INTERNATIONAL MONETARY FUND AND
INTERNATIONAL DEVELOPMENT ASSOCIATION

Heavily Indebted Poor Countries (HIPC) Initiative—Issues Related to the Sunset Clause

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I. Introduction

1. **This paper responds to the Boards' request to present a proposal addressing country eligibility under the HIPC Initiative sunset clause and discuss related issues.** It builds on an informal note to the Boards which explored a number of options to deal with the sunset clause of the HIPC Initiative, which is scheduled to take effect at end-2006. It addresses the concerns raised by Directors in their discussion of the note in July 2006 and proposes that the sunset clause be allowed to take effect and the countries that are assessed to have met the income and indebtedness criteria based on end-2004 data be grandfathered.[1] In response to concerns raised by Directors, it also discusses the issue of a permanent exit from the Initiative for countries wishing to do so.

2. **This document is organized as follows.** Section II provides background on the sunset clause and the outcome of the IDA Board technical briefing and the IMF informal Board seminar on possible options regarding the sunset clause. Section III discusses a number of key issues for consideration. Section IV provides recommendations, and Section V presents issues for the Boards' discussion.

II. Background

3. **A sunset clause was introduced in the 1996 Program of Action at the start of the HIPC Initiative.** The Program of Action stated that "the Initiative would be open to all HIPCs that pursue or adopt programs of adjustment and reform supported by the IMF and IDA in the next two years, after which the Initiative would be reviewed and a decision made whether it should be continued." A sunset clause, restricting access to the HIPC Initiative to countries that had started IMF- and IDA-supported reform programs within a two-year time period, was included in the initial legal framework of the Initiative to: (i) prevent the Initiative from becoming permanent; (ii) minimize moral hazard; and (iii) encourage early adoption of reforms.[2]

4. **The Boards of IDA and the IMF have subsequently extended the sunset clause four times, and it is now scheduled to take effect on December 31, 2006** (see Annex I). These extensions were granted to allow more time to countries to start qualifying programs so as to be able to benefit subsequently from HIPC Initiative debt relief. In September 2004, the Boards decided to extend the sunset clause through December 31, 2006 and to close the Initiative to new entrants by ring fencing its

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[1] In this document, all references to grandfathering the countries that are assessed to have met the income and indebtedness criteria based on end-2004 data include countries that in the future are assessed to have met these criteria and added to the ring-fencing list.

[2] Starting a qualifying IDA- and IMF-supported program by the specified date under the sunset clause is referred to as the "policy eligibility criterion." Qualifying programs include: programs supported by Poverty Reduction and Growth Facility (PRGF) or Extended Arrangements, or, on a case-by-case basis, programs supported by Structural Adjustment Facility arrangements, Stand-By Arrangements, Emergency Post Conflict Assistance (EPCA), Rights Accumulation Programs (RAPs), and/or adjustment operations supported by IDA. IMF staff monitored programs (SMP) do not count as qualifying programs.

application to those countries meeting the Initiative's income and indebtedness criteria based on end-2004 data.[3] In April 2006, the Boards endorsed and closed the list of countries assessed to have met these two criteria.[4] Only countries in that list, henceforth referred to as the "identified countries," and others that are subsequently assessed to have met the relevant criteria using end-2004 data, could be considered for future HIPC Initiative debt relief.

5. **Letting the sunset clause take effect as now scheduled could leave several identified countries with debt burdens in excess of the Initiative's thresholds** (see Annex II). More specifically, five of the identified countries that might wish to avail themselves of the Initiative (Comoros, Eritrea, Liberia, Somalia, and Sudan) do not meet the policy eligibility criterion.[5] Should the sunset clause take effect as now scheduled, these countries would not be eligible for the HIPC Initiative (and eventually for the Multilateral Debt Relief Initiative–MDRI), unless they were to start a qualifying program before end-2006.

6. **At the request of the Boards, staffs put forward a preliminary set of options to deal with the sunset clause** (see Annex III). The following options were presented in July 2006 in the context of an informal Board seminar at the IMF and a Board technical briefing at the World Bank:

- Option 1: let the sunset clause take effect at end-2006;

[3] For IDA, both the income and indebtedness criteria are bound by the end-2004 deadline; hence, countries that later change their IDA-only/PRGF-eligible status would not be considered "potentially eligible" for HIPC Initiative debt relief under the criteria approved by IDA (see "Enhanced HIPC Initiative: Proposals Concerning the Sunset Clause and Provision of Interim Relief" September 15, 2004, http://www.worldbank.org/debt). However, the IMF Board decided that only the indebtedness eligibility criterion be applied to end-2004 data, and not the income criterion (see PRGF-HIPC Trust Instrument–Amendments to Eligibility Criteria, http://www.imf.org/external/np/prsp/2004/100704.htm). In practice, this difference is not expected to lead to divergence in assessments for a country's eligibility for HIPC Initiative debt relief.

[4] See "Heavily Indebted Poor Countries (HIPC Initiative)—List of Ring-Fenced Countries that Meet the Income and Indebtedness Criteria at end-2004," April 11, 2006, http://www.imf.org/external/np/hipc/doc.htm, and http://www.worldbank.org/debt. A total of 14 countries were assessed to have met both criteria based on end-2004 data. Of these, three have indicated that they do not wish to avail themselves of the Initiative, which leaves 11 countries that might wish to be considered for HIPC Initiative debt relief. Directors also decided that the list could subsequently be amended to include other countries whose data are assessed to have met the relevant criteria based on end-2004 data.

[5] In addition, Bhutan (which was assessed to have met the two criteria based on end-2004 data, but indicated that it does not wish to avail itself of the Initiative) and Myanmar (for which data are unavailable) have not started programs since October 1996, and would not be in a position to become eligible for debt relief if the sunset clause is allowed to expire. All other identified countries, and Afghanistan (which may be added to the list upon further analysis of its debt indicators), have met all eligibility criteria and could qualify for debt relief under the Initiative even after the sunset clause takes effect.

- Option 2: let the sunset clause take effect at end-2006, but allow the identified HIPCs that do not meet the HIPC Initiative policy eligibility requirement to earn an extension of one year to meet it;

- Option 3: extend the sunset clause for another two years to end-2008;

- Option 4: let the sunset clause take effect at end-2006 and grandfather all countries that are assessed to have met the income and indebtedness criteria based on end-2004 data; and

- Option 5: let the sunset clause take effect at end-2006 and grandfather all countries that are assessed to have met the income and indebtedness criteria based on end-2004 data, but limit the debt subject to debt relief as of a given cutoff date (end-2006).

7. **In their informal discussion of these options, the majority of Directors expressed the view that they were not in favor of letting the sunset clause take effect (Option 1) and did not favor extending it (Options 2 and 3).** Their concern was that these options would leave several HIPCs without the possibility of benefiting from debt relief under the HIPC Initiative and eventually the MDRI.[6] They recognized that there would be a need to find a comprehensive solution to the debt situation of these countries once the appropriate conditions are in place. This, however, would eventually require either setting up a new debt-relief framework or dealing with each country case by case, which would be politically challenging, time-consuming, and ultimately costly. A few Directors preferred extending the Initiative for an additional two years (Option 3), although recognizing that a further extension may be needed later.

8. **Directors broadly supported letting the sunset clause take effect and grandfathering all countries that are assessed to have met the income and indebtedness criteria based on end-2004 data (Option 4).** Most Directors expressed the view that keeping the HIPC Initiative accessible for countries that meet the two criteria based on end-2004 data by grandfathering them would be the most practical and balanced approach. They did not generally support limiting the debt subject to debt relief as of a given cutoff date, mainly on account of free riding concerns. These, and related issues, are discussed in more detail in the next section.

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[6] In staffs' view, none of the five identified countries that do not meet the HIPC Initiative policy eligibility requirement is likely to be able to begin a qualifying program by end-2006. Impediments to starting a qualifying program include ongoing conflict situations (Somalia, Sudan, Eritrea) and/or the prerequisite to clear (or reach agreements to clear) their arrears (Liberia, Somalia, Sudan, and to a lesser extent, Comoros), which would require a concerted international effort that has been difficult to mobilize (see Annex II).

Table 1. Eligibility Status of Countries That Might Wish to be Considered for HIPC Initiative Debt Relief 1/

(As of end-July 2006)

Countries	NPV of Debt-to-Exports/Revenue Ratio (In percent) 2/
Countries that Meet the Policy Eligibility Criterion	
Central African Republic	**562**
Côte d'Ivoire 3/	**361**
Haiti	**189**
Kyrgyz Republic 3/	**376**
Nepal	**198**
Togo 3/	**409**
Countries that do not Meet the Policy Eligibility Criterion	
Eritrea	**522**
Comoros	**378**
Liberia	**1,433**
Somalia	**1,091**
Sudan	**561**

Source: IDA and IMF Country Documents

1/ These are countries satisfying the Initiative's income and indebtedness criteria based on end-2004 data, as identified in "Heavily Indebted Poor Countries (HIPC Initiative)—List of Ring-Fenced Countries that Meet the Income and Indebtedness Criteria at end-2004," April 11, 2006. They do not include countries that satisfy the two criteria but have indicated to IMF and IDA staffs that they would not avail themselves of the Initiative (Bhutan, Lao PDR, and Sri Lanka). Also not included are countries for which data was insufficient to assess their debt ratios against the HIPC Initiative thresholds (Afghanistan and Myanmar). For Afghanistan, an assessment of its debt ratios will be undertaken shortly that will reflect the final reconciliation of its debt with Russia.

2/ Exports refer to the last three-year average of exports of goods and non-factor services. Revenue refers to the current year revenue of the central government, excluding grants.

3/ Qualifies under the fiscal window. The ratio refers to the NPV of debt-to-revenue.

III. KEY ISSUES FOR CONSIDERATION

A. Moral Hazard and Free Riding

9. **Maintaining access to the HIPC Initiative for the identified countries prolongs moral hazard concerns, but alternative ways to address this issue have their own drawbacks.** If countries that have not yet reached their decision points maintain eligibility under the HIPC Initiative, they may be tempted to borrow unnecessarily in anticipation of eventual debt relief should they find lenders willing to lend. To provide a disincentive for debtors to accumulate new debt, the Initiative could

establish a cutoff date for debt subject to debt relief. Staffs, however, consider this as undesirable for three reasons:

- first, having a portion of debt not subject to debt relief would create incentives for some creditors to increase lending after the cutoff, thereby free riding on the fiscal and balance-of-payments space created by debt relief;

- second, arrears clearance may result in new loans after the cutoff date, which would not be subject to debt relief; and

- third, HIPC Initiative debt relief could be insufficient to bring the debt ratios to the HIPC Initiative's thresholds at the decision point, thus undermining the primary objective of the Initiative.

10. **To eliminate incentives for free riding associated with establishing a cutoff date for debt subject to debt relief, the cutoff date could apply to debt owed only to the international financial institutions (IFIs); this, however, would violate two of the Initiative's fundamental principles**:

- first, it violates the principle of equitable burden sharing. The potential disproportionate increase in debt relief to be provided by other creditors could discourage them from participating in the Initiative, thus potentially perpetuating the free riding cycle;[7] and

- second, it undermines the Initiative's primary objective of ensuring that the resulting overall debt relief be sufficient to bring the country's debt ratios to the HIPC Initiative's thresholds at the decision point, especially given that arrears clearance may result in new loans after the cutoff date, which would not be subject to debt relief.

Neither of these concerns would be eliminated by establishing the cutoff date further into the future.

11. **In any event, some mechanisms already exist to address moral hazard and free riding issues.** For example, the track record of policy performance necessary to reach the decision point requires countries to abide by stringent limits on non-concessional borrowing. Additionally, IDA's Board has recently approved a two-pronged package of measures addressing free riding on future borrowing by IDA grant-recipients as well as post-MDRI countries. On the creditor side, the package involves enhancing creditor coordination around an agreed framework. On the borrower side, it provides

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[7] This free rider situation refers to the possibility that creditors that do not participate in the HIPC Initiative could benefit from the fiscal and balance-of-payments space created by participating creditors. Free riding, in the context of creditor participation, would remain an issue even without establishing a cutoff for debt subject to debt relief. See "Heavily Indebted Poor Countries (HIPC) Initiative and Multilateral Debt Relief Initiative (MDRI)—Status of Implementation," August 2006 (http://www.imf.org/external/np/hipc/doc.htm and http://www.worldbank.org/debt) for a discussion of this issue.

disincentives on new borrowing by reducing volumes and/or hardening the terms of assistance.[8] Furthermore, IDA and the IMF will continue monitoring debt accumulation, including non-concessional borrowing, through the use of the debt sustainability framework for low-income countries (DSF). The DSF could also be used to raise awareness about the consequences of excessive borrowing by HIPCs and facilitate creditor coordination.[9] To encourage HIPCs to reach agreements with their creditors so as to ensure a critical mass of debt relief, the IMF also requires minimum financing assurances (70 and 80 percent after the decision and completion point, respectively) from other creditors regarding the provision of their share of debt relief prior to disbursing its own debt relief. Consideration could be given to raising these thresholds further, or establishing new rules requiring additional financing assurances for the provision of debt relief on debt contracted after a given cutoff date. However, staffs do not recommend either of these options, because countries with significant shares of debt to non-Paris Club and commercial creditors could be cut off from debt relief as a consequence.[10]

B. Perceived Permanence of the Initiative and Incentives

12. **The sunset clause may no longer be needed.** Two of the goals of the sunset clause were to prevent the Initiative from being seen as permanent, and to provide incentives to countries to move toward reform. But repeated extensions of the sunset clause have already reduced its credibility. Moreover, even if the sunset clause were to take effect, the HIPC Initiative would still not be closed, as eligible pre-decision point and remaining interim countries face no deadline to reach either the decision or completion point under the HIPC Initiative. The recent ring fencing of the list of countries assessed to have met the Initiative's income and indebtedness criteria based on end-2004 data has already narrowed the Initiative's scope, further reducing the need for an explicit sunset clause.[11] Finally, some of the countries that do not meet the policy-eligibility criterion are faced with deeper problems (internal conflict, protracted arrears,

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[8] See "IDA Countries and non-concessional Debt: Dealing with the Free-Rider Problem in IDA14 Grant-recipient and post-MDRI countries," June 2006, http://siteresources.worldbank.org/IDA/Resources/Seminar%20PDFs/73449-1155322341160/Freeriderboardpaper.pd

[9] A joint IDA/IMF paper on the debt sustainability framework which discusses this issue will be forthcoming.

[10] Additional financing assurances on debt contracted after a cutoff date (say end-2006) could help dissuade HIPCs to borrow in anticipation of eventual debt relief and would also discourage opportunistic behavior of creditors. Existing limits would continue to apply to pre-cutoff debt, and the cutoff date would only be relevant for the purposes of the amount of financing assurances required, and not for limiting debt actually covered under the Initiative. For example, a country that reaches its decision point at end-2008 would be eligible to receive debt relief based on debt as of the decision point, but would need to obtain financing assurances from creditors representing 70 percent of its debt contracted before end-2006 and 80-100 percent of the debt disbursed after 2006.

[11] Although the list could subsequently be amended to include other countries whose data are verified to have met the income and indebtedness criteria based on end-2004 data, the universe of potential candidates is limited because the income and indebtedness tests are bound at end-2004.

etc.) that could make them less responsive to the incentives expected to be provided by the sunset clause.

13. **While establishing a deadline for all pre-decision point countries to reach their decision point may provide a greater sense of closure to the Initiative, it is not recommended by staffs due to its significant drawbacks.**[12] Such a deadline would be another type of sunset clause, replacing the current policy-eligibility criterion with a new sunset clause on qualification. It would require all identified countries, as well as others subsequently found to meet the two criteria using end-2004 data, to reach their decision points by a certain date (say end-2016, a decade hence). Such a proposal is not recommended by staffs due to a number of drawbacks:

- First, this would amount to a significant change in the Initiative's architecture, by placing an additional deadline on countries that already meet all eligibility requirements (under current rules, these countries have no deadline to reach their decision point).

- Second, setting an effective and realistic deadline for HIPCs has always proved difficult, given the uncertainties surrounding specific country circumstances. If the deadline is set too early, it may need to be extended, creating another extension cycle. If it is set too late, it may be redundant and may not provide the desired incentives to accelerate reform.

- Third, countries already have incentives to obtain HIPC Initiative debt relief as soon as possible. Incentives to go through the HIPC process swiftly are provided by the MDRI since the amount of total debt relief under this initiative declines with the passage of time: debt eligible for MDRI debt relief is bound by fixed cutoff dates and countries are requested to service eligible debt until reaching their HIPC Initiative completion point.[13, 14]

- Finally, this change in the Initiative's framework could be perceived as unfair, as it would place yet another additional deadline on precisely those countries facing greater challenges compared to post-decision-point HIPCs.

C. Possible Further Limits on Country Coverage Under the HIPC Initiative

14. **In April 2006, three of the 14 countries that were assessed to have met the HIPC Initiative's income and indebtedness criteria based on end-2004 data**

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[12] A deadline to reach completion point could also be considered, but this would go against the principle of floating completion points, which was a key feature of the enhancement of the Initiative in 1999. In addition, it could leave a number of countries with unsustainable debt burdens, which would raise the issues described in paragraph 7.

[13] Cutoff dates for debt eligible for debt relief under the MDRI are end-2003 for IDA and end-2004 for the IMF and the AfDB.

[14] This may be of less relevance to the protracted-arrears countries, whose arrears clearance may result in new obligations after the cutoff dates established under MDRI.

indicated that they did not wish to avail themselves of the Initiative. Under the current rules of the Initiative, these countries remain eligible or potentially eligible for the Initiative, with the result that they can change their intent at any point in the future and decide to apply for debt relief if otherwise eligible and qualified to do so at that time. During the discussion of the informal note in July, some Directors asked staff to examine whether it is possible to formally exclude from HIPC eligibility members that have expressed an intent not to avail themselves of the Initiative.[15]

15. **From a Fund perspective, a country's current indication of its intention not to avail itself of HIPC relief cannot provide the basis for making the country ineligible under the HIPC Initiative.** Any criterion relied upon for limiting eligibility must be relevant to the objectives of the provision of the Fund's Articles (and, accordingly, any related Executive Board policy) pursuant to which the relief is being granted.[16] The current HIPC Initiative eligibility criteria clearly satisfy the standard, as they all relate to providing special balance of payments assistance to heavily indebted low-income members with strong economic performance. However, and consistent with past practice,[17] current intent is not considered to be relevant for purposes of denying debt relief if, in the future, the country should change its mind and request such relief. Rather, a strategy to exclude countries would need to be based on criteria that are relevant and applied to all similarly situated countries. For example, the Boards could decide to add to the Initiative a new eligibility criterion related to debt levels at a future point in time. In effect, there would be a second ring-fencing exercise, this time based on debt data as of a different date, whose purpose would be to further limit the list of members that are eligible or potentially eligible for assistance under the HIPC Initiative, in light of resource constraints.

16. **From the Bank's perspective, the Board could revise the terms of the Initiative so as to allow countries otherwise eligible to permanently exit the Initiative**. For example, these countries could be allowed to exit the HIPC Initiative formally and permanently through an amendment of the eligibility criteria or through a future ring-fencing exercise.

17. **Staffs suggest the Boards postpone consideration of the issue of an exit strategy**. The concerns regarding the continued eligibility of the three countries that have indicated an intent not to avail themselves of HIPC Initiative debt relief are important, but are mitigated by the following factors. First, eligible countries not wanting debt relief would never be provided with it, as such relief would be provided only at their request.

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[15] As two of the three members expressing such an intent already meet the policy eligibility criterion, their exclusion would require a change in the general eligibility criteria outside of the sunset clause.

[16] The relevant provision here, Article V, Section 12(f)(ii), provides that "balance of payments assistance may be made available on special terms to developing members in difficult circumstance, and for this purpose the Fund shall take into account the level of per capita income."

[17] Current intent has not been relied upon in other contexts where balance of payments financing has been provided under the same provision of the Fund's Articles. For example, members have never been excluded from PRGF (and SAF/ESAF) eligibility based on an intent not to use resources of that facility; instead, their intent in this respect is only footnoted on the list of eligible members.

Second, to receive debt relief under the HIPC Initiative requires that eligible countries meet the requisite conditions for reaching the decision and completion points, respectively. Finally, should Directors be interested in an exit strategy based on new ring-fencing exercises, this could be done at any time in the future, and staffs could make suggestions in this regard in the annual HIPC Initiative-MDRI progress report.

D. Costs of Providing Debt Relief

18. **Grandfathering the countries that are assessed to have met the income and indebtedness criteria based on end-2004 data would add about US$21.9 billion in end-2005 NPV terms to the costs of HIPC Initiative debt relief already committed to the post-decision point countries** (Table 2). IDA's share in total HIPC Initiative debt relief to the grandfathered countries amounts to US$3.1 billion, while the IMF's share amounts to US$2.5 billion. The total cost of debt relief would increase by an additional US$2.7 billion in end-2005 NPV terms if MDRI costs are also taken into account. Of the additional MDRI debt relief costs, US$1.9 billion would be borne by IDA, and US$0.4 billion by the IMF. As the IMF has made no provision for the financing of HIPC Initiative and MDRI assistance for either the protracted arrears cases or those countries newly identified as potentially eligible, it will need to secure additional financial resources prior to these countries reaching their respective HIPC decision points.[18] The possibility of adding new countries to the HIPC Initiative list (such as Afghanistan and Myanmar, as well as others that could change their minds about participation in the Initiative) would further increase the costs of providing debt relief.

19. **The uncertainty surrounding the cost of debt relief could be reduced but not eliminated.** Costs are uncertain, as they ultimately depend on HIPCs' debt levels at the date of the decision point, discount and exchange rates, exports and revenues at the decision point, all of which are difficult to predict. Allowing countries to exit the Initiative permanently (as in section C above) could reduce the uncertainty of the costs to some extent. Setting a cutoff date for debt subject to debt relief could also reduce this uncertainty, but, as pointed out earlier, it has serious drawbacks.

IV. Recommendations

20. **In light of these considerations, staffs propose that the sunset clause of the Initiative be allowed to take effect at end-2006 and that countries that are assessed to have met the income and indebtedness criteria based on end-2004 data be grandfathered** (including countries that in the future are assessed to have met these criteria and added to the ring-fencing list)**.** Grandfathering is comprehensive in coverage of both countries and their debt, and treats countries equitably. It ensures that all potentially eligible HIPCs continue to have the possibility to benefit from maximum debt relief under existing debt relief initiatives, rather than leaving a few of them with

[18] This issue will be discussed in the forthcoming IMF Update on Concessional Financing and Debt Relief. In the case of the protracted-arrears countries, financing assurances are required at an earlier stage, namely the approval of a Rights Accumulation Program (RAP).

Table 2. Estimated Costs of Debt Relief under the Grandfathering Option 1/
(In billions of U.S. dollars, in end-December 2005 NPV terms)

	Pre-decision point countries 2/ 3/ (11 countries)	Countries that have reached decision point (29 countries)	Total potential cost (40 countries)
Total HIPC costs	**21.9**	**41.3**	**63.2**
Multilateral creditors	8.6	20.7	29.4
o/w World Bank	3.1	9.8	12.9
IMF	2.5	3.1	5.6
Bilateral and commercial creditors	13.3	20.5	33.8
Memorandum item			
Estimated cost of MDRI debt relief	2.3	22.2	24.5
o/w World Bank	1.5	15.3	16.8
IMF	0.4	3.6	4.0
Total HIPC Initiative and MDRI cost	24.2	63.5	87.6

Sources: Country authorities, multilateral creditors, Paris Club Secretariat, Global Development Finance, and IMF and IDA staff estimates.
1/ Based on the estimates presented in the documents "Heavily Indebted Poor Countries (HIPC) Initiative - Statistical Update," March 27, 2006 and "Heavily Indebted Poor Countries (HIPC Initiative)—List of Ring-Fenced Countries that Meet the Income and Indebtedness Criteria at end-2004," April 12, 2006.
2/ Refers to the 11 countries that have been assessed to meet the Initiative's income and indebtedness criteria based on end-2004 data and that might wish to be considered for HIPC Initiative debt relief.
3/ Cost estimates are very preliminary and subject to a number of assumptions, including on: (i) timing HIPC decision and completion points, and, where applicable, of arrears clearance; (ii) type and size of IMF-supported arrangements, (iii) results of updated DSA; (iv) future interest rate path; and (v) modalities of IMF MDRI relief to the protracted arrears cases (after arrears clearance, their debt would not be MDRI-eligible under the current MDRI and traditional arrears clearance frameworks, requiring a modified approach).

unsustainable debt burdens that will eventually have to be addressed under another comprehensive debt relief framework or case by case. It also allows them time to go through the HIPC Initiative process at their own pace, without creating undue pressure.[19]

21. **Staffs will continue to work on addressing some of the other concerns of Directors.** Staffs will maintain their efforts to limit moral-hazard behavior and closely monitor and report on free riding. They will continue to provide the Boards with updates on the results of their efforts, as well as refined costing estimates of debt relief, in the context of annual reports on the implementation of the HIPC Initiative and the MDRI.

22. **On a more practical level, staffs also recommend that the semi-annual statistical updates on implementation of the HIPC Initiative be discontinued.** This would be consistent with efforts to streamline the documentation provided to the Boards

[19] Implementation of this approach would require an amendment of the PRGF-HIPC Trust Instrument; a supplement with a draft decision to effect such an amendment will be circulated to the IMF Board under separate cover.

so as to increase its effectiveness and relevance. The Boards would continue to be informed on progress under the HIPC Initiative and the MDRI, as well as potential policy issues, through the annual progress reports.

ANNEX I: HISTORY OF THE SUNSET CLAUSE

1. **The sunset clause stems from the 1996 Program of Action, which established a two-year limit to the HIPC Initiative "at the end of which a comprehensive review would be held to decide whether to continue with the program."** The 1998 review indicated that the sunset clause "reflects the intention that the HIPC Initiative would not be a permanent facility. The sunset clause gives countries an incentive to adopt IDA- and IMF-supported adjustment programs. It also limits the time available for build-up of new debt, and thus provides for relief on debt which mostly predates the Initiative." The 1998 review proposed a two-year extension. The countries which did not meet the entry requirements for the HIPC Initiative at that time were: Angola, Burundi, the Democratic Republic of the Congo, Equatorial Guinea, Liberia, Myanmar, Saõ Tomé and Príncipe, Somalia and Sudan. Seven of these countries (all except Angola and Equatorial Guinea) were, in the staffs' view, potentially eligible for assistance as they appeared to have had unsustainable debt ratios (with the caveat of very poor data). Some of these countries were just emerging from conflict, and thus had not reached the stage to be able to enter into IDA- and Fund-supported programs. Furthermore, for some, access to new loans—and thus moral hazard—seemed to be limited. Given these considerations, the Executive Directors of IDA and the Fund agreed to an extension of the original deadline for meeting the entry requirement until end-2000.[20]

2. **In 2000, the sunset clause was extended for a second time.** The countries which still did not meet the entry requirement by then were Angola (which was later dropped from the list, since it was estimated not to require HIPC relief), Burundi, the Democratic Republic of Congo, Liberia, Myanmar, Somalia, and Sudan.[21] The HIPC Progress Report noted that a preliminary analysis of the countries which had yet to pass the entry requirement suggested that it would be very likely that they would need comprehensive debt relief, including from multilateral institutions. Since many of the countries were conflict-affected and undergoing social and political strife, there was considerable uncertainty about the timing of a possible decision point. Staff, therefore, recommended the elimination of the sunset clause so that no time limit would constrain these countries to reach the decision point. However this suggestion was rejected by the Boards of the Bank and the Fund, and a decision was taken to extend the sunset clause by another two years.[22]

3. **In 2002, the sunset clause was extended for the third time**. From end-2000 to September 2002, only the Democratic Republic of Congo had started an adjustment program with the IMF and IDA. However, the list of HIPCs that were yet to be considered was expanded to 12 countries: Côte d'Ivoire, Burundi, the Central African

[20] "The Initiative for Heavily Indebted Poor Countries—Review and Outlook," August 25, 1998, http://www.imf.org/external/np/hipc/progrept.htm and http://www.worldbank.org/debt.

[21] Guinea and São Tomé and Príncipe had met the entry requirements.

[22] "The Enhanced Initiative for Heavily Indebted Poor Countries—Review of Implementation," September 7, 2000, http://www.imf.org/external/np/hipc and http://www.worldbank.org/debt.

Republic, Comoros, the Republic of Congo, the Democratic Republic of the Congo, Lao P.D.R, Liberia, Myanmar, Somalia, Sudan, and Togo. Staff proposed that the sunset clause be extended by another two years to end-2004 to provide an opportunity for these countries to begin to establish a policy track record that would allow their consideration for HIPC relief. While the Directors agreed to this extension, several expressed concern about further extensions of the clause in the future, on reputation and moral hazard grounds. Recognizing that the extension up to 2004 would not be sufficient to help all the remaining HIPCs join the Initiative, some Directors suggested extending the sunset clause in the future only on a case-by-case basis.

4. **In 2004, the sunset clause was extended for the fourth time.** From end-2002 to end-2004, Burundi and the Central African Republic started IMF-supported programs. Directors recognized that a number of countries (in particular Comoros, Liberia, Myanmar, Somalia, and Sudan) would still need additional time to fulfill all the eligibility requirements. However, in an effort to prevent the Initiative from remaining open to new entrants, Directors also decided to ring-fence its application to countries meeting the Initiative's income and indebtedness criteria based on end-2004 data. In April 2006, the Boards endorsed and closed the list of countries that had been assessed by staffs as meeting these two criteria based on end-2004 data. The list included 11 countries which might wish to be considered for HIPC Initiative debt relief (Central African Republic, Comoros, Côte d'Ivoire, Eritrea, Haiti, the Kyrgyz Republic, Liberia, Nepal, Somalia, Sudan, and Togo). Three additional countries were found to meet the two criteria based on end-2004 data, but indicated that they do not intend to avail themselves of the Initiative. Directors also decided that the list could subsequently be amended to include other countries whose data are verified to have met the relevant criteria based on end-2004 data (possible candidates include Afghanistan and Myanmar). Recognizing the difficulties faced by some countries in the HIPC list in starting IMF- and IDA-supported programs, they requested staffs to return to them with options regarding the sunset clause.

ANNEX II: POLITICAL DEVELOPMENTS AND REFORM PROGRAM STATUS AND PROSPECTS OF COUNTRIES AFFECTED BY THE SUNSET CLAUSE (AS OF END-JULY 2006)

Country	Political Developments	Reform Program Status and Prospects
Comoros	Progress has been made on cooperation between the union and the three island governments, but inter-island cooperation remains fragile. Ahmed Abdallah Sambi was sworn in as the new president of the Union of the Comoros on May 26, 2006, in the first democratic transfer of power in over a decade.	Comoros has not had an IMF-supported arrangement since 1994. Performance under the 2005 staff-monitored program was mixed. The program was extended through end-June 2006 and may be extended again until end-2006. If performance under the program is satisfactory, a PRGF-supported arrangement could follow. However, this would require reaching understandings with Comoros' official creditors on clearing its sizeable external arrears.
Eritrea	Eritrea remains in a state of military mobilization due to the border conflict with Ethiopia.	Eritrea has never had an IMF arrangement and has not graduated to development policy lending from IDA. Discussions on a staff-monitored program for 2006 are ongoing. This could pave the way for an EPCA or PRGF-supported program in the future.
Liberia	The new President, inaugurated on January 16, 2006, expressed a strong desire to work with the international community to rebuild Liberia's economy and institutions and endorsed the assistance program agreed with Liberia's international partners in September 2005.	A staff monitored program covering the period February-September 2006 was presented to the Board in April 2006. Successful completion of the SMP could pave the way for a RAP and eventual PRGF-supported arrangement in the future. Nearly all of Liberia's debt is in arrears.
Somalia	A Transitional Parliament was inaugurated in August 2004, and a cabinet forming the Transitional Government of Somalia (TGF) was appointed in January 2005. However, the TGF currently lacks sufficient international recognition. While the security situation remains turbulent in south-central Somalia, neighboring Puntland and Somaliland are relatively stable.	Somalia has not had a Fund-supported arrangement since 1987. Arrears are substantial, and Somalia was declared ineligible to use the general resources of the Fund in 1988. The World Bank is engaged with Somalia under the LICUS approach.
Sudan	An Interim National Constitution was passed in July 2005, followed by the establishment of the Government of National Unity and Government of Southern Sudan in fall 2005. However, the situation in Darfur remains critical, and progress toward resolution of the conflict has been slow.	During the past 7 years, Sudan has maintained close cooperation with the IMF, as evidenced by the good performance under successive staff-monitored programs. Performance under the 2005 SMP was broadly satisfactory, and a new SMP for 2006 has begun in May 2006. Assuming a resolution of the conflict in Darfur, this could pave the way for a possible RAP and a subsequent PRGF-supported arrangement in the future. Sudan's external debt is large, and most of it is in arrears.

Source: IDA and IMF Country Documents

See "Heavily Indebted Poor Countries (HIPC) Initiative and Multilateral Debt Relief Initiative (MDRI)—Status of Implementation," August 25, 2006 (http://www.imf.org/external/np/hipc/doc.htm and http://www.worldbank.org/debt) for more details.

ANNEX III: POSSIBLE OPTIONS REGARDING THE SUNSET CLAUSE

This annex presents the five options to deal with the imminent expiry of eligibility of five identified HIPCs at end-2006 owing to the sunset clause discussed by the Boards in July 2006. All the options outlined below apply to the identified countries, as well as to others which are subsequently found to meet the HIPC Initiative income and indebtedness criteria using end-2004 data.

Option 1: Let the sunset clause take effect at end-2006. This option would imply that countries that have been assessed as meeting the HIPC Initiative income and indebtedness criteria but have not started a qualifying IMF- and IDA-supported program (Comoros, Eritrea, Liberia, Somalia, and Sudan) by end-2006 would neither be eligible for HIPC Initiative assistance nor for MDRI relief. Also excluded would be countries which are subsequently found to meet the two criteria using end-2004 data and have not started a qualifying IMF- and IDA-supported program by end-2006 (Myanmar could be such a case).

Advantages:

- This option would end the repeated extensions of the sunset clause that have made the Initiative appear permanent.
- It could also reduce moral hazard concerns, as the five countries bound by the sunset clause would no longer be guaranteed debt relief on their borrowing, and provide an incentive for these countries to start a qualifying program before the end of the year.

Disadvantages:

- International support is unlikely to be mobilized in time to clear the arrears of all the countries with arrears (Liberia, Somalia, and Sudan), thus preventing these countries from meeting the policy-eligibility requirement independently of any of their own efforts to do so.
- Five countries—and possibly more—could be left with unsustainable debt burdens.

Comments: Debt sustainability problems of the excluded countries could be addressed through alternative channels, e.g., on a case-by-case basis, or through a new comprehensive debt-relief initiative. The former, however, would require a decision by the Executive Boards specifying general criteria for dealing with the debt of these countries to IDA and the IMF, which would need to be applied uniformly to similarly situated countries. The latter could prove time-consuming and challenging, as it would involve addressing adequately issues similar to those encountered in the design of the HIPC Initiative, including free riding concerns.

Option 2: Let the sunset clause take effect at end-2006, but allow the five remaining identified HIPCs to earn an extension of one year to meet the HIPC Initiative eligibility requirements. Under this option, Executive Directors could consider allowing the five identified HIPCs that would otherwise become ineligible for the HIPC Initiative to earn a one-year extension through starting an IMF staff-monitored program (SMP) prior to end-December 2006. Comoros, Liberia, and Sudan would have already earned this extension because they currently have SMPs in place. They would still need to start a qualifying IMF- and IDA-supported program by end-2007 to become eligible for HIPC Initiative assistance. Eritrea and Somalia, however, would run the risk of being ineligible for debt relief under this option unless they start an SMP before the end of the year.

Advantages:

- This option would give another chance to HIPCs recently emerging from conflict to meet the Initiative's policy eligibility criterion.

- The "earned" extension would provide a signal that only those HIPCs committed to reforms would eventually become eligible for HIPC Initiative debt relief.

- It would provide an incentive to countries to engage in reforms, mobilize international support, and raise the funds needed to resolve their arrears problems quickly.

Disadvantages:

- A one-year extension may not be sufficient for all identified countries to clear their arrears and start an IMF- and IDA-supported program.

- Two countries, or more, may become ineligible for HIPC Initiative relief and would be left with debt burdens significantly in excess of the Initiative's thresholds.

- This option may raise uniformity of treatment concerns, as SMPs do not have uniform standards and are not endorsed by the Fund's Board.[23]

Option 3: Extend the sunset clause for another two years to end-2008. Such an extension would only apply to the identified countries as well as to others that may be subsequently assessed to have met the income and indebtedness criteria using end-2004 data.[24] Staffs consider that Comoros, Sudan, Liberia, and Eritrea may be able to meet the policy criterion by end-2008, but that Somalia may require more time to do so.

Advantages:

- This option would allow most of the remaining countries sufficient time to start qualifying IMF- and IDA-supported programs.

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[23] In addition, this option could attach an undesirable signaling role to SMPs, which were not designed for such purpose.

[24] It would also apply to countries that meet the two criteria but not the policy-eligibility criterion and that have indicated they do not currently wish to avail themselves of the HIPC Initiative (such as Bhutan), in case they later indicate otherwise.

- Given the new deadline (end-2008), it would also provide an incentive to countries to move quickly to adopt the required program.

Disadvantages:

- It could give the impression that the Initiative is becoming a permanent facility.

- A two-year extension may not be sufficient for all identified countries (in particular Somalia) to start an IMF- and IDA-supported program. Therefore, after two years, the issue of extending the sunset clause could arise again.

- A fifth extension (and the risk that it may be extended again at a later date) could prolong moral hazard concerns (such as further accumulation of debt in anticipation of eventual debt relief).

Comments: A longer extension (five instead of two years) could also be considered, to give more time to Somalia to put in place a qualifying IMF- and IDA-supported program, although this would not eliminate the high degree of uncertainty associated with the two-year extension.

<u>Option 4: Let the sunset clause take effect and grandfather all countries that are assessed to have met the income and indebtedness criteria based on end-2004 data.</u> This option would permit these countries to qualify for HIPC Initiative debt relief at their own pace.[25] Since the list of countries that have been assessed to meet the Initiative's income and indebtedness criteria based on end-2004 data is closed, there is less need for a sunset clause.[26] Moreover, as for all other options, the cutoff dates under the MDRI (end-2003 for IDA and end-2004 for the IMF and the AfDB) provides sufficient incentives for countries to adopt reform programs quickly to be able to benefit from the maximum amount of relief under this new Initiative.[27]

Advantages:

- This option would deal with all identified countries.

- It would not create undue pressure to start an IMF- and IDA-supported program at any cost. Rather, recognizing the enormous challenge that these countries face, it allows them to move at their own pace.

- It would eliminate the possibility of repeated extensions of the sunset clause.

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[25] This option also allows countries meeting the income and indebtedness eligibility criteria, but not the policy criterion, that have indicated that they do not wish to avail themselves of the HIPC Initiative (such as Bhutan) to change their minds at any time in the future.

[26] Although the list could subsequently be amended to include other countries whose data are verified to have met the income and indebtedness criteria at end-2004.

[27] This, however, may be of limited relevance for countries with substantial arrears, where arrears clearance may result in new obligations after the current cut-off dates.

Disadvantages:

- It may weaken incentives for countries to move quickly through the HIPC process and may prolong moral hazard concerns.

- It could be perceived as keeping the Initiative open indefinitely.

Option 5: Let the sunset clause take effect and grandfather all countries that are assessed to have met the income and indebtedness criteria using end-2004 data, but limit the debt subject to debt relief as of a given cutoff date (end-2006). Under this option, only the debt outstanding and disbursed as of a given cutoff date—end-2006—would be eligible for debt relief under the Initiative. This option would be applicable to all countries that have not yet reached their decision points, including those that already met the Initiative's policy eligibility criterion.[28]

Advantages

- This option would eliminate the moral hazard issue (a shared concern in all the previous options).

- Similar to option 3, it would deal with all countries and eliminate the need for a further sunset clause extension.

Disadvantages

- It may result in debt relief that is insufficient to bring the debt ratios to the HIPC

Initiative's thresholds at the decision point, thus undermining one of the main principles of the Initiative.

- It would not deal effectively with countries with substantial arrears, where arrears clearance may result in new obligations after the cutoff date.

- It would require a reconsideration of the policy regarding possible topping-up assistance at the completion point.

- It would constitute a departure from past practice, treating differently countries that reached their decision points before and after end-2006.

- It may create incentives for creditors to lend to HIPCs after the cutoff, exacerbating free riding concerns and violating the Initiative's equitable burden-sharing principle.

[28] This option could be implemented in various ways, depending on the parameters chosen to calculate the debt relief at the decision point.

Annex Table. Estimated Costs of HIPC Initiative Debt Relief under the Different Options 1/

(In billions of U.S. dollars, in end-December 2005 NPV terms)

	Cost related to the different options 2/				Countries that have reached decision point
	Option 1 4/ (6 countries)	Option 2 5/ (9 countries)	Option 3 6/ (10 countries)	Option 4 7/ (11 countries)	(29 countries)
Total costs	**5.5**	**19.9**	**20.2**	**21.9**	**41.3**
Official bilateral creditors	**2.2**	**10.6**	**10.7**	**11.5**	**19.0**
Paris Club	1.9	6.5	6.5	7.1	15.2
Other official bilateral	0.3	4.1	4.2	4.4	3.8
Commercial creditors	**0.8**	**1.8**	**1.8**	**1.8**	**1.5**
Multilateral creditors	**2.6**	**7.4**	**7.6**	**8.6**	**20.7**
World Bank	1.3	2.6	2.8	3.1	9.8
IMF 3/	0.2	2.2	2.2	2.5	3.1
AfDB Group	0.4	0.9	0.9	1.0	3.5
AsDB	0.4	0.4	0.4	0.4	0.0
Other	0.3	1.3	1.3	1.6	4.3

Sources: Country authorities, multilateral creditors, Paris Club Secretariat, Global Development Finance, and IMF and IDA staff estimates.

1/ Based on the estimates presented in the documents "Heavily Indebted Poor Countries (HIPC) Initiative - Statistical Update," March 27, 2006 and "Heavily Indebted Poor Countries (HIPC Initiative)—List of Ring-Fenced Countries that Meet the Income and Indebtedness Criteria at end-2004," April 12, 2006.

2/ Refers to the estimated cost for the 11 countries that have been assessed to meet the Initiative's income and indebtedness criteria based on end-2004 data and that might wish to be considered for HIPC Initiative debt relief.

3/ Additional financing for the Fund is needed for Haiti, Kyrgyz Republic, Liberia, Nepal, Somalia, Sudan, and possibly Eritrea.

4/ Includes the Central African Republic, Cote d'Ivoire, Haiti, the Kyrgyz Republic, Nepal, and Togo.

5/ Includes all countries under Option 1, plus Comoros, Liberia, and Sudan.

6/ Includes all countries under Option 2, plus Eritrea.

7/ Includes all countries under Option 3, plus Somalia.