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The HIPC Initiative and Ghana's External Debt

An empirical assessment and Policy challenges

MAIN ISSUES

The policy brief aims to disseminate information on research findings and their policy implications. In this edition, an assessment of the effect of HIPC debt relief on external debt repayments and its impact on Ghana's poverty reduction strategy and recommended policy measures are presented.

It also sheds light on the HIPC Framework and further addresses Ghana's debt problem and the issues of debt sustainability.

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Introduction

In spite of economic reforms pursued since the 1990s Ghana's economy recorded only modest growth with successive bouts of high inflation and unsustainable balance of payments deficits. Ghana's experience was similar to many poor Sub-Saharan African countries, which continued to see worsening economic conditions leading to unacceptable levels of poverty and high levels of external debt.

The causes of these crises have been attributed to poor domestic policies, deteriorating terms of trade and a high debt burden. The severe crisis was partly due to high debt service requirements that affected the budget of the government and impacted negatively on the balance of payments.

Ghana has had a history of debt servicing problems during which it had difficulties in honouring its external debt servicing obligations. This was evidenced by the fact that: Ghana was on several occasions in arrears in servicing its debt; or it requested the Paris Club of bilateral creditors to reschedule its debt; or it had to resort repeatedly to borrowing from the non-concessionary window of the IMF such as the standby Facility.

The Government decided in 2001 to opt for the enhanced debt relief in order to stabilize the economy. The economy in 2001 was characterised by rapid exchange rate depreciation, high inflation and very low external reserves, which resulted from imprudent policies as well as high debt service payments.

Ghana had pursued a Structural Adjustment Programme (SAP) between the mid 80's and early 90's. The SAP itself was necessitated by the need to resolve a sustained balance of payment (BOP) deficit and its attendant debt problems.

In spite of these adjustments, growth was modest, stagnating or even regressive and the balance of payments (BOP) problems were fully not resolved.

In the light of these difficulties confronting the management of the economy, the new government resolved to adopt the HIPC Debt Relief accordingly.

The HIPC Framework

Since the debt crisis of the 1980s the international financial community has been providing assistance to debtor countries to reduce their external debt burden in order to foster growth and development. Several debt initiatives were proposed including the Toronto, London, Naples, Lyon and Cologne initiatives.

In 1996, the World Bank and the IMF jointly launched the initiative for Heavily Indebted Poor Countries (HIPCs), which aimed at reducing the external debt burden of qualified and eligible countries.The enhanced HIPC targeted promoting more debt relief for countries pursuing a comprehensive country specific poverty reduction strategy programme.

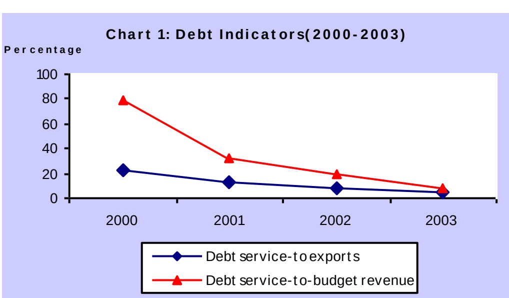
The eligibility criteria requested that countries that benefited from the facility had per capita GDP below $700, had a good track record of policy performance supported by

the amount and timing of the relief. The HIPC Initiative aims at reducing the net present value (NPV) of external debt to a maximum of 150 per cent of exports or, for small open economies, to 250 per cent of government revenue at the time of the HIPC completion point.

The HIPC Initiative aims at creating a debt-servicing situation that allows HIPCs to graduate eventually from concessional financing.

The Impact of Debt Relief on Debt Repayments

On the basis of the macroeconomic assumptions outlined in the decision point document, Ghana's external debt remained unsustainable even after taking advantage of traditional debt-relief mechanisms. The NPV of debt-to-revenue ratio was estimated at 570.3 per cent at the end of 2000 and was projected to be above 250 per cent until 2008. With an export-to-GDP value of 37 per cent and a fiscal revenue-to-GDP ratio of 17 per cent, Ghana qualified for debt relief under the fiscal revenue/openness criteria.



Debt servicing has been a major contributing factor inhibiting economic growth in virtually all developing countries, and the impact of debt servicing has been more severe on African countries in particular. Ghana spent around US$409.7 million on debt servicing in

of goods and non-factor services. In 1995, the country spent US$635 million on debt service, this amount equaled about 40.2 per cent of total export earnings.

been increasing over the years. Ghana continued to utilize a sizeable proportion of her export earnings and generated income (GDP) on external debt servicing. Ghana paid US$640 million in 1998, US$584.9 in 1999 and US$544 in 2000, representing 25.3 percent, 23.7 per cent, and 22 per cent of hard foreign exchange earnings respectively.

After the adoption of the HIPC Initiative, the level of debt servicing has exhibited a declining trend. The amount of debt service payments dropped sharply from US$544.8 million in 2000 to US$306.6 million in 2001, indicating a significant reduction of debt servicing of about 43.7 per cent. The figure is well below the average of US$458.72 million of debt paid during the period 1994-2003.

The value of debt service paid in 2002 further reduced to US$204 million, which is also far below the average figure of US$458.72 million. Ghana enjoyed a significant reduction in debt servicing in 2003, with a reduction in debt servicing of about 38.1 per cent to US$126.2 in 2003 as against the previous year's figure in nominal terms *(see Chart 1)*.

In 2002, Ghana received debt relief amounting to US$275.2 million. In 2003, the country enjoyed debt relief of US$290.8 million and US$318.3 million as at November 2004.

After Ghana has reached the flexible completion point in July 2004, her external debt was expected to remain below the NPV of debt-to-government revenue threshold of 250 per cent established under the HIPC Initiative. The NPV of expected external debt would be US$2.9 billion. After completion point, the country is expected to benefit from additional debt relief as indicated by bilateral creditors. This would further reduce the external debt stock to US$2.4 billion (See HIPC Completion Point Document, June 2004).

The adoption of the Enhanced HIPC Initiative has also led to a drastic reduction in the debt service-

32.5 per cent in 2001. This further reduced to 19.4 per cent in 2002 and 7.6 per cent in 2003(see Chart 1).

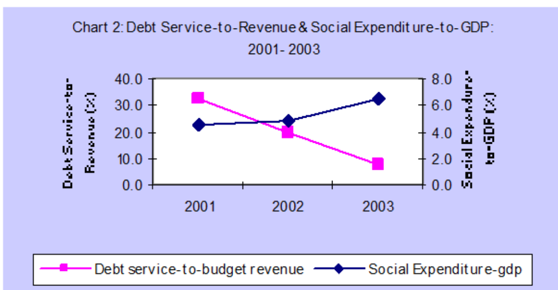
From the foregoing, it is crystal clear that the debt relief has really impacted positively on Ghana's external debt repayments and has therefore reduced the debt-servicing burden that plagued the country over the years. If this trend continuous, it would make Ghana's future debt repayments more sustainable and bearable.

Debt Sustainability Issues

The sustainability analysis from the completion point document shows that Ghana's external debt will remain sustainable during the projection period 2004-2023. The trajectory of the NPV of the external debt-to-exports ratio shows a steep decline from levels above 200 per cent before the completion point, to fairly stable levels below 125 per cent after the completion point. Over the same period, the NPV of external debt-to-government revenue is projected to decline steadily from 350 per cent to 118 per cent.

In line with the significant stock of debt decline, debt service after HIPC relief is expected to average 4.7 per cent of exports and 6.2 per cent of revenue over the period 2004-2023, both with stable profiles. These compare favourably with the 10-year average pre-HIPC debt service levels (on commitment basis) of 21 and 30 per cent.

External debt-to-government revenue ratio (see Chart 2) would be expected to decrease over the foreseeable future to acceptable levels based on the realistic projections. Hence, Ghana's external debt will remain sustainable after the debt relief and cancellations.



Impact of HIPC on Poverty reduction

Ghana has made some progress in poverty reduction since the adoption of the Enhanced HIPC Initiative as more funds have been moved to the development of pro-poor priority areas of the economy. Poverty-related expenditures in Ghana have increased significantly since the GPRS was initiated. This stood at ¢4,464.16 billion in 2003 and ¢5,158.45 in 2004,representing about 29.24 per cent and 27.29 per cent of total government expenditures respectively.

Health sector expenditure has also increased spectacularly in comparative terms, the expenditure on the health sector increased from ¢1072.02 billion in 2003 to ¢1,358.2 billion in 2004. The share of primary health care in total expenditure on the entire health sector was ¢835.19 billion (77.91%) in 2003 and ¢1,146.82 billion (84.44%) in 2004.

The trend in these elements of expenditure, which witnessed significant improvements over the previous years, reflects the impact of the freed resources made possible through the HIPC debt relief to the country.

Poverty focused agricultural expenditure, which stood at ¢124.85 billion in 2003, accounted for 98.88 per cent of the overall agriculture expenditure. In 2004, poverty focused agricultural expenditure stood at ¢146.91 billion, representing about 90.31 per cent of the total agriculture expenditure. As a result of the HIPC relief funds, development projects in all districts have increased. In all, a total of 1,516 projects have been executed nationwide (cumulative for 2002 and 2003) with HIPC funds. These HIPC projects consist of 609 education projects, 194 health projects, 563 sanitation projects, and 141 water projects. Under production and employment generation, all regions received HIPC funds as micro credit-funds for farmers and women trader groups.

A cumulative amount of ¢1,111 billion of the HIPC resources was transferred to Ministries, Departments and Agencies (MDAs) during the period 2002 and 2003. The educational sector utilized about 17 per cent out of the cumulative HIPC relief funds, health sector received 6.47 per cent, roads and transport utilized 7.87 per cent, and water and sanitation also received 10 per cent.

The analysis so far has showed that the availability of the HIPC debt relief has significantly improved government expenditure on social services than it was before the HIPC debt relief.

Conclusion

It has generally been established that debt relief as a result of the HIPC Initiative has impacted positively on Ghana's external debt, by moving it to the threshold of sustainability. With Ghana's external debt becoming increasingly sustainable, it has the potential of increasing the predictability in debt servicing thereby reducing rollover risks, which has the potential of triggering sudden cessation in donor inflows.

To channel gains made from debt relief as a result of the HIPC Initiative into development and poverty reduction, the following policy issues need to be considered critically:

- While the debt relief granted under the HIPC Initiative will substantially reduce the debt service due on existing debt, maintaining debt sustainability will also crucially depend on future macroeconomic policies, growth performance, and financial assistance from donors.

- A pro-poor debt relief strategy like the GPRS must be reviewed and it must address the core issues of ownership, lack of dialogue with civil society and proper participation

- Converting debt relief liabilities into investment in primary health care, basic education, water and sanitation measures would act as a catalyst for accelerated progress towards the 2015 targets, this should be established as such as the core purpose of the HIPC initiative and one explicit objective of public expenditure policy in Ghana.

- There are no easy answers to the fungibility problem, but if the political momentum behind debt relief is to be sustained, debtors and creditors need to acknowledge that it is generating benefits in terms of poverty reduction and human development.