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COMMUNICATION FROM THE COMMISSION

SUPPORT FOR STRUCTURAL ADJUSTMENT AND DEBT RELIEF IN HEAVILY INDEBTED ACP STATES

A COMMUNITY RESPONSE TO THE HIPC DEBT INITIATIVE

Proposal for a

COUNCIL DECISION

concerning Exceptional Assistance for the Heavily Indebted ACP countries

(presented by the Commission)

EUROPEAN COMMISSION

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CONTENTS

1. Introduction

Debt burdens remain heavy for a group of low-income countries, most of which are in Sub-Saharan Africa, in spite of their efforts to pursue economic reforms and sound macro-economic policies. In recent years, creditors and donors have implemented a range of measures to alleviate debt burdens of the poorest countries, but for a group of Heavily Indebted Poor Countries (HIPCs) these measures have not been sufficient to bring down debt burdens to sustainable levels. Consequently, the international debate on the debt issue has increasingly come to focus on the need to find more long-term and comprehensive solutions to the debt problems of the HIPCs. An important response in this respect was the decision by the Paris Club to grant stock of debt operations to provide countries with an exit from the constant process of rescheduling.

More recently, the International Monetary Fund and the World Bank, at their spring 1996 meetings, presented a comprehensive programme of action to alleviate the debt problems of the HIPCs - the HIPC Debt Initiative. The initiative was endorsed by the Interim and Development Committees at the Autumn 1996 IMF/World Bank Annual Meetings. This initiative involves co-ordinated action by all creditors to reduce debt burdens to sustainable levels. A key new element of this approach is the recognition of the need to also deal with the burden of multilateral debt, as part of a country's overall debt burden.

The European Community is concerned by this initiative both as a major development partner of the countries concerned and as a creditor to these countries.

As a donor, it is providing substantial resources within the framework of the Lomé Convention - the overall envelope for the Second Financial Protocol amounting to 14.6 billion ECU for the 70 ACP States. In particular, the Community is providing substantial financial and technical resources to those ACP countries implementing structural adjustment programmes.

As a creditor, total Community-level exposure to the 11 ACP States most likely to need action under the initiative, amounts to around 600 million ECU in nominal terms.

The debt issue has been a major concern to the ACP States during negotiations of successive Lomé Conventions. The Community has taken several measures in order to prevent a further increase in the ACP States' debt to the Community. Since Lomé IV, all EDF resources apart from risk capital are channelled in the form of grants, as there are no longer special loans nor any requirement for countries receiving Stabex transfers to contribute to the replenishment of the system. Furthermore, in 1991, the Council decided to abandon the obligation to contribute to the repayment of Stabex resources granted under earlier Conventions and in the context of the mid-term revision of Lomé IV in 1995, the Community agreed to transform into grants all special loans of the previous Conventions which had not yet been committed.

Within the framework of the HIPC initiative, the Commission is proposing further measures to alleviate the debt problems of the most heavily indebted ACP States. The proposal presented in this Communication aims to strengthen the adjustment process in these countries with the objective of facilitating sustainable growth and poverty alleviation. In order to reach this objective, these countries will continue to need adequate levels of external assistance, even after having benefited from debt relief measures under the HIPC initiative.

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In this context, it should be noted that the major role of the Community vis-à-vis these countries will continue to be as a donor granting financial and technical assistance to support their reform and development efforts. Such support is and will continue to be of vital importance for the HIPCs.

It is proposed that the Community, as a donor, ensures and enhances continued support for heavily indebted poor ACP States by:

i) granting additional structural adjustment support on a case-by-case basis;
ii) considering, on a case-by-case basis, support for debt reduction of commercial debt; and
iii) strengthening support for debt management.

It is proposed that the Community, as a creditor:

iv) takes action to reduce the net present value of the eligible countries' debt to the Community.

2. The HIPC Debt Initiative

The principal objective of the HIPC Debt initiative is to ensure that the adjustment and reform efforts of the Heavily Indebted Poor Countries are not constrained by continued high debt and debt service burdens. Analyses undertaken by the IMF and the World Bank show that, even after the full application of existing mechanisms for debt relief and in spite of their efforts to pursue growth-oriented policies, the debt burdens of a group of HIPCs will remain above sustainable levels over the medium term. The HIPC Debt Initiative is based on a commitment by the international financial community to take action to reduce these countries' debt burdens to sustainable levels, provided that the countries complete a period of strong economic policy performance. A key element of the HIPC initiative is its aim to deal with the debt problems of the HIPCs in a comprehensive way, including co-ordinated action by bilateral, commercial and multilateral creditors. Another key element is the new approach of assessing debt sustainability.[1]

The initiative was endorsed by the Interim and Development Committees at the autumn 1996 Annual meetings of the IMF and the World Bank, when the participation of the Bretton-Woods Institutions in the initiative was confirmed. The Communiqués of the Interim and Development Committees placed particular importance on the comprehensive nature of the initiative, urging other creditors to participate in the initiative on an equitable basis, and for those creditors, that have not already defined their participation, to do so as soon as possible.

With regard to bilateral creditors, the Paris Club indicated its readiness to go beyond Naples terms in providing, on a case-by-case basis, debt reduction of up to 80 percent in present value terms for countries qualifying for additional relief within the HIPC initiative. Furthermore, consistent with current practice, countries receiving assistance under the initiative would be required to seek comparable treatment on their debt owed to other bilateral and to commercial creditors.

[1] Debt sustainability will be defined on a country-by-country basis within the range of 200-250 percent for the net present value of the debt stock to exports ratio and 20-25 percent for the debt service to exports ratio.

The initiative will be open to HIPCs that pursue or adopt structural adjustment programmes supported by the IMF and the World Bank and face an unsustainable debt burden even after the full application of current debt relief mechanisms. In order to qualify for debt relief measures beyond current mechanisms, eligible countries must be able to demonstrate a track record of strong policy performance based on a programme of macro-economic, structural and social policy reforms. In addition to sound macroeconomic management, the HIPC initiative will place particular emphasis on improving the quality of public expenditures, strengthening institutional capacity and enhancing the delivery of social services. A description of the main features and stages of the HIPC initiative can be found in Annex 5.

The World Bank and the IMF have estimated that 13 countries would need action beyond current debt relief mechanisms, of which 11 are ACP States[2]. This country list is tentative; other countries may prove to be eligible at the time when a decision concerning them is to be taken. There are a handful of countries likely to come up for decisions in 1997, when the extent of likely action will need to be agreed upon by creditors, on the basis of specially prepared debt sustainability analyses. At each country's decision point, the creditors concerned will be asked to commit to taking action to reduce the net present value of their exposure to that country, after the country has completed a further track record of good policy performance. The first country likely to require Community action is Uganda for which a decision regarding eligibility and the extent of debt relief needed, is currently expected to be required in spring 1997.

3. Community-level Exposure to the HIPCs and Potential Costs to the Community

The Community's exposure to the HIPCs falls within the framework of the Lomé cooperation: the HIPCs which have debts outstanding to the Community are all ACP countries and their debt has been incurred through the various Lomé Conventions and preceding these, the Yaoundé Conventions. Community exposure to the potentially eligible HIPCs comes from three instruments : special loans, risk capital and EIB loans on own resources.

The European Community is a relatively small creditor in the context of the HIPC initiative. Total Community exposure to the 11 ACP countries which are currently estimated as likely to require action under the initiative amounts to 595 million ECU in nominal terms[3]. Of this amount, special loans account for 69 percent, risk capital for 30 percent and EIB loans on own resources for 1 percent of total Community-level claims. The Commission estimates that the net present value of these claims amounts to about 300 million ECU. A description of the three instruments and individual country exposure for each instrument is provided in Annexes 2 and 3.

Regarding the costs of the HIPC initiative to the Community, two aspects should be stressed. *Firstly,* any overall cost estimates will be subject to substantial uncertainty, because costs will only be determined on a country-by-country basis, as qualifying countries reach their

[2] These 13 countries are Burundi, Ethiopia, Guinea-Bissau, Madagascar, Mozambique, Myanmar, Nicaragua, Niger, Rwanda, Sao Tomé and Principe, Uganda, Zaïre and Zambia. The Community has no claims on Myanmar and Nicaragua.

[3] In line with the framework of the initiative, data in this paper refer only to loans extended to or guaranteed by the public sector and cover amounts already disbursed (unless otherwise noted).

decision points in the initiative. These country decisions will be spread over a number of years. It will therefore remain uncertain which countries will actually require additional debt relief under the initiative, how much net present value debt reduction would be needed for each country to achieve debt sustainability and which countries will qualify in terms of economic policy performance. It is not certain that all the 11 countries estimated as likely to need debt relief measures will qualify for the initiative, as some potentially eligible countries may not adopt adjustment programmes or build up adequate track records. Similarly, it cannot be excluded at this stage that other countries might become eligible for action. *Secondly,* as decisions and implementation of debt relief commitments will be spread over the years, the actual costs of action to creditors will be spread accordingly (see annex 7 showing likely timing of country decision points).

In conclusion, it is difficult to give a reliable estimate of the total implied cost of the HIPC initiative to the Community and any estimates at this stage can only be seen as tentative. According to World Bank/IMF estimates, the cost to the Community could amount to about 150 million ECU in 1996 present value terms, assuming participation in the initiative by the 11 ACP States referred to above[4]. This would correspond to around 5 percent of the total cost to be borne by multilateral creditors. The annual costs are expected not to exceed a few tens of millions of ECU a year on average.

Given the uncertainties surrounding this estimate, as noted above, it should be underlined that actual costs can differ substantially from amounts mentioned here.

4. Principles to Guide a Community Contribution to the HIPC Initiative

The following principles are proposed to guide Community action in the context of the HIPC initiative:

i) the aim of Community participation in this initiative should be to strengthen the adjustment process in the countries concerned, by providing incentives for sustained reforms and to make the adjustment process viable in the long-term by supporting broad-based programmes of macro-economic, structural and social policy reforms;

ii) the Community should continue to play a key role supporting the HIPCs by providing financial and technical assistance to support structural adjustment and poverty reduction;

iii) the Community should affirm its commitment to participate in the HIPC Debt Initiative with respect to Community-level claims, by taking action where needed to reduce the net present value of Community-level exposure on the countries concerned, in parallel to action taken by other creditors;

[4] Two qualifications need to be made here: First, the cost estimates are based on assumptions regarding economic developments in the countries concerned. Actual costs, for a given group of countries, would differ from estimates if underlying assumptions change, e.g. if export growth or the level of aid flows to the countries concerned would be lower or higher than assumed. Secondly, this cost estimate is based on data reported to the World Bank in the Debtor Reporting System and not directly on data provided by the Community. Hence, there could be some errors in the data used. Reconcilitation of data is currently underway and initial work undertaken would seem to suggest that the preliminary WB/IMF estimates of the potential cost to the Community may be an overestimate.

iv) Community action should be consistent with the HIPC initiative and be taken on a case-by-case basis within a general framework;

v) action involving debt relief on Community level claims should be taken in such a way that the preferred creditor status of the participating Community institutions is not negatively affected.

vi) the eligible country must not be in a situation where the development co-operation with the Community is suspended

vii) Community debt relief measures should not include the treatment of arrears. Arrears should in principle be cleared before the eligible country can benefit from any debt relief measures.

5. Enhanced Community Assistance to the HIPCs - Proposed Action as a Donor

It is proposed that the Community, in its role as a major donor, undertakes three measures, within existing EDF resources, to better assist the heavily indebted poor ACP States.

5.1 Additional Adjustment Support

Although the HIPCs have continued to receive positive net transfers, their dependence on external aid flows on concessional terms make them particularly vulnerable. As a major donor of structural adjustment support, the Commission has always stressed the importance of the adjustment process in the heavily indebted countries being adequately funded. For the countries qualifying for additional debt relief under the HIPC initiative, adequate levels of external aid flows will continue to be of critical importance for their development, even after they have participated in the initiative. Financing needs will also remain large for a number of other heavily indebted poor countries, in particular countries whose debt burdens fall slightly below the critical debt sustainability thresholds defined by the HIPC initiative, and which therefore will not qualify for additional debt relief. It is important that these countries also receive adequate levels of external assistance to support their adjustment efforts.

The Commission's view is that there is a need to ensure that HIPCs, receive adequate financial support. Therefore, *the Commission proposes that the Community grants, within available resources under the Structural Adjustment Facility,* additional support to HIPCs, on a case-by-case basis and according to financing needs and economic performance.

5.2 Support for Commercial Debt Reduction

For the majority of the poorest countries, their debt to commercial creditors is relatively small. But even if commercial debt, on average is relatively limited for this group of countries, there can be tangible benefits from eliminating it. Therefore, any comprehensive treatment of the debt problem of the HIPCs needs to include measures to reduce the burden of commercial debt. This is being done through operations to assist these countries to buy back their commercial debt on the secondary market at a large discount. A number of the HIPCs potentially eligible for the HIPC debt initiative have already undertaken debt buy-back operations with financial support from IDA and bilateral donors and further such operations are being planned. Consequently, it is expected that there will be a continued need for such support, although it will diminish as there are less countries still to complete such debt buy-back operations.

There is scope for the Community, together with other donors, to contribute to this effort. *The Commission proposes that the Community, on a case-by-case basis and where the beneficiary country requests such support, should be able to contribute to internationally co-ordinated and supported buy-back operations of commercial debt of heavily indebted ACP States*. Such contributions would be financed from the National Indicative Programme of the country concerned.[5]

5.3 Technical Assistance for Debt Management

Weaknesses in debtor countries' debt management capacity have often made debt servicing more costly and resource consuming. Improved external debt management can therefore have tangible benefits in terms of reducing the administrative burden on the debtor country and sometimes also the costs of servicing the debt. In recent years, many HIPCs have established computerised debt management systems and undertaken training programmes in debt management, supported by donor assistance.

In accordance with article 240 of the Lomé Convention, the Community can grant, at the request of an ACP State, assistance in studying and finding solutions to indebtedness and debt-servicing difficulties, assistance for training in external debt management and international financial negotiations and support to the ACP States in developing flexible techniques and instruments of debt management.

The Commission sees scope for strengthening such support and proposes that the Community, on a case-by-case basis, should explore ways of enhancing its support for debt management, in co-ordination with assistance undertaken by other donors and organisations.

6. Support for Debt Relief - Proposed Action as a Creditor

The HIPC initiative is based on participation by all creditors - bilateral, multilateral and commercial - who are invited to provide exceptional assistance and debt relief beyond current mechanisms as required for the participating countries to reach debt sustainability. The Commission proposes that the Community, as a creditor, joins this effort and takes action to reduce the net present value of its claims on the countries concerned.

6.1 Modalities of Debt Relief

a) Debt forgiveness or refinancing

The HIPC initiative gives each creditor almost limitless scope to design their own mechanisms for participating in the initiative. It is expected that the various international financial institutions will participate in this initiative in a variety of ways, consistent with

[5] It should be noted that donor contributions to debt buy back operations do not relieve the commercial creditors from their share of the burden in the HIPC Debt Initiative. Commercial creditors are still required to grant debt relief on terms at least comparable to those agreed by the Paris Club.

their charters and financial policies. With respect to Community action, the treatment of the Community-level claims should be consistent with the objectives of the HIPC initiative and the principles proposed in section 4 above. In particular, the treatment of Community-level claims raise important questions of principle concerning the status of the participating Community institutions as preferred creditors.

Regarding possible modalities for the Community participation in the initiative, there are, in principle, two key options to obtain the debt relief: i) a direct debt forgiveness (write-off) or ii) refinancing on grant terms of outstanding claims. In the latter case, grants could be provided to assist the country concerned either to prepay, or to service as it falls due, their debt, or a portion of their debt, to the Community.

Action to write off claims might be seen as the most straightforward way to meet the requirements of the initiative. However, this option should be ruled out for *EIB loans on own resources and risk capital*, if the EIB is to be treated in the same way as other multilateral financial institutions, which have rejected the option of a direct debt forgiveness of their claims, on the grounds that such action would risk to damage their preferred creditor status.[6]

The situation might be different for the *special loans*, where a case could be made that the special characteristics of this debt imply that direct debt cancellation could be appropriate. It is worth noting in this context that the special loan instrument was not renewed in Lomé IV, as it was considered to be more appropriate to provide this assistance in grant form. A write-off of this debt would correspond to a retroactive adjustment of the terms of this assistance and it would match similar debt relief initiatives by Member States with respect to their bilateral aid credits. It could be argued that a write-off would have advantages in terms of administrative simplicity and that it might give the Community action higher visibility. Finally, a case could be made that writing off special loans would not have a negative impact on the Community's preferred creditor status more generally, since this action would be taken in the context of an exceptional initiative by the international community to assist a limited group of countries.

Nevertheless, these arguments need to be balanced against any risk that such action, even on special loans, could negatively affect the status of the Community as a de facto preferred creditor. *The Commission recognises the difficulties that a direct forgiveness of Community claims could create and in view of the fact that other preferred creditors have rejected this option, the Commission proposes that the Community takes action by refinancing debt on grant terms.* This approach would be consistent with the approach taken by other preferred creditors.

As mentioned above, refinancing, through the provision of grants, could allow the beneficiary country either to prepay its debt or to service that debt as it falls due (in full or in part). Such refinancing would seem to be better granted in a single tranche for the prepayment of debt, rather than for the servicing of debt as it falls due. The prepayment option would have the advantage of avoiding that implementation of debt relief measures for each country are spread over a number of years and would be administratively more simple for both the Community and the debtor countries. Furthermore, prepayment would be fully consistent with options presented by the World Bank in the context of the IDA-administered Multilateral Trust Fund

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[6] Since EIB loans on own resources and risk capital both are signed by the EIB, the effect of writing them off might negatively affect the EIB's preferred creditor status.

b) Concentrating debt relief on the special loans

As described above, Community exposure comes from three instruments; special loans, risk capital and, albeit to a very small extent, EIB loans on own resources. All three types of loans fall under the initiative. The Community is expected to take measures to reduce the present value of its total exposure to each country eligible for the initiative. However, the Community does not need to take action regarding each instrument separately, but can choose to look at Community-level claims as a whole and to take action to deal with this overall exposure to each country. In other words, this implies that debt relief measures can be concentrated on one of the three Community-level instruments, as long as the Community, through these measures, provides the agreed amount of present value debt reduction for each country.

The Commission proposes that debt relief measures are concentrated on the special loans. Firstly, focusing Community action on one instrument would be administratively most simple. Secondly, as discussed in the previous section, focusing debt relief measures on special loans would seem appropriate given the special characteristics of this instrument. Such action would be in line with measures already taken with respect to this instrument (i.e. the non-renewal of the special loan instrument in the Lomé IV Convention and the transformation of special loans not yet committed into grants). *The Commission's view is that action taken by the Community should aim at eliminating outstanding special loans for the eligible countries.*

For the countries likely to be eligible for the initiative, the share of special loans in their overall debt to the Community varies from one to the other. Most potentially eligible countries have a relatively large share of special loans in their debt to the Community. It is therefore expected that in most cases, it would be sufficient for the Community to take action with regard to special loans, in order to deliver the required present value debt reduction. However, in some cases, the Community may not be able to provide the agreed level of debt relief by only taking action with regard to the special loans. This could be the case for countries whose special loans account for only a minor part of their outstanding debt to the Community and it would obviously also be the case for countries which have no outstanding special loans. *In this case, it is proposed that the countries concerned would receive grants to meet their risk capital obligations to the extent required to achieve debt sustainability.*

As noted in section 3 above, for countries which at present are expected to need action under the initiative, there are practically no outstanding EIB loans on own resources. Nevertheless, it is possible that other countries may become eligible for the initiative for which there is significant EIB own resource exposure. In that event, a case could be made that this exposure should be dealt with by an EIB contribution to the initiative within the overall Community participation in the initiative (see further below).

c) Country decisions

When a HIPC has established a track record of good economic policy performance and hence reached the decision point in the initiative, a decision will be taken regarding the country's eligibility for additional support under the initiative and the extent of debt relief required in order to achieve a sustainable debt burden.

When a country is assessed to be eligible, the Commission will determine the level of debt relief that the Community could provide to that country and, in collaboration with the EIB, prepare a specific proposal for how the Community would assist that country. The country proposals would be developed on a case-by-case-basis taking into account four factors: the structure and level of the country's debt to the Community; the desire for administrative simplicity; the objective of eliminating outstanding special loans and the need to ensure equitable and fair treatment between countries.

After having prepared a country specific proposal in line with these objectives, the Commission would present it to the EDF Committee, seeking Member States' views in line with existing consultation arrangements for EDF operations.

6.2 Source of finance for the Community participation

a) Financing from reflows

The Commission proposes that the cost of action on Community claims is met by the allocation of reflows from EDF-financed loans (special loans and risk capital). A decision by the Council to use reflows for this purpose would be in accordance with article 9 of the Internal Agreement on the financing and administration of Community aid within the framework of the Fourth ACP-EC Convention, whereby the Council can decide unanimously, on a proposal from the Commission, to allocate reflows to other operations than returning them to Member States.

As set out in section 3, the IMF and the World Bank have tentatively estimated the total cost to the Community to about 150 million ECU in 1996 present value terms, to be spread over at least six years. The Commission proposes that a limited amount of reflows is set aside annually to finance the debt relief measures proposed in section 6.1. *An allocation of 25 million ECU a year over the four years 1997-2000 (a total of 100 million ECU) is expected to be sufficient to meet the needs of the initiative over this period. Thereafter, or earlier if the need arises, a review of the possible need for further resources would be undertaken.*[7]

Such a solution would provide additional resources for the Community's participation in the HIPC debt initiative. In order for the initiative to achieve its objectives, the Commission believes that the debt relief measures should be additional to existing levels of resource flows to these countries. Furthermore, it is desirable that the HIPC initiative does not divert resources intended for other developing countries and in particular, from other HIPCs making efforts to implement economic reforms and to improve their growth prospects. In fact, most of the 41 HIPCs will not fulfil the debt sustainability criteria for additional debt relief under the initiative, although there is no doubt that their debt levels and financing needs will remain high.

In this context, it should be noted that the Council has once before decided to use reflows for a similar purpose, namely to partly finance the first Community contribution to the Special Programme of Assistance for Africa, SPA. On that occasion, the Council decided to allocate reflows to an amount of 60 MECU to finance General Import Programmes to SPA countries. These reflows enabled the Community to make a greater financial contribution to the SPA

[7] Total reflows on special loans and risk capital amount to around 100 million ECU a year.

than would have otherwise been the case and to become a major contributor to this programme from the outset.

In addition to the proposed financing from reflows, the issue arises whether a direct EIB contribution should be sought. Although the EIB's own exposure is covered by Member States' guarantees, it would be consistent with the logic of the initiative, as a one-off effort of the international community, for the EIB, to contribute from its own resources, in cases of significant EIB exposure on its own resources. Consequently, an eventual EIB contribution to the financing of the Community-level debt relief is not excluded at this stage; this would be a matter for discussion by EIB shareholders.

b) Practical mechanisms

If the Council agrees to allocate reflows for the Community participation in this initiative, it is possible to envisage a simple mechanism through which the Community's support for debt relief could be channelled. Thus, an amount could be set aside from reflows on special loans/risk capital on an annual basis to a single account managed by the EIB. If the beneficiary country is to prepay its debt to the Community, there could be a one-off operation whereby the country in question would be given a grant from this account to enable it to prepay its debt on a present value basis.

The Commission does not see a need for using the IDA-administered Multilateral Trust Fund (MTF). The Community is a small creditor in this context and should itself be able to finance the amount of relief needed on debt owed to the Community. The MTF is particularly useful for creditors whose own contributions need to be supplemented by contributions from bilateral donors and for creditors who wish that the MTF manages their contributions.

7. Conclusion

As a major donor to most of the HIPCs, the Community needs to ensure that their adjustment and development efforts are not constrained by an unsustainable debt burden. The HIPC debt initiative represents a co-ordinated effort by the international community to deal with the debt problems of the HIPCs and constitutes an appropriate framework within which the Community can contribute to the alleviation of the debt burden of the heavily indebted poor ACP States.

The measures proposed here should all be seen in the context of strengthening the adjustment process in the countries concerned. It is proposed that the Community, as a donor, takes measures to enhance its support for the HIPCs, within existing EDF resources. Such support would include additional adjustment support on a case-by-case basis, a possibility of contributing to debt buy-back operations of commercial debt and enhanced support for debt management.

As a creditor to the countries eligible for action under the HIPC initiative, it is proposed that the Community takes measures with regard to these countries' debt to the Community. The Commission proposes that the Community provides such action by way of allocating grants, as far as possible, for the prepayment of special loans to the Community. Such action would be consistent with action to be taken by other preferred creditors.

The HIPC initiative provides a unique opportunity for the Community to give a political response to the debt issue; an issue which has been of major concern to the ACP States. The political impact of the proposed Community action is potentially great and would appear to considerably outweigh the relatively small costs involved.

ANNEXES

Annex 1	Description of Community lending instruments
Annex 2	Community exposure to countries potentially requiring action under the initiative
Annex 3	Status of arrears on Community instruments
Annex 4	Main features of the HIPC Debt initiative
Annex 5	Debt classification of the 41 HIPCs
Annex 6	Possible timing of decisions regarding potentially eligible countries

ANNEX 1

Description of Community instruments

Special loans

Special loans, financed from the EDF, were granted under the two Yaoundé and the first three Lomé Conventions. This instrument was not renewed in Lomé IV, as it was felt to be more appropriate to provide this type of assistance in the form of grants. The special loans are IDA-like loans which carry an interest of 0.5 to 1 %, with 40 years maturity and a 10 year grace period. The Yaoundé loans were signed by both the Commission and the EIB, while the Lomé loans were signed by the Commission only. These loans are administered by the EIB. The repayments of these loans are returned to the Member States, via the EIB, in proportion to their contribution to the EDF which financed the loan.

There are outstanding special loans[8] to 9 of the 11 ACP countries currently assessed to need action under the initiative, amounting to 410 million ECU.[9]

Risk capital

Risk Capital operations, financed from the EDF, are signed and administered by the EIB on behalf of the European Union. They can take the form of direct equity subscriptions or, which is mostly the case, the form of conditional and subordinated loans, whose repayment is linked to the performance of the project. The terms and conditions of loans depend upon the nature of each project carrying interest rates of up to 3 % and with a maturity of up to 25 years. Repayments flow back to the Member States as for the special loans. As repayments depend on the success of the project, the exact volume of reflows is less predictable than for special loans.

Under this instrument, there is Community exposure to all 11 ACP countries currently assessed as likley to need action under the initiative, amounting to 179 million ECU.

EIB loans on own resources

The EIB also lends to the ACP States from its own resources, at the request of the Member States. The EIB *loans on own resources* are extended on market terms, but benefit from an interest subsidy of up to 4 % from the EDF. Grace periods and repayment periods are determined according to project characteristics. The EIB loans on own resources are guaranteed by the European Union, in proportion to Member States' shares of the EIB capital.

There is exposure under this instrument only to one of the 11 ACP States, currently assessed as likely to need action under the initiative, amounting to 6 million ECU[10].

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[8] Amounts refer to disbursed loans. Loans to the private sector are excluded. All data exclude possible arrears.

[9] Outstanding special loans to the 41 HIPCs amount to 1.2 billion ECU and 1.5 billion ECU for all ACP States.

[10] However, it is possible that other countries to which there is substantial EIB exposure become eligible for the initiative.

ANNEX 2

Community Exposure to Countries Potentially Requiring Action under the HIPC Initiative (disbursed amounts in million ECU as of 15/12/96)

Country	Special Loans	Risk Capital	EIB Own Resource Loans	Total
(a) Countries likely to require action under the initiative				
Burundi	40.72	12.38	0.00	53.10
Ethiopia	30.05	31.49	0.00	61.54
Guinea Bissau	0.00	3.36	0.00	3.36
Madagascar	27.34	20.73	0.00	48.07
Mozambique	0.73	23.53	0.00	24.26
Niger	22.84	12.89	0.00	35.73
Rwanda	19.29	9.70	0.00	28.99
São Tomé e Principe	0.00	1.33	0.00	1.33
Uganda	8.57	29.54	0.00	38.11
Zaïre	132.93	17.90	6.25	157.08
Zambia	127.53	15.77	0.00	143.30
Total	410.00	178.62	6.25	594.87
(b) Other possibly stressed countries				
Cameroon	79.83	0.85	36.07	116.75
Côte d'Ivoire	69.06	0.09	92.72	161.87
Congo	40.02	13.09	3.10	56.21
Guyana	37.65	9.83	0.00	47.48
Tanzania	35.27	16.45	0.00	51.72
Total	261.83	40.31	131.89	434.03
(c) Other unsustainable countries				
Sudan	15.00	26.87	0.00	41.87

1. Loans to the private sector which are not publically guaranteed are excluded, since these loans do not fall under the initiative.
2. Under current IMF/World Bank assumptions, the countries in section b) of this table would not require action under the initiative.

ANNEX 3

Arrears of Countries Likely to Require Action under the HIPC Initiative (in million ECU as of 17/01/97)

Country	Arrears on EIB Own Resource Loans	Arrears on Risk Capital	Arrears on Special Loans	Total
a) Countries likely to require action under the initiative:				
Burundi		0.43	0.91	1.34
Guinea-Bissau		1.30	-	1.30
Madagascar		2.52	0.75	3.27
Niger		2.57	0.76	3.33
Rwanda		1.55	2.48	4.03
Zaïre	7.31	10.41	20.46	38.18
Zambia		1.12	-	1.12
Sub-Total	7.31	19.90	25.36	52.57
b) Other countries with unsustainable debt burdens:				
Sudan		11.56	3.95	15.51
c) Other possibly stressed countries:				
Cameroon	5.27	0.35	4.32	9.94
Congo	6.44	5.28	5.42	17.14
Sub-Total	11.71	5.63	9.74	27.08
Grand Total	19.02	37.09	39.05	95.16

ANNEX 4

Main features of the HIPC Debt Initative

Eligibility

The initiative will be open to HIPCs that pursue or adopt structural adjustment programmes, supported by the IMF and the World Bank, in the two years following the endorsement of the initiative in September 1996, after which the initiative will be reviewed and a decision made whether it should be continued. In order to qualify for exceptional assistance under the initiative, countries would have to be IDA-only, to face an unsustainable debt situation after the full application of current debt relief mechanisms and would have to show a sustained track record of sound economic policies and economic reforms.

As a result of preliminary Debt Sustainability Assessments, countries have been classified as having sustainable, possibly stressed or unsustainable debt burdens (for classification see annex 6)

Main steps

For each country, the initiative will be implemented in two stages.

First stage

The first stage would be the existing three year track record required for a country to qualify for a stock-of-debt reduction by Paris Club creditors on Naples terms. During this period:

- the Paris Club provides flow reschedulings on current Naples terms (up to 67 % debt reduction)
- other bilateral and commercial creditors provide at least comparable treatment
- multilateral institutions and donors continue to provide adjustment support in the framework of a World Bank/IMF-supported adjustment programme

the country establishes a first three-year track record.

The decision point

The first stage leads up to the decision point. At this point, a Debt Sustainability Analysis will determine whether a Paris Club stock-of-debt operation, together with at least comparable action by other non-multilateral creditors, would be sufficient for the country to achieve debt sustainability, after the country has completed another three years of good economic performance.

Three different country situations can be envisaged:

- Countries for which existing mechanisms (Paris Club stock-of-debt operation together with comparable treatment by other bilateral and commercial creditors) would be sufficient for achieving debt sustainability within three years would not be eligible for additional support under the initiative.
- For countries for which debt sustainability cannot be reached through existing mechanisms within three years, creditors would decide on the amount of additional debt relief needed and

give a firm commitment to provide the debt relief needed after a second period of sustained policy performance.
- For borderline cases which are countries where there is doubt whether existing mechanisms of debt relief would achieve a sustainable debt situation, the possibility of receiving enhanced assistance under the initiative will be left open. These countries would be eligible for additional debt relief at the completion point if neede to achieve debt sustainability.

The second stage

Eligible countries will enter into a second stage of three years after which it will be granted additional debt relief if it can show sustained policy performance.

During the second stage:
- the Paris Club goes beyond Naples terms and provides up to 80 percent debt flow relief in net present value terms;
- other bilateral and commercial creditors provide at least comparable treatment;
- donors and multilateral institutions provide enhanced support through interim measures and
- the country establishes a second track record of strong policy performance under a World Bank/IMF-supported adjustment programme.

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The Completion Point

At the completion point, i.e. at the end of the second stage, creditors will deliver the debt relief promised at the decision point. For the borderline countries, a decision will be taken whether they need additional action.

At the completion point:
- the Paris Club provides a stock-of-debt reduction of up to 80 percent in NPV terms on eligible debt;
- other bilateral and commercial creditors provide at least comparable treatment on the debt stock;
- multilateral creditors take measures to reduce the NPV of their exposure.

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If the amount of debt relief needed differ from the forecast made at the decision point, creditors will have to decide whether to give more or less debt relief in order to attain the debt sustainability target set for that country.

Track record

The required performance periods will be implemented flexibly on a case-by-case basis, taking into account countries' policy performance under adjustment programmes up to the decision point. This implies that the required performance period can be substantially shortened for countries which have shown sustained records of sound economic policies.

Debt sustainability

Sustainable debt levels at the completion point would be defined on a country-by-country basis within the range of 200-250 percent for the debt-to-exports ratio and 20-25 percent for the ratio of debt service to exports taking into account country specific vulnerability factors, such as the concentration and variability of exports and taking into account the fiscal burden of debt service.

The HIPCs Trust Fund

As a vehicle for its own participation in the HIPCs Initiative, the World Bank has set up the HIPC Debt Initiative Trust Fund, through which action will be taken to reduce the net present value of its own claims as necessary under the initiative. Other multilateral development banks (MDBs) have been invited to use this trust Fund too. It is envisaged that both the MDBs using the Trust Fund as well as bilateral donors will contribute financially to the Trust Fund to ensure that there are sufficient resources to meet the action required of the relevant MDBs. Whilst a number of MDBs look likely to make use of this Trust Fund, other key multilateral creditors, such as the IMF, plan to take the required action in parallell.

Overall costs of the HIPC Initiative

Overall potential costs of the HIPC initiative have been estimated to 5.6 billion USD in 1996 present value terms, distributed between creditors as follows[11]:

Bilateral and commercial creditors		2.4
Paris Club creditors	*1.9*	
Other official creditors	*0.4*	
Commercial creditors	*0.1*	
Multilateral creditors		3.2
World Bank	*1.1*	
IMF	*0.8*	
Other multilateral creditors	*1.3*	
Total		5.6

11 Source: IMF and World Bank estimates

ANNEX 5

COUNTRIES IN THE DEBT INITIATIVE

41 countries classified as Highly Indebted Poor Countries, whose debt sustainability has been analysed under the initiative[12]:

Angola, Benin, Bolivia, Burkina Faso, Burundi, Central African Republic, Cameroon, Chad, Congo, Côte d'Ivoire, Equatorial Guinea, Ethiopia, Ghana, Guinea-Bissau, Guyana, Honduras, Kenya, Laos, Liberia, Madagascar, Mali, Mauritania, Mozambique, Myanmar, Nicaragua, Niger, Nigeria, Rwanda, Sao Tomé-Principe, Senegal, Sierra Leone, Somalia, Sudan, Tanzania, Togo, Uganda, Vietnam, Yemen, Zaïre, Zambia

⇩

of which 20 have been classified as unsustainable or possibly stressed:

Possibly stressed: Bolivia, Cameroon, Congo, Côte d'Ivoire, Ethiopia, Guyana, Madagascar, Myanmar, Niger, Rwanda, Tanzania, Uganda (12 countries)
or Unsustainable: Burundi, Guinea-Bissau, Mozambique, Nicaragua, Sao Tomé-Principe, Sudan, Zaïre, Zambia (8 countries)

⇩ ⇩

of which 13 are *currently* estimated by IMF/World Bank to require action under the HIPC debt initiative[13]:

Burundi, Ethiopia, Guinea-Bissau, Madagascar, Mozambique, Myanmar, Nicaragua, Niger, Rwanda, Sao Tomé-Principe, Uganda, Zaïre, Zambia

⇩

of which there is Community level exposure to 11 countries:

Burundi, Ethiopia, Guinea-Bissau, Madagascar, Mozambique, Niger, Rwanda, Sao Tomé-Principe, Zaïre, Zambia, Uganda

12 However, data was insufficient to properly analyse Liberia, Nigeria and Somalia at this stage

13 Sudan has also been assessed as likely to require action under the initiative, but has not been considered further in IMF/World Bank work at this stage. The same approach has been taken in this paper.

ANNEX 6

HIPC Debt Initiative: possible timing of decision points for unsustainable and possible stressed countries[14] [15]

1997

Bolivia
Guyana
Uganda
Côte d'Ivoire
Mozambique
Burkina Faso

1998

Ethiopia
Cameroon
Guinea-Bissau
Nicaragua

1999

Congo
Madagascar
Niger
Tanzania
Zambia

Beyond 1999

Burundi
Myanmar
Rwanda
São Tomé and Príncipe
Zaire

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[14] The information in this annex is tentative. It is provided here for illustrative purposes only. Decisions will also be taken with regard to countries presently classified as sustainable which are not shown in this list, apart for Burkina Faso. Some of the countries preliminary assessed to have sustainable debt burdens could prove to be eligible for the initiative.

[15] Sudan has not been included above, but would likely fall into the "beyond 1999" category, in the case it would embark upon an ESAF-supported adjustment programme.

PROPOSAL FOR A COUNCIL DECISION
EC n° ..... of 1997

concerning Exceptional Assistance for the Heavily Indebted ACP countries

THE COUNCIL OF THE EUROPEAN UNION,

Having regard to the Internal Agreement on the financing and administration of Community aid within the framework of the Fourth ACP-CEE Convention, signed on 16th July 1990, hereinafter referred to as "the Internal Agreement", and in particular Article 9, paragraph 1 thereof,

Having regard to the proposal from the Commission,

Whereas Article 9, first paragraph, of the Internal Agreement stipulates that the payments made to the Bank in respect of special loans, together with the proceeds and income from risk capital operations, shall be credited to the Member States in proportion to their contributions, unless the Council decides unanimously, on a proposal from the Commission, to place them in reserve or allocate them to other operations, and whereas it is appropriate to use this possibility in order to allocate these payments to support for structural adjustment and debt relief in heavily indebted ACP States,

Whereas a debt initiative for the Heavily Indebted Poor Countries, hereinafter referred to as the HIPC Initiative, was presented by the International Monetary Fund and the World Bank at their April 1996 Meetings and subsequently endorsed by the Interim and Development Committees at the Autumn 1996 Annual Meetings of the International Monetary Fund and the World Bank,

Whereas the Council recognizes the importance of the HIPC initiative as a way to ensure that the debt burdens of the HIPCs, implementing economic reform programmes, are reduced to sustainable levels, with the assistance of coordinated and comprehensive action by all creditors,

Whereas the Council recognizes the need for continued adequate levels of external assistance to the HIPCs and the European Community's role as a major development partner of the countries concerned,

HAS DECIDED AS FOLLOWS:

Article 1

The European Community shall participate in the HIPC initiative by providing exceptional assistance with a view to reducing the net present value of the Community exposure to the ACP countries defined as eligible for this initiative. For this purpose, the Community shall make available grant resources to be utilised to meet debt service obligations on outstanding Community claims. These grant resources shall primarily be used by the beneficiary countries to meet debt service obligations on special loans, including the possibility of prepayment on a net present value basis. If such action is not sufficient to attain the agreed level of debt relief, the beneficiary country shall use the allocated grant resources to meet outstanding risk capital obligations towards the Community.

Article 2

The Commission shall take, on a case-by-case basis, specific decisions for each eligible ACP country, providing for the amount of assistance in accordance with the rules and procedures laid out in Chapter IV of the Internal Agreement. The Commission's decisions on the amount of assistance to be provided in each case shall be guided by the level of resources necessary to permit a reduction of the net present value of that country's debt to the Community. This assistance, together with resources provided by all multilateral creditors, would allow the eligible country to achieve the debt sustainability targets, taking into account the debt relief to be provided by Paris Club creditors and at least comparable action by other official bilateral and commercial creditors under the initiative. The country specific decisions should further take into account the structure of the country's debt to the Community, the desire for administrative simplicity in the case-specific proposals chosen, the objective of securing full repayment of outstanding special loans and the need to ensure equitable and fair treatment between countries. The Monetary Committee will be kept informed, on a regular basis, on the implementation of this assistance.

Article 3

The ACP countries eligible for receiving this exceptional assistance shall be the countries which have been identified according to the procedures laid out in Chapter IV of the Internal Agreement. The grant assistance referred to in Article 1 shall be provided from an interest bearing single account to be opened for this purpose with the European Investment Bank, hereinafter referred to as the "debt relief account".

Article 4

From the payments, proceeds and income referred to in Article 9, paragraph 1 of the Internal Agreement, 25 million ECU shall be allocated in each of the years 1997, 1998, 1999 and 2000 for financing the grants referred to in Article 1. These amounts shall be transferred to "the debt relief account", mentioned in Article 3.

Article 5

1. The Commission shall report regularly to the Council and inform the Parliament on the implementation of the present decision within the context of the HIPC initiative.

2. At the end of the period of four years, mentioned in Article 4, or earlier if the Commission considers it appropriate, the Commission shall present a report to the Council containing a review of the possible needs for additional financing.

3. If, at the end of the period of four years, as mentioned in Article 4, no decision has been taken to continue the financing, aimed at in the present decision, for a longer period, the Commission may decide to close the account, mentioned in Article 4. Any remaining funds in the account shall be redistributed to the Member States.

Done at Brussels,

For the Council,

The President,

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