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HIPC AND TRADE POLICY REFORM: SOME EARLY OBSERVATIONS

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Executive summary

In September 1996, the IMF and the World Bank launched the Heavily Indebted Poor Countries (HIPC) Initiative to address the unsustainable external debt situation in many low-income countries by offering debt relief to eligible countries that were pursuing sound economic policies to help reduce their external debt burden to sustainable levels. Following a major review, the Initiative was significantly enhanced in 1999 to provide more rapid qualification and deeper and broader debt relief to a larger number of countries conditional on a commitment to poverty reduction. By the end of 2002, 42 countries had been identified by the IMF and World Bank as being HIPC, of which six had reached completion point, i.e. were receiving debt relief after having started to successfully implement a Poverty Reduction Strategy. The total cost of assistance provided or committed to the 42 HIPC amounts to about $37.2 billion (in 2001 present value terms). An approximately equal share of this cost falls on bilateral and multilateral creditors.

The HIPC Initiative requires countries receiving debt relief to undertake a Poverty Reduction Strategy programme involving elements of trade policy reform. This study reviews country experiences with respect to the impact of reforms of trade and trade-related policies on economic performance, export capacity and the ability to attract foreign direct investment. Trade policy reform can be crucial for success in international markets. Opening domestic markets will change relative prices, induce adjustments in consumption and production patterns to reflect comparative advantage and, hence, lead to a more efficient use of resources. The resulting efficiency gains will tend to translate into higher levels of economic growth, which in turn make investments from domestic and foreign sources more attractive and increase the country's production and export capacity.

Many HIPC are not able to realise their full export potential due to supply-side constraints. Indeed, high levels of debt are often the result of the inefficient use of investment resources in the past, e.g. for the development of infrastructure. In this context, trade policy reform, covering border and behind-the-border measures, can complement efforts to overcome structural weaknesses and anti-competitive domestic policy practices and introduce more market-driven institutions and decision-making into often highly distorted domestic economies.

While at present the empirical results on the economic performance of different groups of HIPC are only preliminary and indicative, the available evidence suggests that the set of policy reform requirements expected from countries participating in the Initiative is positively linked to income, investment, and integration into the world market. Countries that have reached economic stability and started to implement policy reforms in the context of their Poverty Reduction Strategies have performed better overall during 1997-2001 than countries that are less advanced in their policy reform programmes, which, however, still did better than countries that had not yet attained economic stability and started with domestic reforms. These findings need, however, to be verified through careful econometric analysis, once a sufficiently comprehensive time-series of relevant economic data becomes available. Such analysis might also shed light on the causality of success. In particular, it might make it possible to establish whether participating countries have performed well because of the HIPC requirements associated with debt relief, or whether good policies and relatively good economic performance in the past have made it easier for them to qualify for debt-relief.

1. Background

1. This study reviews experiences in Heavily Indebted Poor Countries (HIPC) with respect to the impact of reforms of trade and trade-related policies on economic performance, export capacity and the ability to attract foreign direct investment. It presents preliminary evidence on the effects of the HIPC policy reform and debt relief programme, drawing mainly on reports of the World Bank and the WTO. The analysis complements work undertaken by other organisations and OECD Committees. In particular, the project recently initiated by the World Bank on "Trade, Aid and Debt in HIPC" focuses largely on market access issues, while the ongoing work of the OECD's Development Co-operation Directorate (DCD) on HIPC involves primarily the monitoring of debt levels. Some other DCD activities with a broader country range, notably those on good governance, conflict and peace, and trade, development and capacity building, are also of relevance, even though they do not necessarily have a trade policy reform focus. Moreover, the OECD's Export Credit Group is continuing to monitor export credit flows to HIPC with a view of ensuring that they are not used for unproductive expenditures.

2. The remainder of the document is organised in two parts. Section 2 provides a brief description of the HIPC Initiative. Section 3 then reviews the economic, trade and investment performance of HIPC during the five-year period 1997-2001 and reports on recent reform efforts in a number of countries.

2. The HIPC Initiative

3. In the early 1990s, it became more and more apparent that the external debt situation for a number of low-income countries, notably those in Africa, had become extremely difficult. For these countries, even full use of traditional mechanisms of rescheduling and debt reduction together with continued provision of concessional financing and pursuit of sound economic policies appeared not to be sufficient to attain sustainable external debt levels within a reasonable period of time and without additional external support. In September 1996, the IMF and the World Bank launched the HIPC Initiative to address the situation by offering debt relief to eligible countries that were pursuing sound economic policies to help reduce their external debt burden to sustainable levels. Following a major review, the Initiative was significantly enhanced in 1999 to provide more rapid qualification and deeper and broader debt relief to a larger number of countries conditional on a commitment to poverty reduction.

4. Debt relief under the HIPC Initiative is subject to successful adjustment and policy reform. All countries requesting assistance must in principle have (i) established a record of macroeconomic stability and economic reforms (ii) adopted a Poverty Reduction Strategy Paper (PRSP) by the *decision point,* the date at which the Executive Boards of the IMF and World Bank formally determine a country's eligibility for debt relief; and (iii) have made progress in implementing this strategy for at least one year by the *completion point,* the time when multilateral, bilateral and commercial creditors pursue reductions in the net present value of their claims sufficient to reduce the country's debt to a sustainable level. During the period between the decision and the completion points, the World Bank and the IMF are providing "interim relief", while bilateral and commercial creditors are generally expected to reschedule obligations coming due. The total cost of assistance provided or committed to the 42 HIPC amounts to about $37.2 billion (in 2001 present value terms). An approximately equal share of this cost falls on bilateral and multilateral creditors. A detailed description of the HIPC Initiative is contained in the World Bank's communication to the WG-TDF of September 2002 (World Bank, 2002).

5. By the end of 2002, 42 countries had been identified by the IMF and World Bank as being HIPC. Of these countries, six had reached the completion point, for 20 debts relief had been approved at decision point, 12 had not yet reached decision point, and four had been characterised as countries with potentially

sustainable debt levels. The vast majority of HIPC (34 countries) are located in Africa, while four countries each in Asia and Latin America are covered by the Initiative. Twenty-four of the 42 HIPC are classified by the United Nations as Least Developed Countries (LDCs). Table 1 provides an overview of the status of HIPC.

3. Recent economic, trade and investment performance in HIPC

6. The relationship between trade, finance and debt is complex. Many domestic, border and external policies influence a country's trade performance and financial sustainability. Literature reviews on the linkages between trade and finance (WTO, 2002b) and trade and debt (WTO, 2002c) have highlighted a number of relevant factors. The following discussion focuses on the contribution of trade and trade-related policy reforms to improvements in trade capacity and linkages to foreign direct investment.

7. Trade policy reform can be crucial for success in international markets. Opening domestic markets will change relative prices, induce adjustments in consumption and production patterns to reflect comparative advantage and, hence, lead to a more efficient use of resources. The resulting efficiency gains will tend to translate into higher levels of economic growth, which in turn make investments from domestic and foreign sources more attractive and increase the country's production and export capacity.

8. Many HIPC are not able to realise their full export potential due to supply-side constraints. Indeed, high levels of debt are often the result of the inefficient use of investment resources in the past, e.g. for the development of infrastructure. In this context, trade policy reform, covering border and behind-the-border measures, can complement efforts to overcome structural weaknesses and anti-competitive domestic policy practices and introduce more market-driven institutions and decision-making into often highly distorted domestic economies.

9. Trade policy reforms can also contribute to alleviating poverty and fostering pro-poor growth. In many cases, protection favours vested interests of the socio-political elite at the expense of the country's less well-off population. The HIPC Initiative is explicitly aimed at reducing poverty in participating countries and changes in trade policies can form an integral component of the Poverty Reduction Strategy programmes of the participants, even though in some of the early conditionality programmes, such as those in Uganda, trade aspects seem to have received little consideration (Mijumbi, 2001). The sometimes inadequate integration of trade policy reform elements in PRSPs is actively being addressed and increased attention in PRSPs, which are supposed to be prepared by national governments in a participatory process involving a broad range of relevant stakeholders, is to be devoted, for example, to the link between customs reform and governance and the impact of the imminent liberalisation of textiles trade on HIPC economies.

10. Since the HIPC Initiative in its enhanced form was launched less than four years ago and the first country, Uganda, reached completion point just in May 2000, any evaluation of the success of the HIPC Initiate can only be indicative and preliminary. For example, the available anecdotal evidence regarding the success of reforms of trade and trade-related policies (Box 1) is mixed and difficult to link to the recent economic and trade performance of HIPC. Moreover, data on economic developments in HIPC should be interpreted with care, as there is generally considerable uncertainty concerning the statistical quality of the information. Also, the short-term performance of particular countries (see Annex) is often related to external factors, like commodity price developments, and only partly dependent on domestic policy choices.

Table 1: Status of Heavily Indebted Poor Countries

Country	HIPC-Decision Point	HIPC-Completion Point	LDC-Status	WTO member	Last TPR
Countries that have reached completion point					
Bolivia	Feb-00	Jun-01		Sep-95	Jul-99
Burkina Faso	Jul-00	Apr-02	LDC	Jun-95	Nov-98
Mauritania	Feb-00	Jun-02	LDC	May-95	Sep-02
Mozambique	Apr-00	Sep-01	LDC	Aug-95	Jan-01
Tanzania	Apr-00	Nov-01	LDC	Jan-95	Mar-00
Uganda	Feb-00	May-00	LDC	Jan-95	Dec-01
Countries that have reached decision point					
Benin	Jul-00	..	LDC	Feb-96	Sep-97
Cameroon	Oct-00	..		Dec-95	Jul-01
Chad	May-01	..	LDC	Oct-96	
Ethiopia	Nov-01	..			
Gambia	Dec-00	..	LDC	Oct-96	
Ghana	Feb-02	..		Jan-95	Feb-01
Guinea	Dec-00	..	LDC	Oct-95	Feb-99
Guinea-Bissau	Dec-00	..	LDC	May-95	
Guyana	Nov-00	..		Jan-95	
Honduras	Jul-00	..		Jan-95	
Madagascar	Dec-00	..	LDC	Nov-95	Feb-02
Malawi	Dec-00	..	LDC	May-95	Feb-02
Mali	Sep-00	..	LDC	May-95	Nov-98
Nicaragua	Dec-00	..		Sep-95	Oct-99
Niger	Dec-00	..	LDC	Dec-96	
Rwanda	Dec-00	..	LDC	May-96	
São Tomé and Principe	Dec-00	..			
Senegal	Jun-00	..	LDC	Jan-95	
Sierra Leone	Mar-02	..	LDC	Jul-95	
Zambia	Dec-00	..	LDC	Jan-95	Oct-02
Countries that have not yet reached decision point					
Burundi	..	..	LDC	Jul-95	
Central African Republic	..	..	LDC	May-95	
Comoros	..	..			
Congo	..	..		Mar-97	
Congo, Dem. Rep.	..	..	LDC	Jan-97	
Côte d'Ivoire	..	..		Jan-95	Jul-95
Lao P.D.R.	..	..			
Liberia	..	..			
Myanmar	..	..	LDC	Jan-95	
Somalia	..	..			
Sudan	..	..			
Togo	..	..	LDC	May-95	Jan-99
Countries with potentially sustainable debt levels					
Angola	n.a.	n.a.	LDC	Nov-96	
Kenya	n.a.	n.a.		Jan-95	Jan-00
Viet Nam	n.a.	n.a.			
Yemen	n.a.	n.a.			

n.a.: not applicable.
Source: OECD Secretariat based on World Bank and WTO information.

Box 1: Reforming trade and trade-related policies in HIPC: some examples

Many developing countries have made progress since the mid-1990s in the "primary agenda" of domestic trade policy reform, such as tariff reduction, conversion of non-tariff barriers, or reduction in the dispersion of tariff rates. For example, Mauritania reduced its average tariff from 19 per cent in 1996 to 10.6 per cent in 2001. The country also consolidated its tariff structure, reducing maximum rates from 180 per cent to 20 per cent (World Bank, 2001a).

With border duties falling in many countries, some HIPC have started to develop legislation on new anti-dumping, as well as countervailing and safeguard measures. For example, Malawi seems to be heading towards a more extensive use of trade remedies, even at the risk of thereby protecting inefficient industries (WTO, 2002e). However, some countries, such as Cameroon, have legislation regulating contingency trade measures in place, but have not yet applied such trade policy instruments (WTO, 2001a).

Customs procedures are a major problem in many developing countries. One of the three pilot diagnostic studies carried out in the context of the Integrated Framework investigated trade policies in Cambodia (a moderately-indebted, low-income country), and found that 99 per cent of trading firms identified Cambodian customs as their biggest constraint (World Bank, 2001b). Some countries have started to address these problems by streamlining customs procedures, for example, through opening single-window facilities, such as in Cameroon (WTO, 2001a).

One continuing problem in many HIPC is that customs procedures might appear clear on paper, while in practice they turn out to be rather cumbersome and discretionary, thereby discouraging foreign trade (WTO, 2002d). The lack of integrity of public officials is part of the problem. A recent poll found that in Bolivia people rank corruption as the third biggest problem in the country, after poverty and unemployment (Andersen and Nina, 2001). Civil service reforms to increase efficiency, transparency and accountability and decentralise government functions have been launched in 1999, but progress has been delayed by resistance from vested interests (World Bank, 2002b).

In addition to border measures, other types of regulations, such as government procurement practices, have recently undergone reforms in some HIPC. For example, in Malawi new legislation to improve transparency and monitoring of public procurement and to organise open tenders has been under discussion (WTO, 2002e). In Cameroon, wider tender announcements have been established, independent audits for large contract awards have been put in place, and more regular monitoring activities have been instigated (WTO, 2001a).

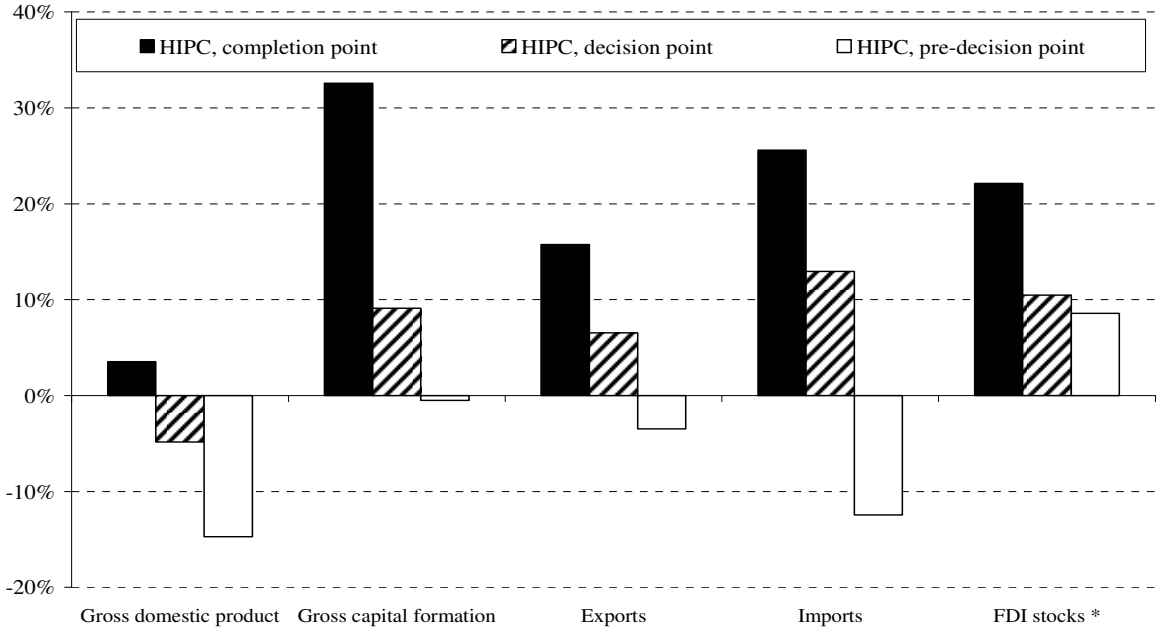
One major problem for many HIPC is their highly concentrated export base, which makes them vulnerable to adverse price developments in world markets for their export products. In Mauritania, for example, 99 per cent of all exports are primary products (fish and minerals). Attempts at diversifying the range of exports has often stumbled due to the countries' inability to attract foreign investors that could have assisted, for example, in the processing, packaging and distribution of agro-food products.

Another serious deficiency in many HIPC is the relatively poor integration of domestic and international markets due to high transport and handling costs. The lack of or poor state of port, rail and road infrastructure gives rise to high shipping costs that erode the benefits from trade. For example, in Cambodia port charges are four times higher than in neighbouring Thailand (World Bank, 2001b). Moreover, because of the small size of domestic HIPC markets, transport companies can relatively easily obtain dominant positions and stifle competition. For example, there are only two (foreign-owned) maritime shipping companies operating in Mauritania, and shipping rates quoted for container shipments from Baltimore to Nouakchott are between two and three times higher than those from Baltimore to Hong Kong/China, despite the former route's shorter shipping distance (World Bank, 2001a).

11. In this context, it might be helpful to compare economic developments in country-groups that differ with respect to the stage of reform under the HIPC Initiative in order to reduce the overall influence of idiosyncratic factors that affect the performance of individual countries. In the following this is done for three country clusters: (i) countries that had reached the completion point by the end of 2002, (ii) countries that had reached the decision point by then, and (iii) countries had not yet established a sufficient record of macroeconomic stability and economic reform to be considered for debt relief. The countries in the different groups are shown in Table 1, while a comparison of economic indicators is undertaken in Figure 1.

12. The results from the group comparison show that countries that have reached economic stability and started to implement policy reforms in the context of their Poverty Reduction Strategies have overall performed better during 1997-2001 than countries that are less advanced in their policy reform programmes, which, however, still did better than countries that had not yet attained economic stability and started with domestic reforms. Only in the six countries that had reached completion point was aggregate GDP in 2001 higher than in 1997, while it fell over time in the other two country groups. Investment for "completion point countries" in 2001 was more than 30 per cent higher than in 1997, while it increased by less than 10 per cent in "decision point countries" and fell in "pre-decision point HIPC". Qualitatively similar results are obtained for exports and imports. All three country groups experienced increases in the stock of foreign direct investment during the late 1990s, but the largest inflows are once again observed for "completion point HIPC". Any inference on the effectiveness of trade policy reforms should be cautious, though, as it seems at this point in time virtually impossible to determine what the relative contribution of reforms of trade and trade-related policies *vis-à-vis* other policy reforms to the overall performance of countries has been.

Figure 1: Developments in economic indicators in different groups of HIPC
(current US$, percentage change during 1997-2001)



*) average annual growth during 1995-2001.
Note: only those countries were included in the comparisons, for which data for 2001 was available.
Source: OECD Secretariat based on World Bank (2002c) and Unctad (2002).

13. In the two groups of countries that reached decision point and completion point, respectively, imports increased faster than exports, implying a deterioration of the trade balance. Over a longer time period, such a development could compromise the countries' ability to service their debt, and, hence, undermine the objectives of the HIPC Initiative. However, in the context of strong short-term inflows of foreign direct investment, the surge in imports might well be due to purchases by foreign investors of capital goods abroad. These imports increase the productive capacity of the countries and make it possible for them to increase their output and exports in the future.

14. While at present the empirical results on the economic performance of different groups of HIPC are only preliminary and indicative, the available evidence suggests that the set of policy reform requirements expected from countries participating in the Initiative is positively linked to income, investment, and integration into the world market. Receiving debt relief while maintaining economic stability and continuing with domestic reforms has the potential to free resources for investment and attract additional foreign investors, and by doing so improve the long-term growth prospects of HIPC. However, it should be noted that the observed effects so far are likely to be only to a very limited extent related to actual reductions in debt levels, which started for the first countries only very recently.

15. The tentative findings will need to be verified through careful econometric analysis, once a sufficiently comprehensive time-series of relevant economic data becomes available. A number of related questions might thereby warrant more profound examination: What have been the consequences of earlier structural adjustment programmes in HIPC? How have trade policy reforms been carried through? What are the short-term *versus* long-term effects of trade liberalisation? How has debt relief influenced trade performance? What has been the impact of trade policy reform on tariff revenues? What has been the effect of international crisis, such as the HIV/AIDS epidemic or the Asian financial crisis on HIPC? Have trade and FDI been complements or substitutes? Such analysis might also shed light on the causality of success. In particular, it might make it possible to establish whether participating countries have performed well because of the HIPC requirements associated with debt relief, or whether good policies and relatively good economic performance in the past have made it easier for them to qualify for debt-relief.

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ANNEX

Recent economic and trade performance in selected HIPC

In the following, selected economic, trade, and investment indicators are compared over the five year period from 1997, the year when the first countries reached decision point under the original HIPC Initiative, and 2001, the latest year for which data are available. The analysis is centred on the six HIPC that had reached completion point by the end of 2002 and, hence, have already started to successfully implement their Poverty Reduction Strategies. These countries are Bolivia, Burkina Faso, Mauritania, Mozambique, Tanzania, and Uganda. Annex Table 1 provides an overview of the development of key economic indicators in the six countries.

Annex Table 1: Developments in economic indicators in selected HIPC (current US$, 1997 = 100)

Gross domestic product					
	1997	1998	1999	2000	2001
Bolivia	100	106	105	105	100
Burkina Faso	100	109	108	96	102
Mauritania	100	91	87	90	94
Mozambique	100	114	117	112	105
Tanzania	100	112	110	117	119
Uganda	100	108	102	98	91
Gross capital formation					
	1997	1998	1999	2000	2001
Bolivia	100	130	98	97	..
Burkina Faso	100	117	103	93	103
Mauritania	100	99	88	147	140
Mozambique	100	142	201	203	175
Tanzania	100	101	117	140	148
Uganda	100	101	104	111	106
Exports					
	1997	1998	1999	2000	2001
Bolivia	100	100	86	87	..
Burkina Faso	100	135	108	88	102
Mauritania	100	93	86	92	90
Mozambique	100	107	121	153	286
Tanzania	100	86	95	104	105
Uganda	100	84	88	76	72

Source: World Bank, 2002c.

There is no clear and common trend in economic indicators across the six countries. GDP increased by 19 per cent in Tanzania during the period 1997-2001, but fell by 9 per cent in Uganda. Moreover, developments over time were not smooth, but showed considerable variation. The five countries, for which data on gross capital formation in 2001 were available, all had higher investment in 2001 than five years earlier, but again with intermediate peaks and troughs in individual countries. The largest variation in the country group can be observed for exports, where Mozambique almost tripled the value of its foreign sales during 1997-2001,[1] while exports fell by nearly 30 per cent in Uganda.

[1] The strong export performance of Mozambique is related to the privatisation programme implemented since the late 1980s and recent large-scale investments by foreign companies, e.g. in aluminium smelting.