAC donors, China is arguably the largest. Data on Chinese aid are however difficult to come by. The authorities only recently released their second White Paper on foreign aid, showing an increasing trend. While Zimmerman and Smith (2011) estimated Chinese aid at around US\$3 billion in 2009, more recent data released by the Chinese authorities themselves show an amount of US\$14.4 billion between 2010-2012, an annual average of nearly US\$5 billion, excluding debt relief. Grants made up 36.2% of this three-year total (US\$5.2 billion), interest-free loans 8.1% (US\$ 1.2 billion) and other concessional loans 55.7% (US\$8 billion). Concessional loans are raised on the market by the Chinese Exim Bank and the difference between the benchmark interest rate released by the People's Bank of China (5.35% since 28 February 2015) and the lower rate charged to the borrower is the subsidy provided by the Chinese authorities. Geographically, the main focus of Chinese aid is on Africa, accounting for 51 of their 121 partner countries and 51.8% of total aid disbursed, even before Asian countries (30 countries and 30.5% of aid) (Chinese Information Office of the State Council, 2014).

Besides concessional aid loans, China also provides a significant amount of non-concessional loans on which even less information is available. For a subset of African HIPCs, Merotto et al. (2014) find that about 30% of non-concessional external public debt is of Chinese origin nowadays. As non-concessional debt represents about a quarter of these countries' external debt, Chinese non-concessional financing would account for about 7-8% of their external financing.

The 2010 report on Brazilian cooperation estimates that aid totalled US\$923 million in 2010, again excluding debt relief. About 81.4% of this total, or US\$752 million, was disbursed to international organisations, most notably Mercosur. Bilateral cooperation totalled US\$171 million and was mainly directed towards Latin American and Caribbean countries. African countries accounted for just 23%, or US\$37 million of bilateral cooperation. All this bilateral aid seemed to have been provided in the form of grants (COBRADI, 2010). Zimmerman and Smith (2011) in addition note that the Brazilian Development Bank has been scaling up its efforts to promote trade and growth by providing loans to developing countries. Between 2007 and 2013 the Development Bank reportedly disbursed US\$2.9 billion to Africa (Green, 2013).

One of the key channels of India's development assistance have been the Lines of Credit (LoC) extended through the Indian Exim Bank, on concessional terms. They are said to 'enable borrowing countries to import goods and services from India and undertake projects for infrastructure development and capacity building, in accordance with their developmental priorities' (Indian Ministry of External Affairs, 2014). Between 2004 and 2014, India allocated 195 LoCs for a total amount of US\$11 billion, of which more than 60% went to African countries. Most recently, between

January 2013 and March 2014, African countries were given LoCs amounting to US\$1.5 billion and non-African countries received US\$480 million in LoCs. This shows the important and growing focus of Indian aid on Africa. In addition, India has different projects focussing on reconstruction (e.g., in Afghanistan and Sri Lanka), economic integration (e.g., Nepal, Myanmar), education (e.g., language and e-resource courses in Myanmar) and capacity building (e.g., increasing agricultural yield in Myanmar) with its neighbouring countries. Also with respect to African countries, recent grant-financed projects have focused on economic development and capacity building. To improve the efficient implementation of its projects, the Ministry of External Affairs set up a Development Partnership Administration in January 2012.

South Africa's development cooperation amounted to about US\$101.3 million in its FY2013-2014. About half of this is spend on membership contributions to international organisations, mainly the African Union, UN and the Southern African Development Community (SADC). The other half is allocated to the African Renaissance and International Fund, South Africa's main bilateral pillar. The stated aim of the Fund is to 'enhance cooperation between the Republic and other countries through the promotion of democracy, good governance, the prevention and resolution of conflict, socio-economic development and integration, humanitarian assistance and human resource development'. The Fund provides both grants and loans and is directed primarily to SADC member countries.

5.3.3 International capital markets

Following much-improved debt sustainability and better macroeconomic conditions in countries that have enjoyed HIPC/MDRI and other debt relief, a number of them have successfully tapped non-concessional sources of finance from commercial external creditors. Especially the use of international sovereign bonds by several African governments over the past few years has been given much publicity in the specialized financial press (witness the extensive coverage of this topic by the Financial Times, Reuters, Bloomberg and many others) and has been vigorously discussed by policymakers, including at the IMF.

Starting with the Seychelles in 2006, no less than 15 Sub-Saharan African governments (excluding South Africa) have accessed international capital markets through internationally issued bonds, most of them for the first time ever (see Table 13). Together they raised approximately US\$21.8 billion between September 2006 and March 2015. The large majority of these international sovereign bonds concerns so-called 'Eurobonds', offered in foreign jurisdictions to US and other international investors under SEC Rule 144A and Regulation S, respectively, and all have been denominated in US dollar. Special cases are the issues by Angola (government-backed loan participation notes by the Russian VTB Bank through a special purpose vehicle named Northern Lights III), Mozambique (a government-backed repackaged loan from Credit Suisse, issued by Ematum, the Mozambican Tuna

Company) and Tanzania (a privately placed floating rate note). Other, non-African low-income countries that have tapped international capital markets since 2005 include Bolivia, Honduras, Sri Lanka and Vietnam (Guscina et al., 2014). As clear from Table 13, most African international sovereign bonds were structured as bearing fixed (semi-annually paid) coupons and a single bullet repayment of principal at maturity, although some securities had variable ('step-up') coupons (Republic of Congo 2029, Seychelles 2026) and/or amortisation spread over a few years (a 'soft' bullet, like Gabon 2024, Ghana 2026 and Cote d'Ivoire 2028) or over a longer period (backed by a sinking fund, e.g., Cote d'Ivoire 2032, Tanzania 2020).²⁹

The funds obtained through international bonds were planned to be used for various purposes (as stated in the respective bond prospectus documents). Many bonds were targeted towards infrastructure financing, often projects in the energy and transport sectors, whereas other were said to serve general budgetary purposes. A number of bonds concerned debt exchange/restructuring operations, in the context of the HIPC initiative or not (Seychelles 2011 and 2026, Gabon 2017, Republic of Congo 2029, Cote d'Ivoire 2032) or were used, at least partly, to retire (more expensive) external or domestic debt titles (e.g., Zambia 2022, Ghana 2023 and 2026); hence not all the money raised can be considered additional. Furthermore, Nigeria employed its maiden Eurobond issued in January 2011 to increase its visibility to international investors and to create a benchmark for the corporate sector. Indeed, already in May 2011 the Guaranty Trust Bank of Nigeria issued a similar US\$500 million five-year Eurobond. International bond issuance by Fidelity Bank and First Bank of Nigeria immediately followed the two Nigerian sovereign Eurobonds issued in 2013. Also Ghana Telecom placed a US\$200 million Eurobond two months after the 2007 Ghanaian sovereign issue.

Several factors are deemed to be responsible for the recent surge in African international bonds (see e.g., te Velde, 2014; Alleyne et al., 2014; Guscina et al., 2014; Sy, 2015a, 2015b; Tyson, 2015). One of the most important 'push' factors, affecting the general climate for international bond sales, has been the record-low interest rates in the US, Europe and Japan, a direct consequence of the ultra-loose monetary policy implemented by advanced economies in the wake of the global financial crisis. These low interest rates have initiated international investors' search for yield and awakened their risk appetite, which in turn has lowered Sub-Saharan Africa's Eurobond borrowing costs. In fact, when risk aversion increased during the global crisis in 2008, several African countries, including Kenya, Uganda, Tanzania and Zambia, postponed their initially planned international bond issuances. Moreover, in October 2008 the Seychelles defaulted on their 2011 bond following a sharp reduction in tourism revenues because of the crisis. Only in December 2009 the market for African Eurobonds was reinvigorated by Senegal's issue. Issuance seem to have peaked in 2013 and 2014, with year

²⁹ In line with standard practice, we refer to the different bonds by means of the year in which they mature.

totals of US\$5.4 billion and US\$7 billion respectively, thanks to record numbers of large first-time issues as well as countries returning to the Eurobond market to refinance (or re-open in the case of Kenya) earlier bonds. Another, related factor is the demand for portfolio diversification by international investors at a time when the correlation between asset prices has increased. As suggested earlier, the improved debt situation and more prudent fiscal and external policies, coupled with rapid recent growth and a positive future outlook, has contributed to African and other 'frontier' markets' attractiveness for portfolio investment. All Sub-Saharan African bond issues were heavily oversubscribed according to the financial media; Zambia reportedly received over US\$11 billion in orders for its first US\$750 million bond in 2012. The available data suggest that US- and UK-based fund managers constitute the largest investor class for African Eurobonds.

On the issuer side, Sub-Saharan African countries continue to have significant infrastructure needs. The recent global low-interest environment has provided them with a window of opportunity to complement aid and domestic savings with commercial external finance through international bond issuance. They have further been helped by increased flexibility in the IMF's limits on non-concessional borrowing for low-income program countries (Sy, 2013).

TABLE 13: SUB-SAHARAN AFRICAN INTERNATIONAL SOVEREIGN BONDS (EXCLUDING SOUTH AFRICA), 2006-2015Q1

Issue date	Country	Size (US\$ million)	Maturity date	Yield at issue (%)	Coupon (%) per annum)	Coupon type	Amortisation	Credit rating at issue (agency)	Investors	Stated purpose
Sep. 2006	Seychelles	230	Oct. 2011	9.466	9.125	fixed	bullet	B (S&P)	10% US, 80% Europe incl. UK, 10% other	refinancing private loans; clearing arrears to multilateral and commercial creditors; general government purposes
Sep. 2007	Ghana	750	Oct. 2017	8.500	8.500	fixed	bullet	B+ (S&P)	41% US, 36% UK, 19% Europe	infrastructure investment, mainly energy and transport
Dec. 2007	Gabon	1,000	Dec. 2017	8.250	8.200	fixed	bullet	BB- (S&P), BB- (Fitch)	54% US, 46% Europe incl. UK	buy-back Paris Club debt at discount
Dec. 2007	Congo, Rep.	478	Jun. 2029	8.770	2.500-6.000	step-up	sink called	unrated	/	HIPC debt exchange/restructuring
Dec. 2009	Senegal	200	Dec. 2014	9.473	8.750	fixed	bullet	B+ (S&P)	9% US, 52% UK, 30% Europe, 9% other	infrastructure investment, mainly energy and highway construction
Nov. 2010	Seychelles	169	Jan. 2026	/	3.000-8.000	step-up	sinkable	unrated	/	debt exchange/restructuring of defaulted bonds held by commercial creditors at discount
Apr. 2010	Cote d'Ivoire	2,330	Dec. 2032	17.354	/	flat trading	sinkable	unrated	/	HIPC debt exchange/restructuring of defaulted Brady bonds held by commercial creditors
Jan. 2011	Nigeria	500	Jan. 2021	7.126	6.750	fixed	bullet	B+ (S&P), BB- (Fitch)	38% US; 42% UK; 15% Europe; 5% other; 70% fund managers; 12% banks; 10% hedge funds; 5% insurance funds; 3% others	ensuring Nigeria's presence in the international market; increasing information disclosure; benchmark for sovereign, subnational and corporate issuances; general budgetary purposes
May 2011	Senegal	500	May 2021	9.125	8.750	fixed	bullet	B+ (S&P), B1 (Moody's)	30% US, 37% UK, 29% Europe, 4% Asia; 89% fund managers, 5% banks, insurance companies 4%, private banks 2%	infrastructure investment, mainly energy and highway construction
Nov. 2011	Namibia	500	Nov. 2021	5.835	5.500	fixed	bullet	Baa3 (Moody's); BBB- (Fitch)	25% US, 40% UK, 30% Europe, 5% Asia	general budgetary purposes
Aug. 2012	Angola	1,000	Aug. 2019	7.000	7.000	fixed	sinkable	Ba3 (Moody's)/BB- (S&P)/BB- (Fitch)	/	state-backed loan participation notes in VTB Capital loan through SPV Northern Lights III
Sep. 2012	Zambia	750	Sep. 2022	5.625	5.375	fixed	bullet	B+ (S&P), B+ (Fitch)	56% US, 40% Europe incl. UK, 4% other	infrastructure investment, mainly priority energy (hydroelectric) and transport (railway); repayment short-term external loan; general budgetary purposes
Feb.	Tanzania	600	Mar.	6.284	6-m LIBOR	floating	sinkable	unrated	/	Infrastructure projects across several sectors, including

2013			2020		+ 600bps					energy, roads and rail equipment
Apr. 2013	Rwanda	400	May 2023	7.000	6.625	fixed	bullet	B (S&P); B (Fitch)	40% US, 33% UK, 8% Switzerland, 6% Asia, 5% Belgium and Luxemburg, 4% Germany; 83% fund managers, 10% banks	construction hydropower plant; debt pay-off; completion construction of convention centre; paying off some of RwandAir's debt
Jul. 2013	Nigeria	500	Jul. 2018	5.375	5.125	fixed	bullet	BB- (S&P); BB- (Fitch)	/	electricity sector projects
Jul. 2013	Nigeria	500	Jul. 2023	6.625	6.375	fixed	bullet	BB- (S&P); BB- (Fitch)	/	electricity sector projects
Aug. 2013	Ghana	1,000	Aug. 2023	8.000	7.875	fixed	bullet	B (S&P); B1 (Moody's); B+ (Fitch)	57% US, 25% UK, 12% Europe, 6% other	counterpart funding for projects with development partners; partly early redemption of 2007 bond; refinancing of maturing domestic debt
Sep. 2013	Mozambique	850	Sep. 2020	8.000	6.305	fixed	sinkable	B+ (S&P); B+ (Fitch); B1 (Moody's)	73% US, 16% UK, 8% Europe, 3% other	purchase and operation of fleet of tuna-fishing vessels
Dec. 2013	Gabon	1,500	Dec. 2024	6.477	6.375	fixed	soft bullet	BB- (S&P); BB- (Fitch)	60% US, 21% UK, 15% Europe, 2% Asia, 2% other; small allocation to local institutional investors	partial buy-back 2007 bond; infrastructure investment, mainly roads and energy
Apr. 2014	Zambia	1,000	Apr. 2024	8.625	8.500	fixed	bullet	B+ (S&P); B (Fitch)	/	investment in transport and energy sectors; general budgetary purposes
Jun. 2014	Kenya	500	Jun. 2019	5.875	5.875	fixed	bullet	B+(S&P); B+(Fitch)	/	general budgetary purposes, including infrastructure projects (roads, rail and healthcare) and repayment of external loan
Jun. 2014	Kenya	1,500	Jun. 2024	6.875	6.875	fixed	bullet	B+(S&P); B+(Fitch)	/	general budgetary purposes, including infrastructure projects (roads, rail and healthcare) and repayment of external loan
Jul. 2014	Cote d'Ivoire	750	Jul. 2024	5.625	5.375	fixed	bullet	B1 (Moody's); B (Fitch)	/	strategic investments in National Development Plan (NDP) with focus on electricity, roads and education
Jul. 2014	Senegal	500	Jul. 2024	6.250	6.250	fixed	bullet	B+ (S&P), B1 (Moody's)	84% fund managers (of which 68% US-based, 25% UK, 4% Europe, 2% Asia, 1% Africa); 13% banks (both public and private); 3% insurance and pension funds	Repayment outstanding syndicated bank loan; investment projects in electricity, transport and services sectors
Sep. 2014	Ghana	1,000	Jan. 2024	8.194	8.125	fixed	soft bullet	B- (S&P); B2	/	counterpart funding for projects with development

2014			2026					(Moody's); B- (Fitch)		partners; refinancing of maturing domestic debt
Nov. 2014	Kenya	250	Jun. 2019	5.000	5.875	fixed	bullet	B+ (S&P); B+ (Fitch)	/	tap/re-opening of 2014 bond; general budgetary purposes, including infrastructure projects
Nov. 2014	Kenya	500	Jun. 2024	5.900	6.875	fixed	bullet	B+ (S&P); B+ (Fitch)	/	tap/re-opening of 2014 bond; general budgetary purposes, including infrastructure projects
Dec. 2014	Ethiopia	1,000	Dec. 2024	6.625	6.625	fixed	bullet	B (S&P); B1 (Moody's)	/	investment electricity, railway and sugar-industry projects; general budgetary purposes
Mar. 2015	Cote d'Ivoire	1,000	Mar. 2025	6.508	6.375	fixed	soft bullet	B1 (Moody's); B (Fitch)	mainly fund and asset managers, predominantly from the US	strategic investments in National Development Plan (NDP) with focus on infrastructure, education, health and agriculture

Source: IMF, Bloomberg, Financial Times, Reuters, prospectus documents and various other sources. A full, detailed list of sources is available from the authors.

External borrowing through international bond issuance has both benefits and risks. On the positive side, international bonds give the issuing government the opportunity to finance longer-term infrastructure investments for which other sources are insufficient, or in which (traditional) donors are less eager to invest (te Velde, 2014). Whereas the due diligence of international bond investors is expected to subject governments to market discipline, this may be experienced as less intrusive than traditional donor support, which often also bears political conditionalities. Indeed, it could well be that Rwanda's maiden Eurobond issuance mid-2013 was in part a reaction to the suspension of donor budget aid over Rwanda's alleged involvement in supporting M23 rebels in the neighbouring Democratic Republic of Congo in late 2012. Moreover, the interest rates paid on international, US dollar-denominated bonds are generally lower than those of local currency domestic bonds, and this has certainly been the case in the global low-yield environment of the past few years, where African rates have been at times below those of troubled Eurozone countries. With the exception of Cote d'Ivoire, all Sub-Saharan international bonds yielded well below 10% at issue, with annual coupons usually around 5-8% (see Table 13). Conversely, even in the relatively well-developed domestic bond market of Kenya, local currency bonds with a ten-year maturity carried interest rates of over 12% in early 2014 (according to Central Bank of Kenya data). In other African countries the contrast is usually much starker (see further), largely because of differences in (expected) inflation, currency movements and liquidity between domestic and international markets.

As noted before, sovereign Eurobonds can serve as a benchmark for corporate international US dollar funding, which may be helpful in countries with large banks or energy firms. Perhaps Eurobonds may also prepare investors for participation in domestic (local currency) bond markets or, more generally, increase African countries' standing (which could in turn attract FDI or other flows).

That said, international bond issuance is a time- and money-consuming undertaking, especially for first-time issuers. Countries usually first go through the process of obtaining a (new) credit rating from one (or more) of the three main rating agencies (Standard & Poor's, Moody's and Fitch) to comfort prospective investors. In addition, governments typically organise expensive before-issue roadshows to market their bonds to important investment funds and need to bear the (often substantial) costs of hiring lead managers and legal advisors that help with preparing issuance in the jurisdiction of choice (see Das et al., 2009). To spread these fixed costs over time (and to qualify for inclusion in certain cross-country bond indices), bond issuers usually prefer large issuances, which may exceed the amounts that are actually needed.

More importantly, the issuance of US dollar-denominated debt implies important exchange rate risks. Devaluation of local currencies against the US dollar will make this debt more costly in local

currency terms and therefore more difficult to bear, especially in countries which have limited foreign exchange reserves and/or export earnings. Oil exporters such as Angola and Nigeria, which have large US dollar revenues, are to some extent 'naturally hedged'. The situation of course changes when oil (or other commodity) prices drop, as has happened on several occasions and very recently, from the summer of 2014 onwards (see further). As a consequence of the recent oil price crisis the Central Bank of Nigeria has been forced to devalue the naira, which has increased the burden of Nigeria's foreign currency debt (Hou et al., 2015). The Ghanaian cedi lost about 40% between January and August 2014, largely due to structural domestic imbalances (which caused huge fiscal and current account deficits). A back-of-the-envelope stress test by Tyson (2015), applying a worst-case 30% devaluation scenario to all currencies of African Eurobond issuers, suggests potential losses of up to US\$10.9 billion (i.e., the increased value of required repayments). While the ballpark loss figure of Tyson (2015) may be greatly overstated (as it applies a uniform devaluation of which the effects are assumed to operate over the total duration of the bonds issued and uses cash rather than PV values; see Sy, 2015b), the exchange rate risks inherent to Eurobonds should not be ignored.

Other important drawbacks are roll-over and interest-rate/refinancing risk. As pointed out above, most international bonds have a bullet repayment structure that requires the whole principal of the bond to be repaid at once, at the end of maturity. As maturities have typically been ten years, such a concentrated repayment profile requires good planning and debt management (independent from opportunistic behaviour by politicians). Of course, repayment can be smoothed out by establishing a sinking fund in which the issuing government sets aside US dollars on a regular basis. A sinking fund structure has so far only been used in some of the African bonds issued for debt restructuring purposes and in the special cases of Angola, Tanzania and Mozambique. One should further stress that Eurobond interest rates are still much higher than the concessional interest rates of donor loans; governments are advised to exhaust these first. Eurobond yields are also much more volatile and expected to increase in the near future, following normalization of monetary policy in advanced economies. A High-yield environment may lead prospective first-time issuers to postpone their entry and adapt their timing (as occurred during the global crisis); but for governments that have already issued, these higher yields, whether due to domestic or global factors, raise the cost of refinancing. Zambia's Eurobond coupon rate, for example, increased from 5.375% on its 2012 issue to 8.5% on its 2014 issue.

More generally, internationally issued bonds increase countries exposure to external shocks and overall investor sentiment, which only partly depends on country fundamentals (see Guscina et al., 2014; Gueye and Sy, 2015). Figure 24 shows the evolution of the yields to maturity (i.e., the expected rates of return if the bonds would be held until the end of their lifetime and all coupons would be

reinvested) on several Sub-Saharan African Eurobonds (all of which will mature in 2023-2024) over the past year, from April 1st 2014 to March 31st 2015. In Panel (a) of Figure 24 the yields for selected Eurobonds of (former) HIPCs are presented together with the Chicago Board Options Exchange Volatility Index (CBOE VIX), a measure that is calculated from the implied volatilities of a wide range of S&P 500 Index options and standard proxy for global investor sentiment (with higher values indicating higher global risk aversion). Bond yields seem to have moved largely in tandem with each other and with the VIX, especially since August 2014, which conveys the message that international market conditions do matter for the (re)financing costs of Sub-Saharan African issuers. Yields peaked in Mid-December 2014, which at first sight seems to be connected with an accelerated drop in commodity prices around that time, and remained relatively high thereafter. Ghana fared worst among HIPCs, arguably because its domestic macroeconomic problems (its twin deficit, in particular) compounded the effects of international factors. The co-movement of bond yields and commodity prices is clearly visible in panel (b) of Figure 24, where the yields of non-HIPCs Nigeria, Gabon and Kenya are plotted together with the spot price of Brent crude oil (which often serves as a benchmark for West African oil varieties). Oil exporters Nigeria and Gabon have seen their initially low bond yields (relative to other African sovereigns) increase significantly because of the steep oil price drop. Kenyan yields also shot up in December 2014, probably because of cross-country contagion (as different African Eurobonds are seen by investors as belonging to the same asset class), but quickly returned to previous levels.

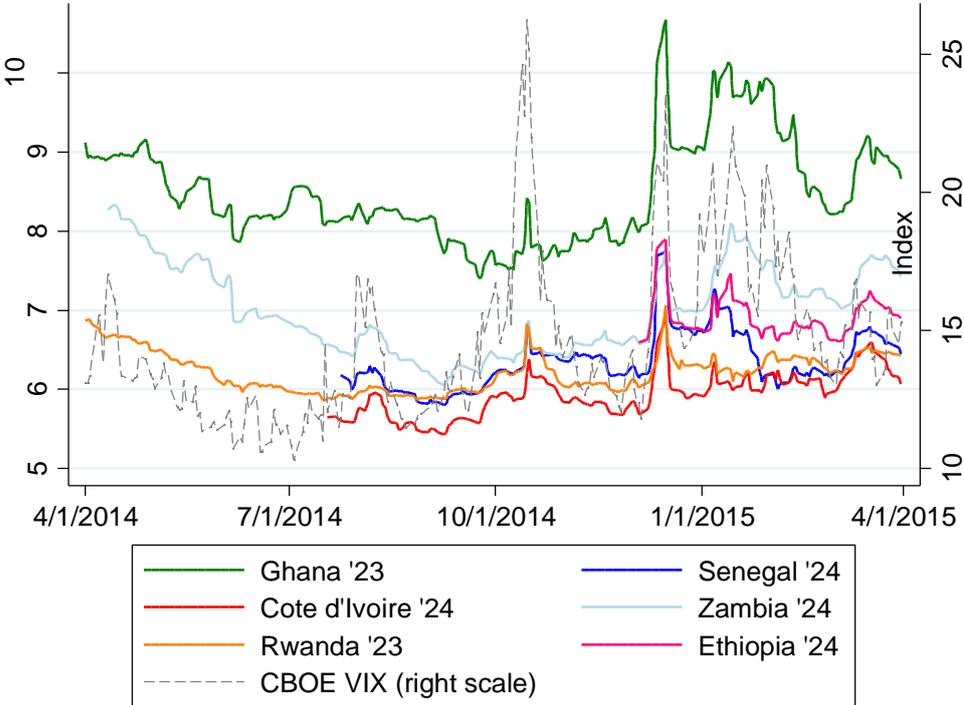
An additional disadvantage of Eurobonds is that debt workouts in the event of a default may be more difficult than in the Paris Club or under the HIPC Initiative because of the fragmentation of bond creditors and potential holdout problems (although contractual clauses may ameliorate this; see further). As argued by Thomas and Giugale (2014), for its debt management and future debt restructuring, 21st century Africa may have more to learn from Latin America than from its own recent past. Perhaps the current venturing into Eurobonds will lead eventually to an 'African Brady Plan'. Both the Seychelles and Cote d'Ivoire have already defaulted on and exchanged earlier bonds (the latter did so in 2011 in the violent aftermath of its presidential elections).

Much will depend on the quality of (infrastructure) investments for which international bond proceeds are used. In this area, the verdict is still out. So far, there have already been a reports of delays in project implementation and of money being spent differently than communicated to investors.³⁰

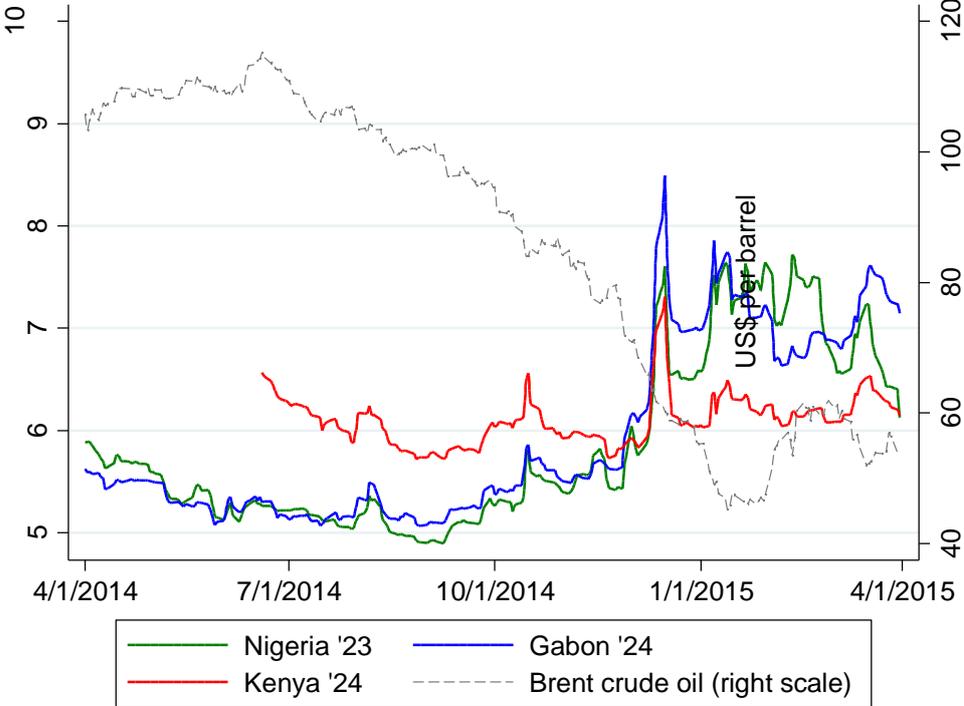
³⁰ Most notably, Ematum, the Mozambican Tuna Company, marketed its repackaged loan as funding 'fishing infrastructure', but reportedly also used some of the money raised to buy (armed) anti-pirate patrol boats. See <http://www.bloomberg.com/news/articles/2013-11-13/mozambique-tuna-bonds-fund-anti-pirate-fleet-in-surprise>.

FIGURE 24: EVOLUTION OF YIELDS TO MATURITY OF SELECTED SUB-SAHARAN AFRICAN EUROBONDS, APRIL 2014-MARCH 2015

Panel (a): HIPCs



Panel (b): non-HIPCs



Source: Bloomberg and Federal Reserve Bank of St. Louis

5.3.4 Domestic debt

Because of its historical dominance in developing countries' overall public debt stock, most of policymakers' and researchers' attention has focused on external public debt; as we ourselves do throughout the current report. It is this external debt, traditionally including (mostly concessional) bilateral and multilateral lending and (non-concessional) syndicated bank loans, that has been the subject of the large international debt restructuring and relief initiatives rolled out over the past three decades (see before; Cassimon and Essers, 2013). However, and largely because of the generous relief granted on external debt, domestic debt, i.e., debt owed to resident creditors, now constitutes an important part of total public debt in most developing countries. Broad estimates by Bua et al. (2014) for HIPC and non-HIPC low-income countries and by Essers et al. (2014) for Sub-Saharan Africa put the average domestic share of public debt in 2010/2011 at around 40%.

Reliable, detailed and cross-country comparable data on such domestic public debt is however hard to come by for low-income countries, again partly due to the relative lack of interest of policymakers and researchers until recently. Presbitero (2011) provides a useful overview of the existing databases on domestic debt and points to a number of important limitations and issues that hamper comparability between databases and even between countries within the same dataset. First of all, the distinction between domestic and external public debt, which according to official IMF/World Bank/OECD/BIS definitions should be made on the basis of creditor residency, is often accomplished by looking at the currency in which debt is issued or at the place of issuance and jurisdiction governing the debt contract; mainly because of the difficulty to track the ultimate holders of bonded debt (Panizza, 2008a). Even in the IMF and World Bank's own DSAs the latter two domestic-external taxonomies are regularly used instead of the official, residency criterion. There is not necessarily a close match between these three definitions for 'domestic' debt, as in some countries foreign investors actively participate in domestic debt markets or part of domestically issued debt is denominated in foreign currency. Second, some domestic public debt data refers to central government debt only, whereas other sources comprise the general government, including state and local governments and sometimes even state-owned enterprises. Third, there are important differences in the types of debt instruments covered by the different databases. Domestic debt can take on many different forms, including but not limited to securities such as Treasury bills, notes and bonds with maturities ranging from a couple of days to 20 years or more; commercial bank loans; currency and deposits; insurance technical reserves; financial derivatives; and other accounts payable, such as Central Bank advances (see IMF, 2013d for a more detailed overview).

To better understand the vulnerabilities associated with countries' respective domestic debt stocks one would ideally decompose domestic debt into different categories, along creditor types,

currencies, maturities and/or instruments. Unfortunately, such disaggregated information on domestic debt structure is not systematically collected for large, representative samples of low-income developing countries; although some useful studies by individual researchers are available. Based on a sample of African HIPCs between 1994 and 2003, Arnone and Presbitero (2010) find that increased domestic debt in the wake of the HIPC initiative was heavily dominated by short-term instruments, mainly treasury bills held by the domestic banking sector. They suggest that, at least initially, the currency mismatches of external debt were replaced by the maturity mismatches of domestic debt. Because of the IMF programs they found themselves under, HIPCs seeking to bridge their deficits were largely prohibited from engaging in new, non-concessional external financing or monetizing these deficits, and therefore 'forced' to issue domestic debt. According to Hussain et al. (2009), some HIPCs, including Tanzania and Uganda, also used Treasury bill issuance to sterilize large aid inflows. A more recent study by Bua et al. (2014), which follows a larger low-income country sample over 1996-2011, shows that the share of longer-term securities in domestic debt has risen over time, especially in non-HIPCs. Central Bank advances, another important debt category for HIPCs, increased post-2007 when countries responded to the global financial crisis.

Many low-income countries have taken steps to expand and enhance the longer-maturity marketable component of their domestic debt in particular, by developing and deepening (local currency) government bond markets. Spurred by the G20's November 2011 *Action Plan to Support the Development of Local Currency Bond Markets* (LCBMs), the IMF, World Bank EBRD and OECD have produced a joint 'diagnostic framework' aimed at helping developing country authorities analyse the state of their LCBMs and identify best practices and reform priorities (see IMF et al., 2013). Recent years have seen a number of initiatives by international (financial) institutions to directly support LCBM development in developing countries, including the World Bank's Global Emerging Markets Local Currency Bond (GEMLOC) and Efficient Securities Markets Institutional Development (ESMID) programs and the African Development Bank's African Financial Markets Initiative (AFMI). Whereas the majority of beneficiary countries are larger emerging markets, some low-income 'frontier markets', such as Kenya and Nigeria, are targeted as well by these schemes (see Essers and Cassimon, 2012 for more details).

Well-developed government LCBMs have a number of advantages over other, external sources of debt. First of all, of course, they reduce the currency risk that is inherent to traditional multilateral and bilateral loans and commercial lending, including the recent spate of US dollar-denominated Eurobonds (see before). The dangers of large, open currency mismatches on government balance sheets are well-established in the literature (Goldstein and Turner, 2004; Eichengreen et al., 2005). When exchange rates come under pressure, for example because of a sudden stop in foreign capital

inflows, countries that operate a floating exchange rate regime will see their debt service costs rise (see before). In case of a fixed exchange rate regime, country authorities will have to raise interest rates and use their reserves to defend the exchange rate peg, which may result in self-fulfilling runs and/or push the economy into recession. Developing countries have traditionally not been able to borrow externally in local currency, a phenomenon known as ‘original sin’ (Eichengreen and Hausmann, 1999) and the few countries that can do so now have started by developing their domestic LCBMs first. Second, if supported by a sufficiently broad investor base of local banks, pension and insurance funds and other institutional investors, LCBMs reduce countries’ exposure to external financial shocks, such as those experienced during the global crisis, and function as a ‘spare tyre’ that stabilizes the domestic economy. In other words, the development of LCBMs leads to a welcome diversification of countries’ overall debt structure. A third set of advantages over other forms of (external debt) relates to LCBMs’ potential spill-over effects and collateral benefits (beyond just additional funds). As government bonds fulfil the role of ‘safe asset’ in the economy, provide a pricing benchmark for corporate bonds and other financial products, and are used in open-market transactions by monetary authorities, they may help to mobilize domestic savings, boost financial market development more generally, and improve monetary policy transmission (see e.g., World Bank and IMF, 2001; Kumhof and Tanner, 2005; Abbas and Christensen, 2010; IMF et al., 2013). Also, because the development of LCBMs requires a strong and credible institutional framework and sound macroeconomic management (see e.g., Burger and Warnock, 2006; Claessens et al., 2007; Mu et al., 2013; Essers et al., 2014 for empirical evidence), governments seeking to finance larger budgets may have additional incentives to put their house in order and build a good reputation.

It is important to keep in mind, however, that government LCBMs are no silver bullet. Especially if government bond holdings are dominated by domestic commercial banks (by choice or because of regulatory requirements), as they do in most low-income African countries for example (Essers et al., 2014), there may be a crowding out of domestic credit to the private sector (Christensen, 2005; Mbate, 2013). Moreover, when banks are the dominant investor class, the envisioned diversification benefits of LCBMs are weakened, since LCBMs will no longer act as an alternative source of finance during a banking stress-induced credit crunch, and there could potentially be risky interlinkages and negative feedback loops between sovereign and bank balance sheets (Panizza, 2010).

Equally important, in the early stages of LCBM development in which low-income countries find themselves, domestic government bonds have typically much shorter maturities and bear much higher and volatile interest rates than concessional donor loans and other, non-concessional foreign currency borrowing (whether through Eurobonds or syndicated bank loans). Hence, local currency bonds often expose governments to substantial interest rate and roll-over risks (Hanson, 2007;

Prizzon and Mustapha, 2014). Sy (2015a) gives the example of Ghana, whose government would have paid about 4.3% on new ten-year borrowing in US dollar in January 2013, according to secondary market yields of its Eurobond, while at the same time interest rates on its three-month local currency Treasury bills hovered around 23%. After accounting for inflation differentials and depreciation of Ghana's cedi, the difference in US dollar and local currency borrowing costs remains a non-negligible 5.4%. Merotto et al. (2014) point to substantial roll-over risks in Senegal in 2012 due to the short maturity of its domestic debt stock.

On the positive side, several low-income countries have succeeded in lengthening the maturity profile of their government securities, diversify their investor base away from local banks, and bring down domestic borrowing costs (Essers et al., 2014; Bua et al., 2014). In Sub-Saharan Africa, even former HIPCs such as Tanzania, Uganda and Zambia now issue fixed-rate local currency government bonds with tenors of ten years and more through regular bond auctions. On the other hand, secondary market liquidity in most LCBMs remains very shallow, which *ceteris paribus* lowers the prospect of further declining yields. Liquidity could be boosted by further opening up domestic LCBMs to foreign investors, but that would again increase host countries vulnerability to external shocks.

Finally, one should note that it is difficult for LCBMs to develop without a critical mass of investors and basic financial market infrastructure (the construction of which involves large fixed costs). This implies that very small economies may be better served by international capital markets or a regional approach to LCBM development (Laeven, 2014). Both in the Economic and Monetary Community of Central Africa (CEMAC) and West African Economic and Monetary Union (WAEMU) countries have organized their LCBMs regionally, which has contributed to the rapid growth of these markets in the latter integration bloc. Insufficient coordination of issuances between the different member countries and a lack of information sharing have been cited as obstacles to further development of LCBMs in WAEMU (Sy, 2010; Diouf and Boutin-Dufresne, 2012). Also the East African Community (EAC), which plans to transform itself into a monetary union in the near future, has made some progress on bond market regionalization by removing restrictions on capital transactions among EAC members and an harmonization of regulatory bodies (Yabara, 2012).

Ultimately, developing country government should try to balance the short- and medium-term costs and risks associated with building deep and liquid LCBMs with their longer-term benefits. Developing well-functioning LCBMs is not an easy task, especially not for low-capacity bureaucracies in the poorest countries, and should be approached as a broad, gradual sequencing of reforms, starting with sound macroeconomic policy and institutional frameworks (IMF et al., 2013). In the end, the

‘optimal’ external-domestic debt mix is one that takes into account important trade-offs: local vs. foreign currency, domestic vs. external creditors, short vs. long maturities, etc. (Blommestein, 2005; Panizza, 2008a, 2010). A strengthening of debt management will, however, be crucial to remain on top of such a more diversified debt structure and achieve the overarching objective of minimizing the longer-run cost of the required funding subject to prudent levels of risk (IMF, 2014h; see further). For example, Sy (2015b) rightly argues that, equipped with stronger debt management policies, African countries (and other low-income economies) will be in a better position to ‘opportunistically exploit the boom-bust cycle of international interest rates, tapping international markets when borrowing costs fall and relying on local markets when such costs rise’.

6 How to maintain debt sustainability now and in the future?

6.1 Mechanisms to maintain debt sustainability

6.1.1 The macroeconomic and fiscal basis of debt dynamics

Whether a country’s debt is sustainable depends on many factors, including its current debt stock, overall repayment capacity, fiscal balance, and global macroeconomic conditions. Here we focus on the key macroeconomic and fiscal factors that drive the debt dynamics of a debtor country. These particular factors may be closely related to other determinants of debt sustainability, such as political and economic institutions.

To study the role of key fiscal and macroeconomic variables in the evolution of a country’s debt we consider the following (simplified) public debt ‘law of motion’ (see Cassimon et al., 2007 for the derivation of this formula):

$$\Delta d_t = \frac{r_t^* - g_t}{(1 + g_t)} d_{t-1} + \frac{\varepsilon_t \alpha^f (1 + r_t^f)}{(1 + g_t)} d_{t-1} - pb_t$$

where

d_t : debt-to-GDP ratio at time t

Δd_t : change in the debt-to-GDP ratio between time t and t-1

r_t^* : weighted average real interest rate on both foreign and domestic public debt

g_t : real GDP growth rate

ε_t : relative change in the exchange rate, $\frac{\Delta e_t}{e_{t-1}} = \frac{e_t - e_{t-1}}{e_{t-1}}$, in which e_t is the nominal exchange rate (expressed in local currency units per US);

α^f : share of foreign currency denominated debt

r_t^f : real interest rate on foreign debt

pb_t : primary (i.e., non-interest) fiscal balance-to-GDP ratio

The equation shows three factors as having an impact on the evolution of the debt stock over time. The first term, which is referred to in the literature as the 'endogenous debt dynamics' element, encapsulates the impact of the real interest and growth rate on the debt stock. The second term brings into the analysis the effect of possible exchange rate movements. The third and final term represents the direct impact of the primary balance on changes in the debt-to-GDP ratio.

Leaving aside exchange rate effects for a moment, the equation demonstrates that if a country's real interest rate is higher than its real economic growth rate, its debt-to-GDP ratio will increase unless the country runs a primary surplus (i.e., the government spends less than it receives in tax and other revenues). If, on the other hand, the first term is negative, due to low interest rates or high growth rates, the debt ratio may still remain constant or decrease under a primary deficit. For (low-income) developing countries that grow at high rates and borrow at concessional interest rates, the first term will be negative, leading to a gradual reduction of the debt burden over time. Under such conditions, debt sustainability is relatively easy to attain, even when running moderate primary deficits. However, as countries grow richer, growth rates generally decrease and access to concessional financing is reduced, making it more difficult for the first term to be debt-reducing.

As most public debt of LICs has historically been external, the evolution of the exchange rate is an important factor to take into account. As it is clear from the second term of the above equation, a currency depreciation (positive ε) will increase the debt-to-GDP ratio, *ceteris paribus*, and the strength of the increase will be determined by the importance of foreign debt in the public debt portfolio (α^f) and the interest on foreign currency denominated debt (r_t^f). The growing importance of domestic, local currency debt in LICs (see Section 5.3.4) has reduced the impact of this term. However, to the extent that foreign concessional debt is replaced by domestic debt with higher interest rates, such as local currency bonds, the endogenous debt dynamics might become less favourable.

While the discussion until now has been limited to the impact of the different individual elements of the equation, the interaction between these elements should not be overlooked. For example, next to the direct impact of the government's primary balance on the country's debt stock, it might also more indirectly influence the growth rate (through changes in particular forms of government spending or taxes) or the interest rates (through changes in the risk premium demanded by creditors,

as a result of fiscal policy). The full impact of these channels is not necessarily easy to predict and may depend on global risk aversion and other factors out of the control of debtor country authorities. The exact impact of monetary policy through its effects on the interest rate, primary balance, inflation and the exchange rate may also be difficult to project.

The example of Ghana illustrates the importance of fiscal policy for debt sustainability. In recent years Ghana's fiscal deficit increased to about 10-11% of GDP. The deficit financed an increase in civil service pay, a spending category which is hard to reduce. Consequently, Ghana now has to adjust its medium-term fiscal path to stabilize its growing public debt, by increasing revenues and reducing expenditures like energy subsidies (Merotto et al., 2014; IMF, 2014i).

6.1.2 DSA/DSF and its criticisms

While the DSA/DSF framework of the IMF and the World Bank has been widely used by donors and multilateral creditors as a reference, it has also been criticized on a number of points. Partly in response to these criticisms, the framework has undergone a number of adaptations since its introduction in 2005, most recently in 2012. The next review is foreseen for 2015. Despite these changes, a number of criticisms remain.

A first set of criticisms targets the DSA/DSF's concept of sustainability. Debt sustainability is obviously related to the concept of solvency, which basically implies that the PV of a government's expenditures should not exceed the PV of its revenues. Solvency is however just a necessary condition for sustainability and only a weak requirement, given that (ever-larger) primary surpluses can simply be postponed to the future to make the two PVs balance. A more pragmatic definition relates a country's debt to its capacity to repay, as proxied by GDP, exports or government revenues. Ratios based on these proxies have been used in the DSA framework of the IMF and the World Bank to estimate the tipping points at which the probability of debt distress increases rapidly and to propose debt sustainability thresholds accordingly (see Section 4.3). A number of authors have, however, proposed different, typically much lower, debt levels at which debt should be considered unsustainable. A first alternative concept of debt sustainability is linked to the debt overhang hypothesis. Krugman (1988) defines debt overhang as 'the presence of an existing, 'inherited' debt sufficiently large that creditors do not expect with confidence to be fully repaid'. If creditors no longer expect to be repaid in full, they will stop lending to the country in question, even in the presence of profitable projects. Based on this hypothesis, debt sustainability could be defined as the level of debt just before creditors start to expect that they will not be fully repaid. This is not necessarily the same level as the one at which debt servicing problems start to manifest themselves. As it becomes increasingly clear that countries tend to overborrow, are reluctant to default and delay restructuring, there might be a negative effect on growth even before debt-servicing problems start

to manifest themselves (see e.g. Krueger, 2003; Panizza, 2013). As such this sustainable debt level might be lower than the one under the DSA.

Yet another way to define debt sustainability is the human development approach. This approach does not start from the debt sustainability concept itself but argues that, even if a government has sufficient means to fulfil all its debt service obligations, governments must first use their available resources for essential poverty-reducing or other MDG- or PRSP-related expenditures. Remaining resources could be used for less essential expenditures, including debt service (Eurodad, 2001; UN, 2007). As such, debt sustainability is defined in relation to the debt levels at which debt service no longer crowds out MDG-priority public spending. Again such debt levels are expected to be much lower than the DSA debt thresholds.

A second group of criticisms focuses on the stress tests used in the DSA. These tests gauge the sensitivity of the baseline debt scenario to shocks. However, by changing one parameter at the time and keeping the others constant, the macroeconomic adjustment process triggered by the shock and correlations among the different possible shocks are not taken into account. In this sense, the current stress test approach of the DSA ignores the co-movement of different macroeconomic variables during a crisis, which might underestimate the ultimate risk to debt sustainability. Fiscal policy is also assumed not to react to the simulated shocks, as if a country would not adapt its spending and tax behaviour when hit by economic turbulence. Moreover, each stress test itself has a nearly zero chance of happening in reality (Arizala et al., 2010; Celasun et al., 2007). As a result of these criticisms, fan charts, which have become common practice in risk management, are increasingly being used for debt sustainability analysis (Arizala et al., 2010). Fan charts, in contrast to stress tests, incorporate feedback effects between macroeconomic and fiscal variables driving the debt dynamics, based on econometric analysis and historical country-specific data. On the basis of such interactions, the fan charts show a spectrum of possible outcomes around the baseline using confidence intervals (IMF, 2013c). In the latest version of the IMF's Market Access Countries (MAC) DSA, a fan chart tool is integrated to be applied to higher scrutiny countries³¹. Two versions are currently being used, including one based on expert advice from IMF country staff.

For HIPC and LICs the use of a fan chart might provide more realistic predictions of future debt-to-GDP ratios. Technically however, the estimation procedure may prove difficult. The MAC DSA fan chart is based on historical country-specific data on growth, the effective interest rate on government debt, exchange rate information and the government's primary balance for the past 11 years. For a number of LICs this information may not be available for such a long timeframe (World

³¹ MACs are classified as higher scrutiny on the basis of a set of benchmarks of debt burden and other indicators and access to Fund resources. These countries are considered more risky.

Bank and IMF, 2012). Moreover, Kaffo Melou et al. (2014) find that the dynamics of debt accumulation in HIPC countries show a break-point around 2006, a cross-country proxy for HIPC-MDRI debt relief. As debt dynamics significantly differed before and after 2006, forecasts of debt accumulation can only be based on data starting after countries reached completion point, 2007 on average. This leaves too little data for certain countries to do rigorous analysis. An alternative, using panel data which groups data of different countries over time, could create more significant results but implicitly assumes the impact of shocks to be similar among all countries, sacrificing country specificity (World Bank and IMF, 2012; Kaffo Melou et al., 2014). The World Bank and IMF (2012) have therefore proposed to introduce this methodology on an experimental basis only.

A final set of criticisms focuses on the CPIA. At a general level, the CPIA has been criticized for not necessarily measuring those policies which underpin economic growth, and the measurement of CPIA is not without its imperfections (see e.g., UN, 2007; Rodrik, 2008). Specifically for the DSA, commentators lament the fact that the CPIA is the only criterion used to differentiate debt thresholds. While the impact of the CPIA score on the probability of debt distress is statistically significant, the use of thresholds based on just one explanatory variable risks being too restrictive and ignores other important country characteristics (Panizza, 2008b; Wyplosz, 2011). Related to this, the use of just three categories of CPIA may lead to grouping countries into too broad categories in which the borrowing capacity of countries in the bottom of a category might be overstated, while for countries at the top of the category it might be understated (UN, 2007).

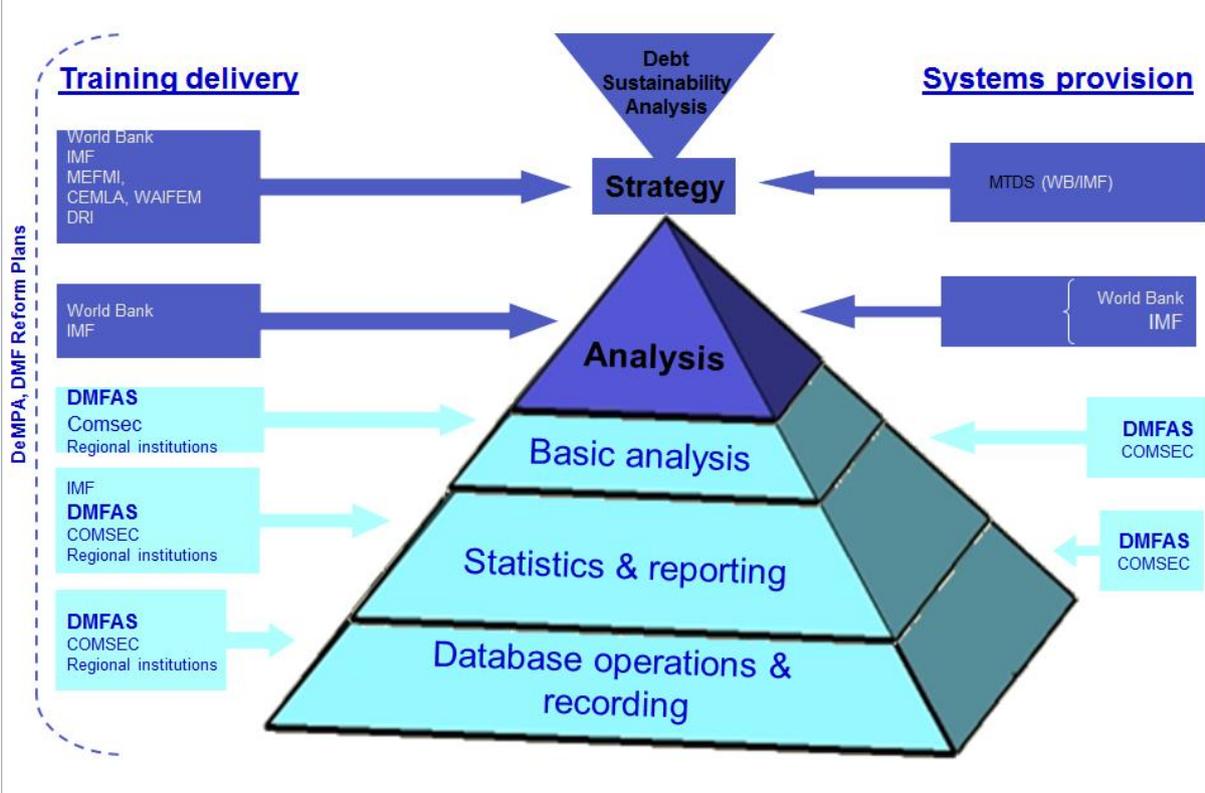
6.1.3 Debt management (donor) support

While the previous section focused on the importance of having an appropriate debt sustainability framework, efforts in this respect have to be framed within the broader concept of strong public debt management. Often, this broader dimension is forgotten or underrated. It needs to be clear that a lack of debt management capacity poses an important threat to all efforts made under the several debt relief initiatives, as well as DSA/DSF monitoring. In other words, there can be no longer-lasting exit from unsustainable debt burdens without sound debt management. Especially in LICs, public debt management capacity, systems and institutions have traditionally been very weak. As such, the international donor community has set up technical assistance (TA) provisions targeted especially at improving debt management in those countries, and increased these efforts alongside the HIPC debt relief process.

Figure 25 provides a schematic overview of the architecture of debt management support initiatives (UNCTAD/DMFAS, 2011). It shows that the debt management functions can be visualized using a pyramid structure, with different levels. Typically, the three lower levels, database operations and recording, statistics and reporting, and some basic analysis, are denoted as *downstream* activities,

while the levels of more sophisticated analysis (including DSAs) as well as debt strategy development and implementation are referred to as *upstream* activities. Figure 25 moreover lists the providers of both systems (right of the pyramid) as well as training support (left of the pyramid). In terms of system ('hardware') provision, downstream support is provided by either UNCTAD (through its Debt Management and Financial Analysis System (DMFAS)), or by the Commonwealth Secretariat (through its Commonwealth Secretariat Debt Recording and Management System (COMSEC-DRMS)), while upstream support is jointly developed and provided by the IMF and World Bank. On each of the dimensions, these providers also give TA. Within the framework of the HIPC Initiative, donors also decided to scale up TA targeted to beneficiary countries in order to increase their capacities, more specifically with respect to upstream activities (DSA, medium-term debt strategy formulation etc.). This was realized through support, under the so-called HIPC-CBP program, to South-based regional technical expertise agencies, such as the Macroeconomic and Financial Management Institute of Eastern and Southern Africa (MEFMI), the Centre for Latin American Monetary Studies (CEMLA), and the West African Institute for Financial and Economic Management (WAIFEM), under the leadership of the UK-based expert agency Debt Relief International (DRI).

FIGURE 25: TOOLS AND ACTORS IN DEBT MANAGEMENT TA



Source: UNCTAD/DMFAS, 2011.

Since end-2008, an attempt to streamline and further upgrade the provision of 'upstream' training support in public debt management for LICs is organized through the donor-funded and World Bank-

administered Debt Management Facility (DMF). Upgrading has been mainly achieved through the development and application of a *diagnostic tool*, called Debt Management Performance Analysis (DeMPA), to evaluate a country’s debt management capacity; assistance in formulating *Reform Plans*, to cure the weaknesses detected by the DeMPA; and assistance in formulating *Medium-Term Debt Strategies* (MTDS), all while streamlining these efforts among the different established TA providers.

Looking at a sample of DeMPA results provides us with an aggregate picture of the overall level of debt management quality in LICs. Figure 26 presents such an overview for a sample of 22 countries for which DeMPA analyses were executed during the 2010-2012 period (World Bank and IMF, 2013). The DeMPA tool scores the debt management capacity of a country according to 15 criteria, each evaluated on a scale from A to D, similar to the Public Expenditure and Financial Accountability (PEFA) tool. A score of ‘C’ means that the minimum requirements have been met. A score of ‘D’ means that there is a deficiency and corrective action needs to be taken. If for certain reasons an assessment of a dimension cannot be made, that dimension gets a rating ‘N/R’ (not rated). Figure 26 shows that substantial weaknesses remain for most countries in a number of indicators, especially for more sophisticated dimensions such as audit, data security and the use of risk management instruments (such as derivatives and guarantees); but also more basic dimensions such as loan reporting, staff capacity and strategy development. Overall, it clearly exposes a remaining need for support in improving the quality of debt management in recipient countries.

FIGURE 26: CROSS-COUNTRY SUMMARY ASSESSMENT OF DEBT MANAGEMENT PERFORMANCE BASED ON 2010-2012 DEMPAS.



Source: World Bank and IMF, 2013. The percentage indicated refers to the percentage of countries scoring at least ‘C’ on this dimension.

6.2 Future debt restructuring mechanisms

6.2.1 The need

The HIPC and MDRI Initiatives will soon come to an end. From the onset, both initiatives were not meant to be permanent mechanisms. To minimize moral hazard and to encourage HIPC countries to adopt early economic reform programs, the HIPC initiative included a sunset clause, a two-year period which would originally expire in 1998, after which the final list of (potential) beneficiaries would be finalised and countries should fulfil the eligibility requirements. After a number of extensions, the sunset clause was finally allowed to take effect in 2006 and the HIPC Initiative was closed to new entrants (IMF and IDA, 2011).

Unfortunately, with the end of the HIPC Initiative, the most elaborate international process of debt restructuring will disappear and no comparable mechanism will be available for future debt work-outs. However, debt crises will most certainly reappear, also in developing countries which have been blessed with record-low debt stocks (thanks to HIPC and MDRI relief). To ensure that the restructuring of sovereign debt remains manageable in the future, the international community must reflect on the strengths and weaknesses of (and draw lessons from) past debt relief mechanisms (UN, 2014a).

While debt restructuring operations in the 1990s were already burdensome undertakings, a number of changes in the international debt landscape (which we have documented through this report) have led to increased complexity. First, debt titles have dispersed. In the 1980s, non-concessional external debt mainly consisted of syndicated bank loans, which made it relatively easy to bring together the main banks involved and negotiate a debt restructuring or relief. Nowadays, however, the issuance of international sovereign bonds and similar instruments has made debt ownership more fragmented, involving a wider and constantly changing spectrum of creditors to negotiate with, sometimes in different legal jurisdictions. In addition, there is also the growing importance of the domestic debt market (and participation of foreign investors therein). With such a dispersed creditor community, collective action is much more difficult to secure, making restructuring costlier (Krueger, 2002; Panizza, 2013).

Although proposals to solve problems related to sovereign debt restructuring have repeatedly been put forward, Buchheit et al. (2013) argue that both the nature and understanding of these problems have changed; making the case for reforms that enable orderly debt work-outs today much stronger than ten years ago (when the IMF proposed a significant overhaul of debt restructuring; see Section 6.2.3). First, while before many feared that countries would restructure too early and opportunistically in the presence of well-organised debt restructuring mechanisms, it is now

increasingly asserted that, in the absence of such mechanisms, countries tend to overborrow, are reluctant to default and delay restructuring, which increases the losses to both creditors and debtors (e.g., Krueger, 2003; Panizza, 2013). Second, a number of recent court rulings (most notably with respect to Argentina) have increased the attractiveness of holdout strategies, complicating the conclusion of negotiated debt restructuring deals. Finally, (looming) debt crises in advanced economies, instead of only emerging and other developing economies, have put the topic of debt restructuring again firmly on the agenda of policymakers. We will limit ourselves in the remainder of this section to a discussion of two options for future debt restructuring that are currently on the table (and, arguably, represent the two extremes of a wider spectrum of intermediate solutions): first, a purely market-based approach, i.e., reforms to the clauses of international bond contracts; and second, a statutory approach, providing a binding multilateral legal framework for debt restructuring.

6.2.2 Sovereign bond contractual adjustments

One approach to improve future debt restructuring consists of market-based reforms to the contracts underlying international sovereign bonds, mainly with the aim of addressing collective action problems.

A first modification concerns the so-called *pari passu* clause which has been referred to by US hedge fund NML Capital to demand full repayment on its claims vis-à-vis Argentina (Hagan, 2014; Stiglitz and Guzman, 2014). Typically, this clause has been interpreted as a 'ranking' clause, in the sense that all creditors should be treated equally and that. Some recent interpretations have however been more strict and have encompassed a payment obligation, requiring the sovereign to pay its creditors on a *pro rata* basis. Indeed, in the case of Argentina, a New York judge ruled that the *pari passu* clause implied that Argentina could only continue to pay its main creditors, which agreed on large debt restructurings³², if it fully paid out a small group of holdouts, which did not participate in the restructuring and often bought their debt titles at a heavy discount on the secondary market (Stiglitz and Guzman, 2014). To the extent that this peculiar interpretation of the clause would be followed in the future, the leverage of holdouts would be increased, as would the incentives for creditors not to participate in debt reschedulings. Furthermore, as the ruling of the New York court eventually also lead to a full stop in payments to creditors which had earlier agreed to reschedule, the disincentives to future debt restructuring are not to be underestimated. To avoid similar (mis)interpretations, sovereign issuers have taken action to modify the clause in new bond issuances or clarify it in the memorandum of the contract. At the end of August 2014, the International Capital Markets

³² Following default in 2001, Argentina negotiated two debt exchanges, in 2005 and 2010, thereby restructuring 93% of its external debt. Creditors who participated in the exchanges agreed to receive about a third of the original value of their claims (Khor, 2014 ; IMF, 2014j).

Association (ICMA), a trade association representing debt capital market participants, added a new standardized form of the *pari passu* clause (which more clearly invalidates the second interpretation) to its list of Model Clauses (ICMA, 2014; IMF, 2014j; Khor, 2014).

A second modification addresses some of the collective action problems that might undermine debt restructuring operations *ex ante*. Following discussion in the early 2000s and recommendations from a G10 Working Group, it was agreed to include Collective Action Clauses (CACs) in sovereign bonds. Such clauses allow 'the key financial terms of a bond to be modified upon receipt of support of a qualified majority of bondholders holding a requisite percentage (typically 75%) of the outstanding principal of a given series' (IMF, 2014j, p.17). While these CACs mitigate the collective action problem in each particular bond series, they do not eliminate the problem across different series. As such, with the standard CAC, if a certain creditor can obtain a 'blocking position' in one bond series, rescheduling of that specific series becomes impossible and consequently creditors in other series might also be less inclined to accept a rescheduling (Stiglitz and Guzman, 2014). This is exactly what happened in the 2012 Greek debt restructuring, in which holdouts were able to obtain blocking minorities in about half of the foreign law-governed bond series. As early as 2003 it was therefore proposed to introduce bond clauses allowing for the aggregation of claims. If claims are aggregated across different series for voting purposes, it becomes much more difficult for a particular creditor to obtain a blocking position. The case of Greece illustrated the potential of this solution. By adapting domestic laws and 'retrofit' CACs, aggregation across all domestic-law bond series could be achieved (Zettelmeyer et al., 2013; IMF, 2014j).

A first kind of 'aggregation' CACs, already adopted by a number of debtor countries, uses a 'two limb' voting structure, which 'requires that a minimum threshold of support be achieved *both* (a) in each series *and* (b) across all series being restructured' (IMF, 2014j, p 19). At the level of the individual series the minimal level of support is lowered, generally from 75% to 2/3, while at the aggregate level the minimum is set at 75% or 85%. While such clauses lower the risk of holdout, they does not eliminate it. By obtaining just over a third of the outstanding principle in one bond series, a creditor can still obtain a blocking position. This has triggered discussions on 'single limb' voting procedures, in which only the support at the aggregate level is counted, with a required supermajority of, say, 75%. As such aggregation CACs carry the risk that creditors from larger bond series might agree upon restructurings that discriminate against bond holders in smaller series, the Model Clauses recently proposed by the ICMA attempt to guarantee adequate protection of creditor rights (ICMA, 2014; Hagan, 2014). The proposed clauses, for example, require that all bond holders are offered the same instruments or an identical menu of instruments. More generally, issuers and creditors are free to adopt different voting procedures, depending on the needs of the restructuring (IMF, 2014j; Hagan,

2014). First adopters of the new clauses have been Mexico, Vietnam and Kazakhstan, without any significant impact on bond prices it seems (Hagan, 2014; Moore, 2014).

While the just-described contractual modifications could solve, or at least attenuate the problems with restructuring foreign law-governed bonds, they do not address the larger coordination problems *across* the different creditor groups that one finds in many developing countries (international banks and bond holders, official bilateral and multilateral creditors, domestic debt holders, etc.) (Krueger, 2002; Panizza, 2013). The modifications also do not take into account seniority differences between creditors. Junior creditors might vote to have themselves treated in the same way as more senior creditors (Stiglitz and Guzman, 2014). Furthermore, as a market-based mechanism and since these changes to clauses have to be integrated in (new or old) bond contracts, they ultimately depend on negotiations (or other interactions) between the sovereign issuer and its creditors. Finally, and perhaps most importantly, such contractual adjustments do not have an immediate impact today on the current stock of debt, which might still fall prey to ‘vultures’. In the absence of large, swift debt exchanges (which are deemed unfeasible), the effects of improved bond clauses will only become noticeable gradually and with a (long) time lag, at the pace at which existing bonds expire and are replaced by new ones (Eichengreen, 2014).

6.2.3 A multilateral legal framework for sovereign debt restructuring

While the adjustments to bond clauses discussed above may mitigate important collective action problems, they do not take on a number of other issues for which, arguably, a more structured and forceful approach would be needed, e.g., the problem that countries may restructure too late (Panizza, 2013). To tackle these other problems, some are now advocating a centralized, treaty-based approach, similar to debt restructuring mechanisms that exist for private companies and municipalities (cf. Chapter 9 or 11 of the US Bankruptcy Code).

In 2001, former IMF First-Deputy Managing Director Anne Krueger proposed such a mechanism, the so-called Sovereign Debt Restructuring Mechanism (SDRM). The mechanism would involve a stand-still in debt service payments and the start-up of negotiations between the debtor and its creditors, administered by the IMF as an arbiter. If a qualified majority of creditors agreed on a restructuring arrangement with the sovereign, taking into account seniority of claims and the diversity of creditor interests, this would also apply to the minority (Krueger, 2002, 2003; Panizza, 2013). Following two years of negotiations, the SDRM was eventually rejected at the IMF Spring Meeting of 2003, primarily due to opposition from the US (which was reluctant to give up power to supranational rules or institutions) and from a number of emerging market countries (which feared higher *ex ante* borrowing costs) (Panizza, 2013). When discussing potential debt resolution mechanisms in 2013, the IMF opted for the market-based approach discussed above (IMF, 2014k).

Following the case of Argentina, the South Summit of the G77 + China in May 2014 in Bolivia revived the proposal of a multilateral framework for sovereign debt restructurings (Khor, 2014). In a next move, the G77 successfully passed a resolution at the United Nations General Assembly on September, 9th 2014, which aimed 'to elaborate and adopt through a process of intergovernmental negotiations, as a matter of priority during its sixty-ninth session [by the end of 2015], a multilateral legal framework for sovereign debt restructuring processes'. To ensure progress, it also decided 'to define the modalities for the intergovernmental negotiations and the adoption of the text of the multilateral legal framework at the main part of its sixty-ninth session, before the end of 2014' (Khor, 2014; UN, 2014b). The proposed mechanism will likely be based on discussions that have been going on within UNCTAD since early 2013 (Elmers, 2014).

Although support for the resolution was overwhelming, with 124 votes in favour, 11 votes against and 41 abstentions (including Belgium), the main jurisdictions in which foreign law-denominated debt is issued voted against (i.e., the US and UK). The US representative stressed that 'she could not support a statutory mechanism for sovereign debt restructuring as such a mechanism was likely to create economic uncertainty. That uncertainty could impact upon the provision of financing to developing countries' (UN, 2014c). More recently the UN Secretary General noted in his synthesis report on the post-2015 agenda the need to 'strengthen arrangements for transparent, orderly and participatory sovereign debt restructuring', but proposed as an immediate step only the development of an 'informal forum on sovereign debt'. However, while the initial prospects for the multilateral framework might not look bright, this was also the case for the HIPC Initiative. Following support from civil society organizations, with campaigns like Jubilee 2000 and Drop the Debt, the initiative ultimately passed. Also now different civil society organizations are promoting the initiative, although not yet on the same scale and equally voraciously as in the late 1990s (when debt sustainability problems were much more pressing).

While the creation of a full-fledged, legally binding multilateral debt restructuring regime that deals with many problems at the same time is probably the first-best approach, a recent Brookings Committee maybe rightly noted that 'such a regime is practically and politically unfeasible' (Buchheit et al., 2013, p.29). The SDRM mechanism proposed by the IMF was rejected after years of negotiation and the recent proposal at the UN was rejected from the outset by both the US and the UK (as well as Japan, Canada and a number of EU member states). The future of this initiative therefore does not look very promising at the moment, and much will depend on the more concrete modalities and suggestions that will follow from the UN resolution.

The market-based approach of incremental changes to the contractual framework of international bonds is indeed only a second-best avenue towards better debt restructuring, but one that can bring about meaningful progress over time (Hagan, 2014). While initially sovereign bonds issued under New York State law did not include CACs, such clauses were introduced in 2003; it is estimated that, as of June 2014, 75% of New York State law-governed bonds include CACs. The gradual introduction of the strengthened CACs in newly issued foreign law-governed bonds over the following years constitutes a further step towards solving collective action problems in debt restructuring. Currently, the outstanding stock of bonds issued under English or New York State law is approximately US\$900 billion (the large majority of foreign law-governed bonds), of which approximately 71% matures within ten years (IMF, 2014j). Ten years from now, collective action may be much less of a problem than it is today, and that without a radical overhaul of the current debt restructuring (non-)system. True, solutions to other problems, such as a lack of coordination between more diverse creditor groups and costly delays in sovereign default, will need to be sought. But it is far from guaranteed that the strive for a comprehensive multilateral legal framework for sovereign debt restructuring will deliver these solutions any time soon.

6.2.4 More traditional debt restructuring/relief mechanisms: the Paris Club

For countries who still rely primarily on official bilateral debt, the Paris Club is still an important mechanism. With the introduction of the Evian Approach, the Paris Club attempted to formalize a system of debt restructuring and relief arrangements for non-HIPC countries.

However, with changes in the geopolitical landscape and the emergence of new (official) creditors, the importance of the current 20 permanent member countries of the Paris Club is gradually decreasing. As the effectiveness of Paris Club interventions crucially depends on the participation of a critical mass of creditors, broader participation of creditors will be needed if the Paris Club is to remain a key forum for negotiating debt restructurings and relief. For the moment, broader participation is realised by inviting other official creditors on an ad hoc basis to the monthly meetings of the Paris Club. Extending the permanent membership to non-traditional creditors would be a next (bolder) move. The recent organisation of a joint meeting of the Paris Club and G20 member states could be a first step forward in this direction (Morris, 2013).

7 Conclusion

This report has reflected on the legacy of major international public debt relief efforts that have benefited low-income countries; the HIPC Initiative and its successor, the MDRI, in particular. It has also provided insights into post-relief debt sustainability and management in light of a number of key trends in development financing and recently introduced or proposed initiatives. We acknowledge that, on several fronts, more in-depth research and country-level analysis is needed to fully appreciate the magnitude of current and future risks to public debt sustainability in low-income countries and better inform the design of solid risk mitigation mechanisms. Nevertheless, we hope that the current report will help in keeping the topic of low-income country public debt sustainability and management alive and on donor and other policymakers' agendas, despite the unwinding of debt relief under HIPC and MDRI, and that it will contribute to ongoing discussions in international fora. The following twelve bullets capture what we believe are the main takeaways from the report.

- Major debt relief initiatives are coming to an end. 35 out of 39 eligible HIPCs have completed the process and received full HIPC/MDRI debt relief. Chad will do so very soon, whereas Eritrea, Somalia and Sudan are making limited progress in reaching their HIPC decision points.
- Paris Club bilaterals and the largest multilateral creditors have almost fully delivered their share of HIPC debt relief, which is close to 75% of total estimated costs. Participation of non-Paris Club bilaterals and commercial creditors in the HIPC Initiative is lagging and varies significantly. Efforts are being made to bring reluctant creditors on board and to halt litigation by 'vulture funds' and others, with some success.
- Together with pre-HIPC relief and additional bilateral debt relief beyond HIPC, the HIPC/MDRI framework will have reduced eligible countries' public debt stocks by more than US\$125 billion upon completion point, or about 90% in end-2010 PV terms. These grand, concerted initiatives have been necessary (although not always sufficient) interventions to make low-income countries' overall debt burdens and service again sustainable.
- The available evidence further suggests that HIPC/MDRI debt relief may also have contributed to improved governance and higher investment and pro-poor spending in recipient countries, although causality is difficult to establish.
- According to the latest DSAs conducted by the IMF, the outlook for debt sustainability in (former) HIPCs is moderately positive. Only in a few countries the risk of debt distress has worsened since HIPC completion point. That said, a number of countries remain classified as being at high and a majority of post-completion point HIPCs at moderate risk of debt

distress in spite of the large debt relief they have received (partly because of differences between HIPC and DSA definitions of debt sustainability).

- There are currently several potential risks to debt sustainability which need to be monitored closely. Important trends are the declining relative importance of aid in overall resource flows to developing countries and, in recent years, a slight increase in the share of loans in ODA (as opposed to grants) to low-income countries (and more so to middle-income countries). Furthermore, fast-growing HIPCs and other countries may cross the World Bank's IDA eligibility threshold in the not-too-distant future, which implies they will have less (and, eventually, no more) access to concessional IDA support. Grants and concessional loans will become increasingly focused on the most fragile of developing countries.
- Whereas concessional debt continues to make up most of low-income countries' external public debt (nearly 70% on average in 2012), non-concessional borrowing is on the rise. This includes aid-cum-investment packages from emerging donor-creditors such as China, India and others, on which detailed data (comparable with DAC figures) is largely missing.
- Another source of non-concessional finance are international capital markets, where low-income countries, including several post-completion point HIPCs, have issued sovereign bonds. Because of their (typical) US dollar denomination, bullet repayment structure and marketing towards foreign investors, these internationally issued bonds expose the issuing country to important exchange rate and roll-over risks. Also, whereas recent bond yields are still relatively low, normalization of monetary policy in the US (and in other advanced economies) as well as continued declines in oil and other commodity prices may increase the cost of refinancing international bonds.
- Largely due to external debt relief, domestic debt has gained importance in the overall public debt portfolio of low-income countries. The development of domestic local currency bond markets in particular lowers currency risks, may reduce countries' exposure to external shocks and holds other collateral benefits, which is why several multilateral organizations are actively providing support. Typically, however, domestic debt has shorter maturities and higher and more volatile interest rates than external public debt.
- If public debt is to remain sustainable, above all, countries themselves will need to better manage the key drivers of debt dynamics, through prudent fiscal, monetary and exchange rate policies and growth-enhancing strategies. Donors can be of great help in contributing to improve the current DSA/DSF and in building debt management capacity more generally. Various forms and providers of debt management support, involved in both downstream

(data collection, reporting and basic analysis) and upstream (more strategy-level) activities, already exist (some at least since HIPC). However, these initiatives continue to need funding, and arguably more so now than before, as debt management is becoming increasingly complex.

- Several proposals aimed at facilitating orderly debt work-outs in the future have been floated. One approach, which has gained prominence in the wake of the debt restructuring cases of Argentina and Greece and where already some progress has been made, is that of adjusting particular clauses of international bond contracts to overcome creditor holdouts and other collective action problems. These incremental ‘market-based’ changes, while important, however do not offer a solution to other problems in debt restructuring, such as a lack of coordination between various groups of creditors and costly delays in sovereign default.
- History and recent developments do not bode well for a ‘statutory’ approach, i.e., the establishment of a full-fledged multilateral legal framework for sovereign debt restructuring. An earlier IMF proposal along similar lines was buried in 2003 and also now the main financial centres seem strongly opposed to a recently adopted UN resolution which calls for the elaboration of such a legal framework. Much will depend on the concrete modalities that will emerge from further discussions and negotiations, which are expected to prove very difficult. Meanwhile, steps are being taken to open up the Paris Club to non-traditional official creditors and thereby increase its relevance.

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