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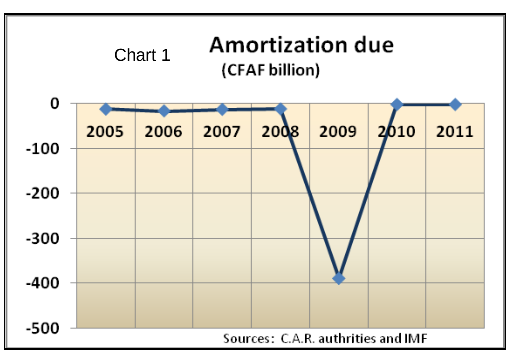
Moving beyond the neutral effects in HIPC Debt Relief to achieve real savings for post-conflict economic recovery: the experience of the Central African Republic

Viewpoint by Bécaye DIARRA, Economics Advisor, UNDP Bangui, C.A.R

Is reaching HIPC Debt relief enough for triggering economic recovery? The announcement that the C.A.R. has reached the HIPC completion point and will as a result benefit from debt forgiveness of US$ 578 million has been celebrated in official ceremonies, fuelled national enthusiasm and even found resonance in prayers in its churches and mosques. C.A.R. became the 25th country to reach the completion point. Moreover, the country will benefit from US$ 185 million in additional relief of its multilateral debt[1] from IMF, IDA and the African Development Fund. While these achievements are a step in the right direction, it is important to assess their likely impact within the post-conflict context of the C.A.R. .

The aim of this brief is first to analyze the effect of debt forgiveness under the HIPC programme and second to look at how to manage the “post-completion” phase in order to maximize the resulting economic benefits.

The IMF commended efforts made by the country and stated in its press release of 30 June 2009 that “[d]espite a difficult post-conflict environment, they have undertaken important reforms to reach the Completion Point for debt relief under the HIPC Initiative. Debt relief will reduce significantly C.A.R.'s debt burden and free up resources to finance spending in areas critical to meeting the Millennium Development Goals." However, it is argued in this policy brief that as a result of the accumulation of external debt arrears and debt service payments due, the debt forgiveness will not create sufficient fiscal space for development financing. Yet, significant economic benefits could be captured from this new situation if a larger framework, including poverty reduction and growth policies, forms the basis of new negotiations with donors. The brief concludes with lessons learnt.



A glance at the evidence of the burden of C.A.R debt re-payment: Between 2005 and 2008, debt repayment was an average of CFAF 12 billion (USD 25 million), and did not fluctuate much. Compared to the CFAF 389 billion (USD 827 millions) drop due to the overall debt relief occurring at the HIPC completion point in 2009, there were no important debt re-payment flows over the four last years, as shown by the flat portion of the curve between 2005 and 2009 in Chart 1. In this context, the gains seem to leave the country’s economic situation unchanged. In fact, the new “post-completion” phase will allow savings of no more than USD 25 million of annual disbursements. This further shows that debt relief is more likely to affect the immediate issue of arrears clearance rather than create fiscal space through savings for development finance.

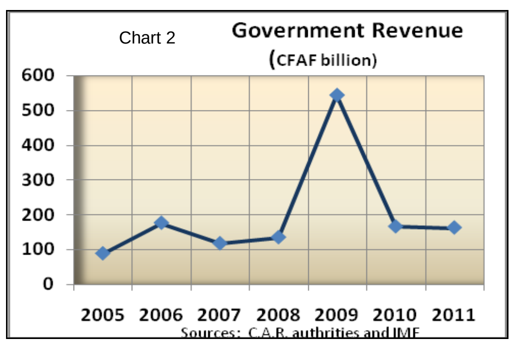
Why does debt relief have neutral effects? It can be argued that reaching the HIPC completion point and the resulting debt relief are likely to provide neutral effects in strictly financial terms for the following reasons:

- The country was not repaying much: USD 25 million per year of amortization;

- The arrears liquidation was no more than USD 30 million per year and the current debt relief would concern clearance of arrears;

- The country is used to getting debt relief between the HIPC decision and completion points and benefited from temporary assistance.

Neutral effects manifest themselves as absence of financial margins which could be saved from funds previously destined for debt servicing and which could be reoriented into social and productive investments.



A part from the financial aspects, opportunities exist beyond the neutral effects. The reason to fear limited financial effects for C.A.R. in attaining the HIPC completion point has been demonstrated. However, the country does have an opportunity to capitalize on debt relief. The point is to focus on economic effects rather than financial margins

As shown in chart 2 above, debt forgiveness appears as a boost in Government revenue since it is cancelled repayment. This amount (XAF 389 billions) represents more than 40% of C.A.R. GDP. Donors are holding the government to commitments related to PSRP implementation since it was part of the agenda (list of “déclencheurs”) leading to the HIPC achievement point. In the case

1 UNDP INFORAPIDE, 6 June 2009, C.A.R.

of Zambia (Noyoo 2009), for example, this debt relief would allow the country to start re-allocating funds since almost no reimbursement remains to be repaid. Investments in social infrastructures that were delayed, particularly due to the global economic and financial crisis, could then be re-considered.

How to capitalize on potential economic opportunities from debt relief?

• **Country's credibility is restored:** Once the HIPC completion point has been reached, debt forgiveness appears in public accounts as new resources. The posted operations permit the country to improve its public finance ratios and this is positively reflected in a new solvency status. C.A.R. is then able to start looking at new agreements with donors who already think the country's credibility is restored by the new credit rating and the fact that doing business with the country now becomes conceivable. During the entire process of reaching the HIPC completion point, the country was not allowed to raise its stock of debt, but now that the goal is attained, C.A.R. is eligible for a wider range of borrowing. Overall, grants are expected to reach an average of US$ 110 million per year between 2010 and 2011.

• **No more debt overhang:** Accumulating arrears in debt servicing can lead to a debt overhang when potential investors fear their future profits may be captured by high taxation collected by the government for repayment (Krugman 1988). By benefiting from debt relief, the country dispels any doubt of running in a debt overhang context. By completion point, C.A.R. demonstrated its debt management capacity and sent a strong signal to the potential investors that the stock of debt was sustainable.

• **Recalling negotiated package:** The HIPC Initiative is not a separate agreement with concerned countries. It was negotiated mainly from a perspective of implementing Poverty Reduction Strategies in the LDCs, drawing from a unique framework which links financial agreements and growth policies. C.A.R. is currently going beyond its PRSP by hosting a series of sectorial roundtables in order to close the financial gap. C.A.R. authorities are already considering implementing second-generation PRSP II. For that, C.A.R.'s government has requested and obtained support from the UNDP Country Office to formulate an alternative strategy of resource mobilization targeting non-traditional donors.

The impact of Global Economic and Financial Crisis on the HIPC arrangements for C.A.R. : In the case of the C.A.R., the global crisis has had a negative effect on the HIPC arrangements through two channels of transmission. The debt (present value)/exports ratio declined drastically in 2008 when the C.A.R.'s two main commodity exports (timber and diamonds) fell by about 20% due to the crisis. This had the effect of reducing tax revenues and therefore the debt (present value)/Government revenue ratio. These two critical ratios are used by donors to evaluate countries' debt sustainability and ability for debt management. Their fall did not raise questions on C.A.R.'s eligibility for the HIPC Initiative but shows the negative effects of the global crisis on the arrangements as follows:

1. **The crisis affected trends to restore debt viability:** At the beginning of the process, the lack of debt management abilities is one of the conditions for eligibility in the HIPC Initiative. However, once it has entered the completion process, the country is supposed to implement a package of measures in order to restore capacities. In the case of the C.A.R., the effects of the crisis raise the probability that the country will be pulled back to an unsustainable level of debt due to the financial gaps registered.

2. **The crisis upset the agenda of the negotiations:** the global crisis was an unexpected situation which led to hesitations among some donors (Paris Club and multilaterals) and as a result, part of the debt relief was delayed (until mid-June, announcements of debt relief concerned only 78% of CAR's debt instead of the 90% needed earlier).

3. **Pragmatism prevailed among donors:** Donors realized that the global crisis resulted in added costs which were too high for the country to be able to meet all the commitments of its reform agenda. Then, they pragmatically chose to go further in the process and assist the C.A.R. in attaining the completion point, even while some measures remained 'in progress'.

Now that the country has reached the HIPC completion point, they expect the debt forgiveness to play a stabilizing role in the context of the global crisis.

Two important policy messages:

• C.A.R. should negotiate with donors new conditions for ensuring debt sustainability and also introduce a new growth strategy in a second-generation PRSP.

• C.A.R. should focus on a new resource mobilization strategy which addresses its post-conflict specificities.

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For more information contact:
United Nations Development Programme
Regional Bureau for Africa
One United Nations Plaza, DC1-24th floor
New York, NY 10017
africa.viewpoint@undp.org
www.undp.org/africa