

RESULTS OF INTERNATIONAL DEBT RELIEF IN ZAMBIA

CASE STUDY FOR THE IOB EVALUATION OF DUTCH DEBT RELIEF

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PREFACE

This report contains the findings of one of the eight country case studies that were undertaken in the context of an evaluation study of Dutch debt relief during the period 1990-1999, conducted by the Policy and Operations Evaluation Department (IOB) of the Netherlands' Ministry of Foreign Affairs. As the results of Dutch contributions to debt relief cannot be distinguished from the effects produced by contributions from other donors and creditors, the eight country studies analyse the results of the combined efforts of all actors.

The research was carried out – in close consultation with the chief consultant for the evaluation, Dr. A.G. Dijkstra – by Ms. M.E. Lindner of ETC Crystal, who is responsible for the contents of this report. It is published in the series of IOB 'Working Documents', comprising consultant studies of interest to a wider public.

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ABBREVIATIONS

AfDB	African Development Bank
BoP(S)	Balance of Payments (Support)
BoZ	Bank of Zambia
DGIS	Directorate General for International Co-operation
DfID	Department for International Development
DRF	Debt Reduction Facility
ERIP	Economic Recovery and Investment Promotion
ESAC	Economic and Social Adjustment Credit
ESAF	Enhanced Structural Adjustment Facility
FDI	Foreign Direct Investment
GDF	Global Development Finance
GDP	Gross Domestic Product
GNP	Gross National Product
GoZ	Government of Zambia
HIPC	Highly Indebted Poor Countries
IBRD	International Bank for Reconstruction and Development
IDA	International Development Association
IFIs	International Financial Institutions
IMF	International Monetary Fund
MMD	Movement for Multi-Party Democracy
MoF	Ministry of Finance
NGO	Non Governmental Organisation
NIO	Netherlands Investment Organisation
NPV	Net Present Value
ODA	Official Development Assistance
OGL	Open General License
PA	Programme Aid
PC	Paris Club
PIRC	Privatisation and Industrial Reorientation Credit
PNG	Private Non-Guaranteed
PPG	Public and Publicly-Guaranteed
PRGF	Poverty Reduction and Growth Facility
PRSP	Poverty Reduction Strategy Paper
RAP	Rights Accumulation Programme
ZCCM	Zambia Consolidated Copper Mines

EXECUTIVE SUMMARY

This country case study assesses the results of debt relief in Zambia in the period 1990-1999. It examines the effects of debt relief provided by all creditors, and also provides insight in the role and effects of Dutch debt relief. This report addresses three questions: (i) To what extent were debt relief inputs in the form of financial and political interventions efficient in generating outputs, including a reduction in the debt stock (stock effect), a reduction in actual debt service (flow effect), effects on internal and external accounts (increases in imports and government expenditure), and changes in government policy?; (ii) To what extent were debt relief outputs effective in producing desired outcomes, such as increased debt sustainability, improved investment and creditworthiness, and improved social indicators?; and (iii) To what extent were debt relief outcomes relevant by impacting on economic growth and poverty reduction? Before addressing these questions, the report starts with an analysis of the build-up of the debt problem during the 1970s and 1980s and the resulting debt situation at the start of the evaluation period in 1990, and provides an overview of debt relief inputs in the 1990s.

Buildup of the debt problem 1970-1990

Zambia's debt stock started to grow rapidly from the mid-1970s onwards, from USD 1,200 million in 1975 to USD 3,200 million in 1980 and USD 6,700 million in 1990. Various economic and political factors contributed to the development of the debt problem to unsustainable levels, including unsustainable economic policies with heavy state control of the economy, high dependence on copper exports, and failure to adjust the economy in the wake of the collapse of the copper price later in the 1970s. During the period 1976-1986 several half-hearted attempts at reform were undertaken under International Monetary Fund (IMF) and World Bank structural adjustment programmes, each of which was abandoned. After more than a decade of economic decline, the economy was in a dismal state at the end of the 1980s, with low or negative economic growth, very high inflation and high government deficits. International Finance Institution (IFI) and donor financing had led to a sharp increase in the country's debt while both stabilisation and reform failed.

Zambia entered the 1990s with a highly unsustainable debt burden. Liquidity problems were reflected in very high arrears (USD 2,300 million in 1990, or over 40% of total long-term and IMF debt) rather than a high debt service ratio, while solvency problems were reflected in high debt-to-Gross National Product (GNP) and debt-to-exports ratios in 1990 standing at 225% and 500% respectively. Bilateral debt was twice as high as multilateral debt excluding IMF. However, when adding the substantial IMF debt, multilateral debt including IMF (USD 2,300 million or 43% of long-term and IMF debt) approached the level of bilateral debt (USD 2,700 million or 49% of long-term and IMF debt). Commercial debt had declined substantially to 10% of long-term and IMF debt in 1990. By 1990 Zambia could no longer pay its debt service obligations. The massive build-up of arrears included arrears to IMF and World Bank, barring the country from access to much foreign aid. This compounded the severe economic problems Zambia already experienced since the mid-1970s.

Debt relief inputs in the 1990s

During the 1990s Zambia benefited from a variety of debt relief arrangements. Relief on bilateral debt was provided through four Paris Club (PC) relief operations. Relief on multilateral debt was provided through specific debt relief and lending operations to settle arrears with the World Bank and the IMF (the latter through a Rights Accumulation Programme or RAP), and through the Fifth Dimension Facility whereby bilateral donors

provided relief on International Bank for Reconstruction and Development (IBRD) interest payments. Relief on commercial debt was provided by means of a commercial debt buy-back through the Debt Reduction Facility (DRF). In 2000, after the evaluation period, debt relief under the Heavily Indebted Poor Countries (HIPC) Initiative was agreed, focusing on the multilateral debt burden. Total debt relief according to Global Development Finance (GDF) data during the 1990s amounted to USD 3,800 million, of which USD 2,300 was rescheduling, USD 1,100 million was forgiveness, and USD 500 million was debt stock reduction. This figure does not include relief on multilateral debt through the Fifth Dimension and programmes to settle IMF and World Bank arrears. Debt relief focused on both bilateral and multilateral debt. However, multilateral relief was concentrated in the first half of the decade, with none provided after 1995, despite increased importance of the multilateral debt burden. Generally debt relief decreased substantially in the second half of the decade along with other aid, as donors grew increasingly dissatisfied with policy implementation and governance issues.

Dutch debt relief to Zambia during the 1990s amounted to about USD 70 million (NLG 137 million), all of which was provided in the first half of the decade. Almost two-thirds of it was allocated to bilateral debt relief and 30% to multilateral relief. After the evaluation period the Netherlands provided an additional USD 20 million to the HIPC Trust Fund for Zambia. A substantial part but not all of the Dutch relief was additional to Dutch aid flows to Zambia. The Netherlands co-operated as part of a broader group of donors concerned about the debt problem, but did not play a leading role in tackling the debt problem, especially where it related to multilateral debt.

In addition to debt relief Zambia received large amounts of foreign aid during the 1990s, amounting to USD 650 million per year excluding IMF loans. Aid was provided in support of the reform programme, which started after a new government came to power in 1991 through democratic elections on a platform of radical reform. As bilateral aid was mostly in the form of grants, the bulk of lending originated from multilateral creditors, especially the World Bank/International Development Association (IDA). In addition, the IMF also provided substantial loans. An increase in multilateral debt during the 1990s resulted. Overall, loans became more concessional. The Netherlands was not a major donor of programme aid to Zambia. Its role in providing debt relief funds was more pronounced.

Conditionality attached to debt relief consisted of the existence of an appropriate economic programme supported by the IFIs which demonstrated the need for debt relief, and adherence to the policy measures and benchmarks described therein and to an agreed debt service payment schedule. Governance issues became more important in the second half the 1990s, and were particularly insisted upon by bilateral donors. As part of social conditionality at least one-third of government expenditure (excluding interest payments) needed to be allocated to the social sectors.

Outputs of debt relief: Efficiency

Debt relief led to a reduction in the debt stock. PC debt relief had a stock effect through its forgiveness component, part of which was used to settle arrears; on the other hand, the stock effect was restricted by the fact that a substantial part of PC debt relief concerned rescheduling. There was some stock effect of multilateral debt relief, but this was largely confined to the effect of the settlement of World Bank arrears early in the decade. The commercial debt buyback was very effective in reducing the commercial debt stock. Nevertheless, as commercial debt constituted only a limited proportion of total debt this did not have a major effect on the total debt stock. The total nominal debt stock stabilised in the 1990s and was somewhat lower than its 1990 level in most years. This was the result of a combination of an increase in long-term and IMF debt, largely due to substantial new lending by IMF and World Bank, and a decline in short-term debt. At the

same time, as forgiveness and debt stock reduction amounted to a considerable proportion (one-third) of the 1999 long-term debt stock, and new loans were contracted on very concessional terms, the Net Present Value (NPV) of the debt stock probably declined. HIPC debt relief, to which Zambia gained access only after the evaluation period, is expected to result in a substantial stock effect.

Debt relief had a modest flow effect. At the same time, it was additional to other aid. While debt service paid on long-term and IMF debt stood at a higher level than in the second half of the 1980s, it showed a declining trend during the 1990s. However, this probably reflects an increase in grants (bilateral donors) and improved concessionality of loans (multilateral creditors) rather than a flow effect. PC debt relief resulted only in a modest flow effect, as part of the operation involved settlement of arrears and as arrears probably would have accumulated in the absence of agreements. At the same time, PC agreements involved more rescheduling than forgiveness. As a result, actual bilateral debt service went up during the 1990s, while multilateral debt service paid, decreased. This mainly reflected increased concessionality of multilateral loans. As a substantial part of multilateral debt relief involved settlement of arrears and rescheduling, this did not lead to a direct flow effect. On the other hand, Fifth Dimension relief, while not leading to a reduction in debt service paid, did relieve its burden and had an important flow effect. Terms of the IMF loans in the mid-1990s led to low debt service payments on these loans, but will translate into a high increase in debt service after 2000. No flow effect resulted from the commercial debt buyback. Debt relief resulted in a larger decline in debt service due than that in debt service paid. HIPC is expected to have a substantial flow effect after the evaluation period. Bailing out of multilateral creditors by bilateral donors took place.

With regard to the external accounts, while imports did not increase because of declining exports and aid flows, aid including debt relief did allow imports to be sustained at a higher level than would have been possible without these resource inflows. Further, it allowed the country to maintain debt service payments as a prerequisite for further donor support. It benefited both the import of investment goods and that of consumption goods. As the latter does not appear to have been a major cause for concern, overall the trend in the composition of imports was favourable to promoting economic growth.

With regard to the government accounts, aid including debt relief allowed public expenditure to be higher than would have been possible without aid and debt relief, and government deficits would have been higher without it. As such it helped to sustain public investment, although this may to a large extent have been due to project aid. Aid including debt relief and social conditionality helped to maintain social expenditure at a higher level than would otherwise have been possible, keeping social expenditure at one third of total government expenditure (excluding interest payments). Nevertheless, this could not prevent the stagnation of social expenditure as a proportion of Gross Domestic Product (GDP) in the face of a general expenditure squeeze. Further, inflation and inflationary financing, while they continued to be high, would have been higher without aid and debt relief.

Donors exercised influence on policy through conditionality and the policy dialogue. Most of the reforms that were implemented were those supported by donors. On the other hand, many planned reforms were slowly or not properly implemented. Withdrawal of support in reaction to non-compliance with targets was less frequently applied with regard to economic reforms than in relation to problems in the area of governance. While bilateral donors followed the lead of the IFIs with regard to economic policy, in the area of governance and political reforms they took a more independent and leading stance. Donors became increasingly disillusioned with Zambia, as expressed in substantial cut-backs in aid after 1995, especially related to governance problems.

Outcomes of debt relief: Effectiveness

Developments in liquidity indicators indicated improved debt sustainability during the 1990s. A large cutback of arrears took place, made possible by large amounts of aid including debt relief. At the same time some improvement in the debt service ratio occurred, which was driven by a reduction in debt service paid and took place despite negative developments in exports; this was partly due to a positive flow effect, as well as to a grace period in IMF lending. Nevertheless, the liquidity situation did not yet reach sustainable levels. Arrears remained high (USD 800 million in 1998, USD 200 million in 1999) and the debt service ratio amounted to more than 20% most of the decade, although it showed an improving trend in the second half. The HIPC initiative aims to achieve sustainable liquidity indicators. Zambia continued to have serious long-term sustainability problems during the 1990s. Solvency indicators remained very high (debt-to-GNP ratio 200-250%, debt-to-exports ratio 550-600%). This was due to the fact that despite a stock effect of debt relief, the debt stock remained very high because of substantial new multilateral lending, while adverse performance of the export sector also contributed. HIPC is expected to have a substantial stock effect, and the NPV of debt-to-exports ratio is expected to reach a sustainable level.

The private investment record in Zambia was not favourable. The continued debt overhang was one of the factors impacting on this development, as the debt stock remained very high despite a substantial reduction as a result of debt relief. Other factors also played a role, including problems in the design of reform programmes, lack of credibility of government policies and commitment to the reform programme, as well as the dismal economic situation. Nevertheless, public investment benefited from extra resources brought by aid and debt relief, without which it would have been lower. Aid and debt relief also eased the foreign exchange shortage, positively impacting on imports, and through this on investment. Evidence with regard to developments in creditworthiness was mixed. Inasmuch as it indicated a lack of creditworthiness, it was not clear to what extent this was caused by the high debt overhang. Factors such as credibility of government policies and government commitment to reforms, as well as the continued bad economic performance, compounded by a decline in donor support, may have been more important factors.

Developments in social indicators showed a mixed record. Overall social indicators remained at a very low level and failed to recover from the severe decline they experienced during the 1980s. Although it is difficult to establish a direct link from debt relief to trends in social indicators, aid and debt relief through its flow effect and social conditionality are likely to have allowed higher government expenditure than would otherwise have been possible, and as such to have contributed – albeit to a limited extent – to an increase in expenditure layouts to the social sectors. However, other factors prevented this from leading to a substantial improvement in social indicators, including a public expenditure squeeze resulting in stagnating or declining real social expenditures, declining output of social services, and a failure to properly redirect spending to services for the poor, among other things.

Impact of debt relief: Relevance

Economic performance continued to be weak in the 1990s. Aid including debt relief through its flow effect probably made some contribution to growth by freeing resources for public investment and imports, and easing the foreign exchange shortage. It also allowed a reduction of arrears and continued debt service payments, without which agreement on adjustment programmes and access to foreign loans could not have been obtained. The continued high debt overhang, despite a substantial stock effect from debt relief, was not conducive to improvement of the private investment record, which remained weak and

hence did not serve as a major factor driving growth. Economic reforms which were part of conditionality affected growth, although not always in the desired way. A particular problem related to the alleged inadequate sequencing of reforms, leading to higher inflation at the same time that a great expenditure squeeze was brought about, negatively impacting on growth. Nevertheless, there was evidence of substantial structural change and removal of distortions in the economy. Other factors which negatively affected growth included doubts about government commitment to the reforms and credibility of government policies; problems in the area of governance; the resulting strained relations with donors and a decline in aid and debt relief after 1995; and adverse external developments such as a decline in the copper price and drought.

Poverty stood at a high level and increased somewhat during the evaluation period. This development was partly related to the fact that social indicators remained at low levels. Still, there were indications that aid and debt relief, through the flow effect, allowed public expenditure including social sector spending to be higher than it would otherwise have been, and that it may have played a limited role in preventing social indicators from deteriorating even further. Weak private investment and economic growth did not contribute to poverty reduction, although it can be argued that without aid this performance would have been even worse. Continued high inflation disproportionately affected the poor. Social conditionality appeared to have played a role in maintaining social expenditure. However, social safety nets which were part of the reform programmes do not appear to have had the desired effect. In general, insufficient attention to poverty reduction issues was given in government and donor policies until changes occurred later in the decade with the advent of HIPC. Poverty increased in urban areas and decreased in rural areas, but the incidence of poverty remained far higher in rural areas. On the positive side, the proportion of extremely poor declined, while the income distribution became somewhat more equitable. Overall, Zambia's poverty situation remained very dire, with almost three-quarters of the population considered poor and one-third extremely poor.

1 BACKGROUND: DEBT PROBLEM ANALYSIS 1970-1990

This chapter provides an introduction to Zambia's debt problem. It provides an overview of the build up of the debt problem since the 1970s, and addresses the nature, causes and consequences of the debt problem as it manifested itself in 1990, i.e. at the start of the evaluation period.

1.1 Background and causes of the debt problem

The massive build up of Zambia's external debt started in the mid-1970s. The total debt stock increased from USD 1,200 million in 1975 to USD 3,200 million in 1980, and further to USD 6,900 million in 1990 (World Bank 2001-a). Various economic and political factors contributed to the development of Zambia's debt problem to unsustainable levels.

Zambia's economic development is closely linked to copper. At independence in 1964 copper and related mining activities accounted for 40% of the Gross Domestic Product (GDP) (White and Edstrand 1998). Copper accounted for over 90% of export receipts over the past decades. The first decade after independence the Zambian economy performed well with an annual GDP growth rate of 2.4% (IMF 1993). In the late 1960s the government started to build an economy based on heavy state control. Most productive sectors became centrally controlled, industries were nationalised and government intervention became pervasive. Focus was on the expansion of import substituting manufacturing industries. At the same time the development of the agricultural sector lagged behind. Expansion of the government sector and high social spending were financed by the copper boom.

Zambia's approach to economic development which relied on state-control became inviable when in the second half of the 1970s the world market price for copper collapsed, resulting in severe deterioration of the terms of trade. The government-based economy became strained as tax revenues declined, leading to a large fall in per capita gross income. At the same time, an inefficient and loss-making parastatal sector drained the public budget. In 1976 Zambia sought assistance from the International Monetary Fund (IMF) for the first time. However, as it was assumed that the drop in copper price was a temporary phenomenon, no proper adjustment to face the economic crisis was undertaken. As the government stepped up controls in response to the crisis, inefficiencies deepened. Despite the drop in income, consumption was maintained through extensive external borrowing, and went at the expense of savings and investment that saw a substantial decline.

Between 1976 and 1986 a range of mostly half-hearted attempts at reforms were undertaken through a series of IMF and World Bank-supported adjustment programmes, each of which was abandoned. An overview of these programmes in the 1970s and 1980s is provided in Table 1-1. Economic policy mostly concentrated on stabilisation of the economy through demand contraction (expenditure reduction), while in the latter years structural reforms were targeted at, the most important of which were the exchange rate and price liberalisation. These reforms collapsed in 1987, and the economy reverted back to controls and rationing, while the budget deficit rose to 18% of GDP.

Table 1-1 IMF and World Bank-supported programmes in the 1970s and 1980s

Year	IMF	World Bank
1976	Stand-by agreement	IBRD Programme loan
1978	Stand-by agreement	
1981	Extended Fund Facility: Broke down 1982	
1983	Stand-by agreement: Not fully used because of debt payment arrears	
1984	Stand-by agreement: Suspended in 1985 because of debt arrears	IBRD Export Rehabilitation and Diversification Loan
1985		IDA/IBRD Agricultural Rehabilitation project
1985		IDA Industrial Reorientation Credit
1986	Stand-by agreement (24 months): Suspended when auction reform abandoned in May 1987	IDA Economic Recovery Credit: Suspended in 1987 when auction abandoned; completed in 1991

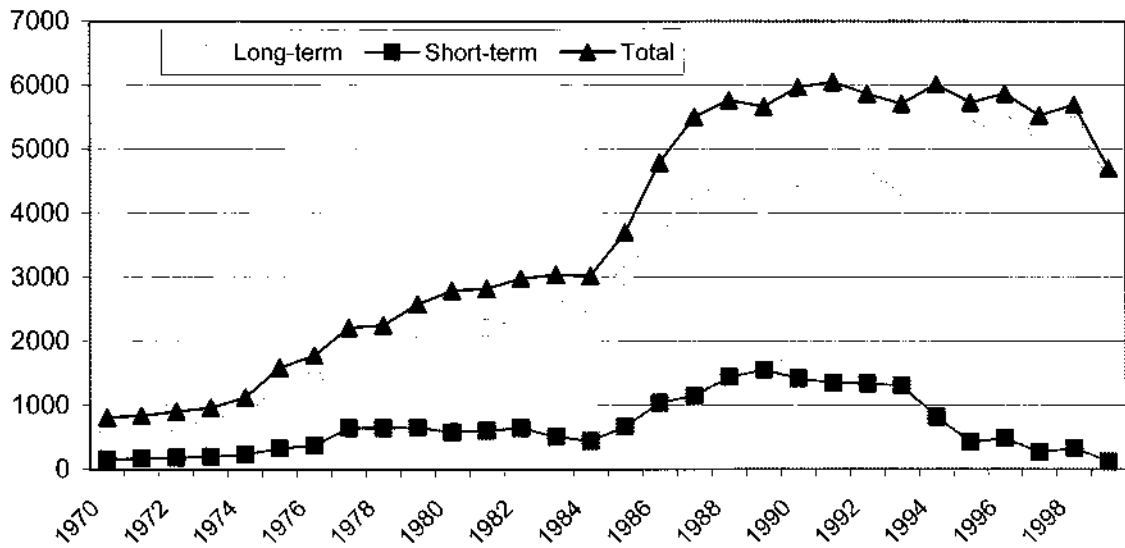
Overall, between 1976 and 1986 the government did not strongly support liberalisation. During this period per capita GDP declined by one-fourth (Botchwey e.a. 1998). Financing by the International Financial Institutions (IFIs) and other donors led to a sharp increase in the country's external debt while both stabilisation and adjustment failed. The 1987 collapse of reforms caused a major break, and no lending by the IFIs took place until 1991. In 1989 the Kaunda government did approach the IFIs again with an adjustment strategy focusing on liberalisation of the economy. However, while formally most price controls were lifted, informally they continued. Although parastatals were restructured, no privatisation was pursued, and the government remained the dominant player in the economy (IMF 1993).

In tandem with the above-mentioned developments, Zambia experienced a severe economic decline throughout the 1970s and 1980s. Between 1975 and 1990, real per capita consumption fell by two thirds (White 1999). At the end of the 1980s, Zambia had a stagnating economy, a very high budget deficit, and accelerating inflation (increasing from double to triple digit figures, or 129% in 1989).

1.2 Buildup and composition of Zambia's debt

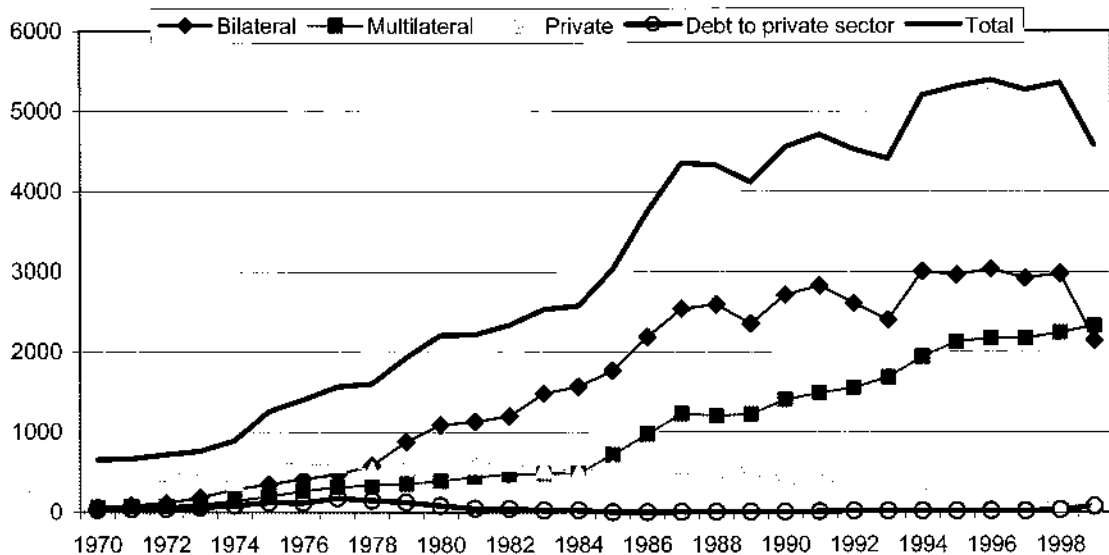
Zambia's total debt stock started at a relatively modest level in the early 1970s as it grew from USD 800 million in 1970 to USD 1,200 million in 1975. Thereafter it increased sharply to USD 3,200 million in 1980 and USD 6,900 million in 1990 (World Bank 2001-a) (Figure 1-1). Long-term debt rose from about USD 800 million in 1975 to USD 2,200 million in 1980 and USD 4,600 million in 1990. IMF debt grew rapidly from about USD 100 million in 1977 to USD 780 million in 1981, on to a level of about USD 900 million later in the 1980s. Short-term debt also grew substantially, from less than USD 200 million in the early 1970s to almost USD 600 million in 1980 and USD 1,400 million in 1990, surpassing IMF debt in the mid-1980s. Long-term debt as a proportion of total debt remained steady between 60% and 70% during the 1980s, while IMF debt and short-term debt each ranged between 14% and 22% of total debt.

Figure 1-1 The debt stock: long-term and short-term debt (USD million)



With regard to the composition of long-term debt, virtually all long-term debt consisted of public and publicly guaranteed (PPG) debt (Figure 1-2). In the period 1970-1990 bilateral debt was the most important debt component. It rose from less than USD 100 million in 1970 to USD 1,100 million in 1980, and USD 2,700 million in 1990. In 1990 Paris Club (PC) debt accounted for half of long-term debt, and more than three-quarters of bilateral debt (IMF 2000-b). The amount of multilateral debt (excluding IMF) was considerably lower than bilateral debt. Nevertheless it was substantial and also grew rapidly from less than USD 100 million in 1970 to USD 400 million in 1980, and further to USD 1,400 million in 1990, at which point it amounted to half of bilateral debt. Commercial long-term debt had built up mostly during the 1970s, when part of private inflows were used to sustain consumption; it stood at about USD 500-600 million during the 1970s and 1980s.

Figure 1-2 Composition of the long-term debt stock, to government by creditor and to private sector (USD million)



The importance of the multilateral debt burden becomes more pronounced when IMF debt is added. IMF debt stood at about 20% of long-term and IMF debt combined in the 1980s. Total multilateral debt including IMF debt reached USD 2,300 million in 1990, approaching the level of bilateral debt which stood at USD 2,700 million in the same year. IMF debt constituted the biggest component of multilateral debt in the first half of the 1980s, namely about 53%-64%. Its share of multilateral debt declined from 53% in 1985 to 40% in 1990, but it still remained the largest multilateral debt component. IBRD and IDA debt was about one-third of multilateral debt during the 1980s. The bulk of World Bank debt was hard window debt owed to the IBRD. IDA (soft window) debt became more important in the second half the 1980s, but still accounted for only 30% of World Bank debt, or 5% of total long-term debt, while IBRD debt accounted for 12-16% of long-term debt. Other (non-IMF and non-World Bank) multilateral debt increased from 5% of total multilateral debt (or USD 46 million) in 1980 to 25% (almost USD 600 million) in 1990.

In percentage terms, in 1980 41% of long-term and IMF debt combined was bilateral debt, and only 15% was multilateral debt (excluding IMF). In 1990 the corresponding figures were 50% and 25% respectively. Hence the amount of multilateral debt (excluding IMF debt) was half the amount of bilateral debt. However, multilateral debt including IMF amounted to 32% of total long-term and IMF debt combined in 1980, which increased to 43% in 1990. The share of commercial long-term debt declined from about one third of total long-term and IMF debt in 1977 to one quarter in 1980 and 10% at the end of the 1980s.

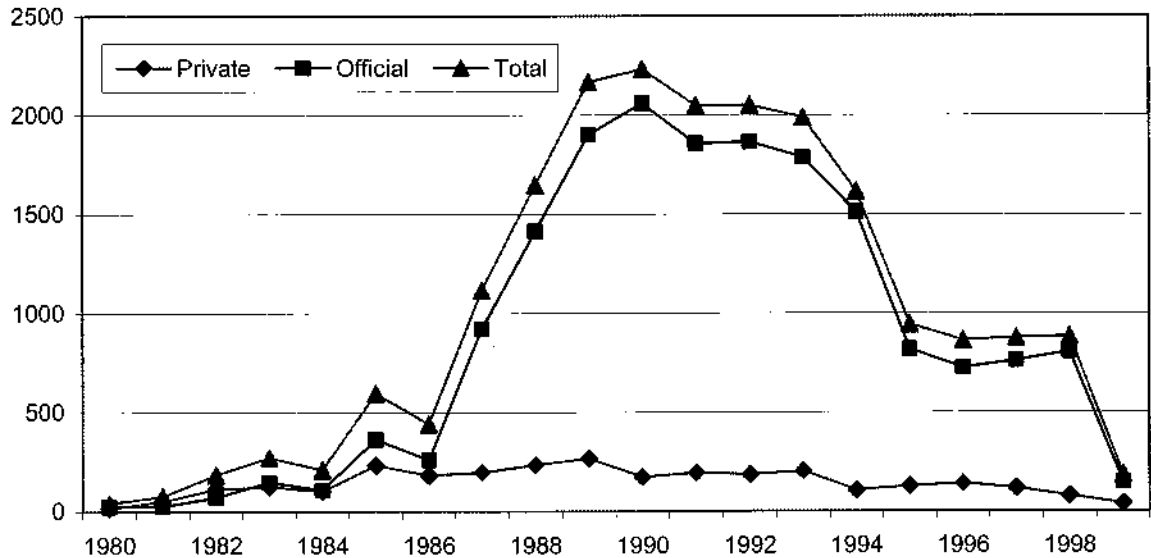
In the early 1980s heavy lending took place by IMF and IBRD on non-concessional terms. From the mid-1980s onwards lending became more concessional, with a shift from IBRD to IDA loans, while bilateral donors started to increase grant disbursements. At the same time, while concessional debt increased from USD 50 million in 1970 to USD 800 million in 1980 and more than USD 2,000 million in 1990, as a proportion of total long-term debt it did not change much during the 1980s, remaining at a relatively low level of 25%.

Average interest rates on new loans for all creditors fluctuated substantially during the 1980s (between 2.5% and 9.2%), amounting to an annual average of 6%, against an average of 7% in the 1970s. Interest rates on official loans amounted to an annual average of 4% during the 1980s, and that on commercial loans 11%.

Figure 1-3 shows the massive buildup of arrears during the 1980s, especially after 1985. While in 1980 arrears on long-term debt were USD 39 million, they had increased to almost USD 600 million mid-decade and reached a peak of USD 2,200 million in 1990. The bulk consisted of arrears on debt service to official creditors, which accounted for about 60% of total arrears in the first half of the decade, and increased to over 90% in 1990. Arrears were built up against debt owed to all types of creditors, including IMF and World Bank.

Three external debt relief operations by the PC took place before 1990. In 1983 an amount of USD 380 million was treated, in 1984 USD 207 million, and in 1986 USD 547 million. All three operations were on classic terms, whereby eligible credits were rescheduled at the prevailing market rate on a case-by-case basis, and with a specific repayment profile for the country. The Netherlands was a participating creditor in the relief operations of 1984 and 1986.

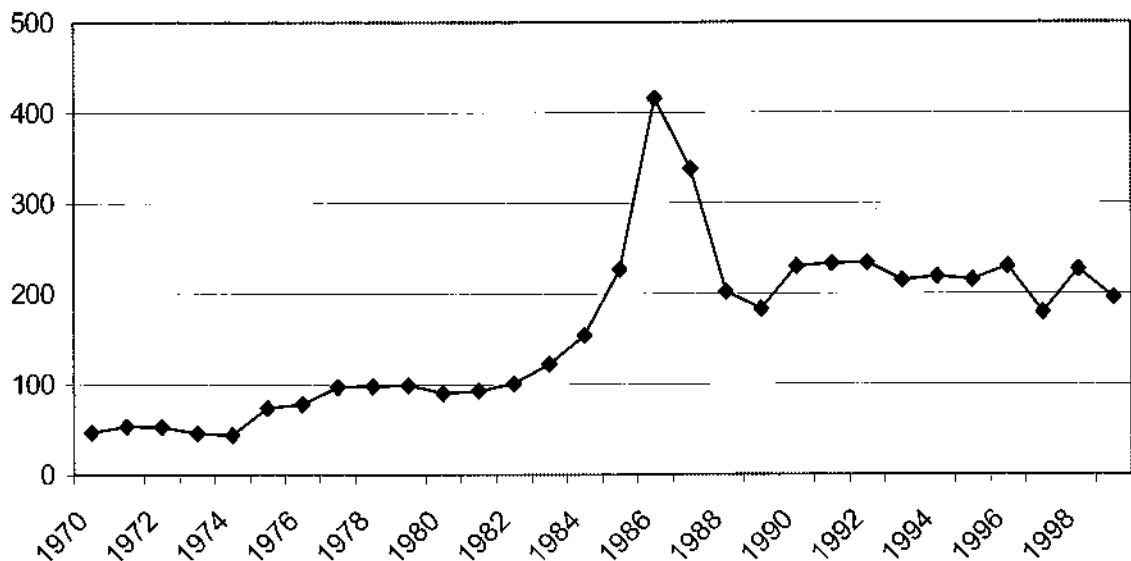
Figure 1-3 Arrears (USD million)



1.3 Nature and consequences of the debt problem

Long-term debt sustainability can be measured by solvency indicators such as the debt-to-GNP ratio and the debt-to-exports ratio. According to the debt to GNP ratio, the debt became unsustainable since the mid-1970s when it exceeded the 50% sustainability threshold as established by Cohen (Cohen 1997). In 1980 the ratio amounted to almost 100%, after which it skyrocketed to a completely unsustainable level of over 400% in 1986 in conjunction with massive IMF and World Bank lending (Figure 1-4). After this the ratio dropped to about 225% in 1990, still a highly unsustainable level. The debt to exports ratio showed a similar pattern (Figure 1-5). According to this indicator debt was unsustainable throughout the 1980s, as it increased from the sustainability threshold of 200% in 1980 to a peak of almost 800% in 1986, after which it declined to the still highly unsustainable level of 500% in 1990.

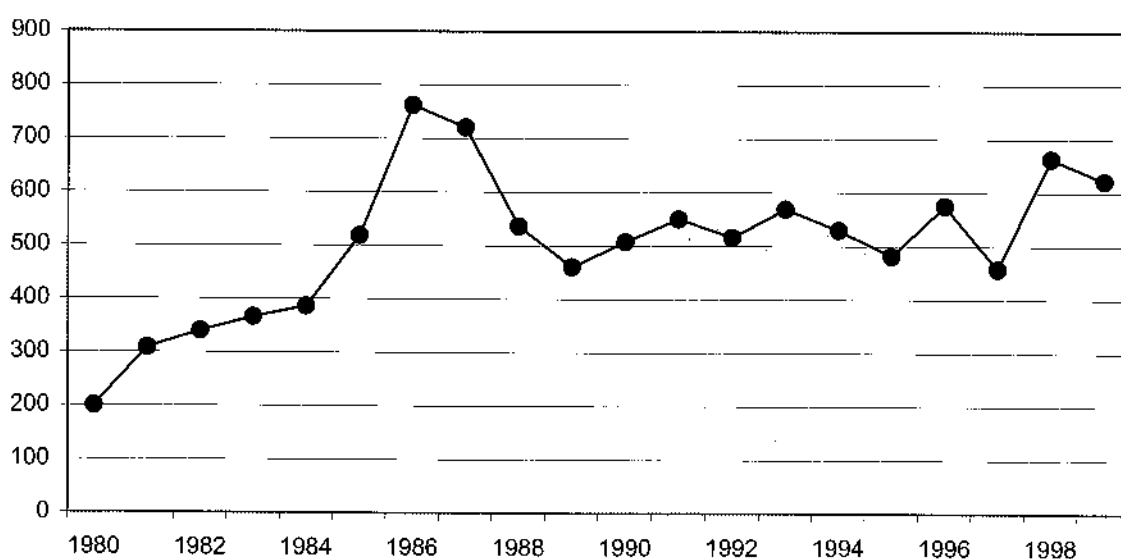
Figure 1-4. Debt-to-GNP ratio (per cent)



The trends in both debt-to-GNP and debt-to-exports ratios were driven as much by an increase in the debt stock (the nominator) as by the developments in GNP and exports (the denominator). The growth of GNP and exports (measured as five-year rolling averages, based on current dollar prices) was negative during the period 1984-1988, reaching the lowest point in 1985-86, and became positive only from 1988 onwards, which contributed to a decrease in the debt solvency indicators.

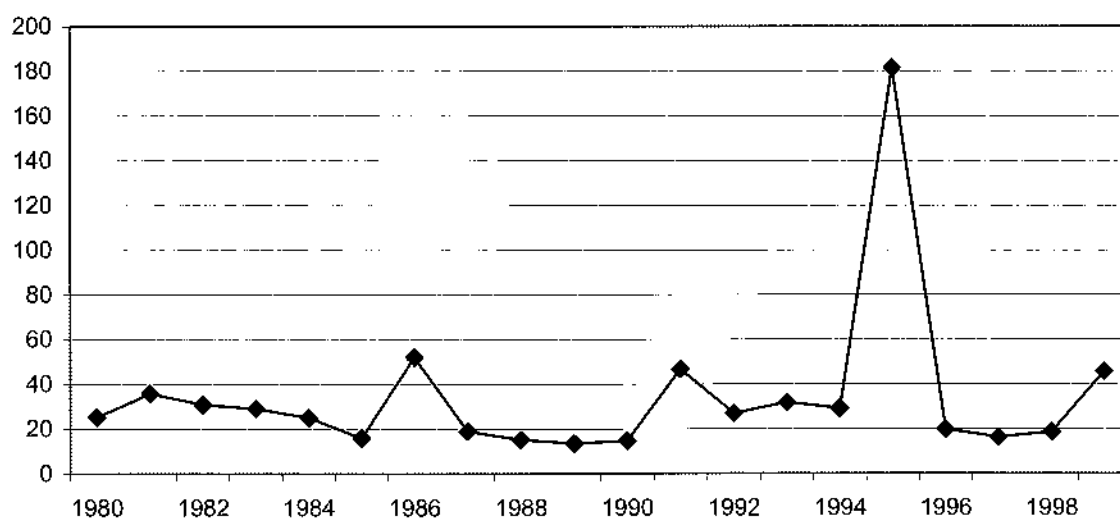
Indicators used to measure the extent to which liquidity problems (i.e. temporary payment problems) exist, include the debt service-to-exports ratio (debt service ratio) and the extent to which arrears are built up. Values for the debt service ratio indicated that liquidity problems existed before 1990, although these seemed less severe than the solvency problem. The debt service ratio declined from almost 40% in 1981 to under the sustainability threshold 20% in 1985, then showed an isolated peak level of almost 60% in 1986, and again dropped below 20% in the last years of the 1980s (Figure 1-6). As export growth (in current dollar prices) was negative, this improvement was due to a decline in debt service payments on long-term and IMF debt from over USD 400 million in 1980 to USD 140 million in 1985, while after an isolated peak of USD 400 million in 1986 they remained relatively low at the end of the 1980s at about USD 180 million per year.

Figure 1-5 Debt-to-export ratio 1980-1999 (per cent)



The low level of the debt service paid was accompanied by a rapid accumulation of arrears to USD 2,200 million in 1990, signalling a serious liquidity problem. This is further illustrated by the increase of arrears as a proportion of total long-term and IMF debt from a negligible level in 1980 to 40% in 1990.

Figure 1-6 Debt service paid (including IMF)-to-export ratio (per cent)



Net transfers on debt¹ were positive – although heavily fluctuating – during most of the 1980s. This reflected the substantial (albeit declining) amount of loans contracted by Zambia until 1987, combined with a simultaneous reduction of debt service as arrears built up. As lending decreased at the end of the 1980s, after the breakdown of the structural adjustment programme and the suspension of lending by the IMF, net transfers on debt became negative, even while arrears on debt service payments escalated. Aggregate net transfers² also fluctuated substantially without showing a clear trend, and were positive throughout the 1980s. They were below net transfers on debt in the 1970s, but exceeded them during most of the 1980s. This coincided with an increase in grants, as well as – to a lesser extent – in foreign direct investment.

Zambia's debt situation was unsustainable throughout the late 1970s and the 1980s. The country entered the 1990s with a severe liquidity problem that was reflected in the build up of arrears rather than an unsustainable debt service ratio. At the same time, foreign exchange remained very scarce. While lending decreased and net transfers on debt became negative, grants increased, contributing to positive aggregate net transfers. In this context, imports and public expenditure could be sustained, albeit at minimal levels. The economy continued to stagnate with negative or barely positive growth rates. At the end of the 1980s Zambia also experienced serious solvency problems expressed in high debt-to-GNP and debt-to-exports ratios. Although foreign direct investment increased in the second half of the 1980s, overall private investment remained at a low level. While many factors harmed investment, such as the lack of growth and weak policies, low investment seemed at least partly related to the debt overhang and the lack of creditworthiness of the Zambian economy.

¹ Net transfers on debt = loan disbursements - debt service payments.

² Aggregate net transfers = loan disbursements + Foreign Direct Investment (FDI) + portfolio equity flows (zero in the case of Zambia) + official grants - (principal repayments + loan interest + FDI profits)

1.4 Conclusions

In 1990, at the start of the evaluation period, Zambia's debt stood at a very high level, amounting to almost USD 7000 million. While bilateral debt was twice as high as multilateral debt excluding debt to the IMF, a different picture emerges when IMF debt is added, showing the importance of the overall multilateral debt burden. IMF debt stood at a high level amounting to about 20% of total long-term and IMF debt in 1990. As a result, in 1990 multilateral debt including IMF debt stood at USD 2,300 million (43% of total long-term and IMF debt), thereby approaching the level of bilateral debt, which stood at USD 2,700 million (49% of total long-term and IMF debt). Commercial debt constituted a limited part of total debt as it declined from one-third of long-term and IMF debt in the 1970s to 10% in 1990. A relatively low and stable proportion of debt (25%) was contracted at concessional terms.

The debt situation was highly unsustainable in 1990 from a solvency as well as a liquidity perspective. The debt-to-GNP ratio stood at 225% and the debt-to-exports ratio at 500%, far above the sustainability thresholds for these solvency indicators of 50% and 200% respectively. While the debt service ratio was somewhat below 20% at the end of the 1980s, this coincided with a massive buildup of arrears, including arrears on World Bank and IMF debt, as Zambia was not able to pay its debt service obligations. This pointed at severe liquidity problems. As a result, the country was denied access to much foreign aid, which compounded the severe economic problems Zambia was already experiencing since the mid-1970s.

2 INPUTS OF DEBT RELIEF IN THE 1990S

This chapter contains an outline of the debt relief inputs to Zambia in the 1990s. The chapter starts with a brief overview of the main economic policies pursued by Zambia and donor funding provided in the 1990s. It is followed by a summary of the various debt relief arrangements that Zambia received from all creditors. The chapter ends with a section on Dutch debt relief inputs.

2.1 Economic policy and donor support in the 1990s

After a decades long one-party rule by President Kenneth Kaunda, a new government led by the Movement for Multi-Party Democracy (MMD) under President Chiluba came to power in 1991 through democratic elections on a platform of radical economic reform. In the same year normal relations with the IFIs were restored. Arrears to the IMF and World Bank were cleared, paving the way for new lending under IMF and World Bank-supported programmes. An overview of IMF and World Bank programmes in the 1990s is provided in Table 2-1.

Table 2-1 IMF and World Bank-supported programmes in the 1990s

Year	IMF	World Bank/IDA
1992	Rights Accumulation Programme (RAP) 1992-95	Economic Recovery Credit II
1992		Privatisation and Industrial Reorientation Credit (PIRC I)
1993		Privatisation and Industrial Reorientation credit (PIRC II)
1994		Economic and Social Adjustment Credit (ESAC I)
1995	Enhanced Structural Adjustment Facility (ESAF): Suspended 1997-98	Economic Recovery and Investment Promotion Credit (ERIP I)
1996		Economic and Social Adjustment Credit (ESAC II)
1999	ESAF/Poverty Reduction and Growth Facility (PRGF) 1999-2002	Public Sector Reform and Export Promotion Credit

Conditionality attached to debt relief was similar to the macroeconomic and structural reform measures linked to programme aid of the IFIs. Donor contributions were provided on the condition that the country would follow sound macroeconomic policies and apply the external debt strategy, especially adherence to a strict schedule of debt service payments. The policy dialogue focused on these issues accordingly. PC debt relief and bilateral relief of multilateral debt were granted on the condition that structural adjustment programmes were agreed with the IMF and World Bank, and that the country showed a good track record with regard to key macroeconomic and reform indicators.

Political conditions including governance issues played a major role from 1995 onwards, especially where it concerned democratic elections and corruption; these were in particular stressed by bilateral donors. Social conditionality included allocation of at least one-third of public expenditure (excluding interest payments) to the social sectors, while measures to cushion the poor from the adverse effects of adjustment were made part of

reform programmes. At the end of the 1990s the government made poverty alleviation its overarching development objective, to be pursued through a three-pronged strategy including the removal of constraints on growth, improvement in governance, and increasing access to basic services.

In the early 1990s radical fiscal adjustment was a major aspect of stabilisation policies, and a cash budget was introduced in 1993. Several reforms were carried out, including rapid liberalisation of the foreign exchange market, the domestic financial market, and capital account operations; price decontrol and elimination of subsidies; and trade liberalisation (World Bank 1999, Botchwey e.a. 1998). However, while fiscal adjustment was dramatic, problems in the sequencing of the reforms fuelled inflation and prevented it from declining until only later in the decade, when it still remained high at 25%. In 1993 problems started to emerge in the three areas that have particularly plagued Zambian reforms throughout the 1990s, namely privatisation, public sector reform, and governance. Stabilisation and reform programmes did not lead to sustainable economic growth, and the Zambian economy remained in a dismal state throughout most of the decade.

During the 1990s Zambia received substantial amounts of foreign aid (loans and grants) in support of economic reform, amounting to an annual average of USD 660 million (Table 4-3)³. This is substantially more than aid provided to Zambia in the 1980s, which amounted to USD 440 million per year. The bulk of lending originated from multilateral creditors (especially IDA) which lent an average of USD 200 million per year, mostly on concessional terms. Bilateral donors only lent a total of about USD 200 million – or USD 20 million per year – during the 1990s, compared to USD 1,200 million during the 1980s.

The proportion of grants in total aid (excluding IMF) fluctuated between 48% and 80%, and amounted to an average of about 60% during the 1990s, compared to only 30% during the 1980s (although a rapid rise in the proportion of grants in total aid occurred during the 1980s, from about 10% in 1980 to 50% in 1989). Grants constituted the bulk of bilateral support in the 1990s, although some bilateral lending still continued – even some on non-concessional terms – averaging about USD 20 million per year (compared to an annual average of USD 115 million in the 1980s). Commercial lending was limited and amounted to an annual average of USD 25 million, becoming nil towards the end of the decade. Overall, non-concessional lending by all types of creditors became negligible in the last years of the 1990s. Debt became increasingly concessional during the 1990s, from 30% of total debt in 1990 to 60% in 1999.

IMF lending was by and large confined to a big disbursement of USD 1,300 million at the culmination of the Rights Accumulation Programme (RAP) in 1995 (see section 2.4)⁴. Total lending by IMF and World Bank to Zambia during the 1990s amounted to USD 2,700 million, compared to a total of USD 1,400 million in the 1980s.

Programme aid (PA) excluding debt relief and IMF lending amounted to an annual average of about USD 300 million during the period 1991-1998 (White 1999), while showing substantial year-to-year fluctuations. It was at its highest in 1991, then fell drastically in 1993, and again in 1996-97 when all donors except the World Bank suspended aid in view of political conditionality. The bulk of programme aid – or 62% during the period 1991-98 – originated from multilateral sources. The largest share was provided by the World Bank, which accounted for close to half of the total programme aid. Somewhat more than one-third of programme aid (38%) was provided by bilateral donors.

3 Aid does not include loans from the IMF.

4 Global Development Finance (GDF) (World Bank 2001-a) data quote IMF disbursement amounting to USD 2,300 million. However, it appears that GDF is erroneous and that the correct figure should be USD 1,300 million, which would also be in line with other sources such as the balance of payments statistics.

2.2 Debt relief inputs: overview

Zambia received a variety of debt relief arrangements during the 1990s. These included modalities for relief on bilateral debt through PC operations; relief on multilateral debt through the Fifth Dimension Facility under which bilateral donors covered IBRD debt service; specific debt relief and lending operations to clear arrears to World Bank and IMF; and multilateral debt relief through the Highly Indebted Poor Country (HIPC) Initiative (which strictly speaking fell outside the evaluation period); and relief on commercial debt by means of a debt buyback through the World Bank's Debt Reduction Facility (DRF).

Total debt relief is presented in Table 2–2. Major relief was provided especially in the first half of the decade. After 1994 debt relief declined substantially (as did other programme aid). Rescheduling, totalling USD 2,300 million in the 1990s, constituted a considerably larger part of debt relief (60%) than forgiveness⁵. Nevertheless, forgiveness was still substantial with USD 1,100 million.

Table 2–2 Debt relief 1990–1999

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	Total
Total forgiveness*	137	89	233	312	163	2	30	2	2	90	1,060
Interest	22	13	14	31	67	1	7	1	0	37	194
Principal	114	76	218	282	96	1	23	1	2	53	866
Total rescheduling	824	218	221	185	146	12	202	127	77	273	2,286
Interest	321	62	116	81	72	5	81	72	55	92	956
Principal	466	120	105	105	74	7	121	55	22	182	1,256
Debt stock rescheduling	38	36	0	0	0	0	0	0	0	0	74
Debt stock reduction	26	0	0	0	446	2	0	0	0	0	474
of which buyback	0	0	0	0	8	0	0	0	0	0	8
Total relief											
Excl. stock reduction	961	308	453	498	309	14	232	129	79	363	3,346
Incl. Stock reduction	987	308	453	498	756	15	232	129	79	363	3,820

* Debt forgiven does not include relief on multilateral debt.

Source: World Bank 2001-a

While a considerable part of lending by the IFIs was used to settle arrears, IFI lending during the 1990s was the main factor responsible for a further increase in the long-term and IMF debt stock from about USD 5,500 million in 1990 to USD 6,500 million in 1998. This meant a 20% increase in the debt stock, compared to a more than doubling of the debt stock during the 1980s (from USD 2,700 million in 1980 to USD 5,500 million in 1990). While the bilateral debt stock also increased somewhat, as short-term and commercial debt decreased, a stabilisation of the total debt stock during the 1990s resulted, to an amount of USD 6,900 million in 1999.

In the course of the 1990s the composition of the debt became increasingly dominated by multilateral debt, the largest part of which consisted of IDA debt. Of the total debt stock in 1999 three-fifths or 61% was owed to multilateral creditors (41% multilateral PPG consisting mainly of IDA debt, and 20% IMF), compared to 43% in 1990 (Table 2–3).

⁵ However, major forgiveness was granted in 2000, outside the evaluation period.

Bilateral debt fell from 50% of total debt in 1990 to 37% in 1999. Commercial debt became a negligible 1%, down from 8% in 1990. PC debt accounted for the bulk of bilateral debt (93% in 1999, compared to 77% in 1990) (IMF Selected Issues and Statistical Appendices 11 March 1999 and 18 July 2000). Hence, whereas relief on bilateral debt was important, tackling the multilateral burden became increasingly crucial. However, debt relief concentrated insufficiently on the multilateral component, until more drastic measures were taken only after the evaluation period.

Table 2-3 Composition of Zambia's (long-term + IMF) debt stock (per cent)

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999
Long term debt	83	84	84	85	87	81	82	82	82	80
PPG	83	84	84	85	86	81	82	82	81	78
Official Total	75	77	77	79	82	78	79	79	80	78
Bilateral	49	50	48	46	50	45	46	45	45	37
Multilateral	25	26	29	32	32	33	33	34	34	41
Commercial Total	8	7	7	6	4	3	3	3	2	1
PNG (Private Non-Guaranteed)	0	0	0	0	0	0	0	0	0	1
IMF	17	16	16	15	13	19	18	18	18	20
Total multilateral (PPG + IMF)	43	43	45	47	46	51	51	52	52	61
Total long-term debt + IMF	100	100	100	100	100	100	100	100	100	100

Source: World Bank 2001-a

2.3 Zambia's external debt strategy

A comprehensive debt strategy was elaborated in the early 1990s as an essential component of Zambia's overall programme for stabilisation of the economy and improvement of its access to sufficient external resources to permit economic recovery (World Bank 1995). With regard to multilateral debt, it included payment of IBRD interest through the Fifth Dimension Facility, new IDA loans, and the RAP to treat outstanding obligations to the IMF. With regard to bilateral debt, PC debt relief would be sought on the best possible terms, while treatment of non-PC debt would be sought on PC-comparable terms. Commercial debt reduction was planned through a commercial debt buyback operation. In addition, new borrowing from bilateral and multilateral sources should take place on concessional terms (i.e. IDA-equivalent terms) only (World Bank 1995, Government of Zambia (GoZ) 1997).

The new 1997 external debt exit strategy focused on multilateral debt relief. Additional debt relief under the HIPC Initiative would be sought, as would be more generous PC debt relief. Multilateral debt relief would include conversion of the then prevailing Enhanced Structural Adjustment Facility (ESAF) terms applying to IMF debt of 10 years maturity with 5.5 years grace to 20 years maturity with 10 years grace, which meant postponement of repayment to the IMF. It would also include special grant contributions from IDA in addition to the current IDA flows (GoZ 1997).

While a considerable part of these policies was adhered to, substantial multilateral debt reduction was only provided in 2000. Further, some borrowing on non-concessional terms continued, especially during the first half of the decade.

2.4 Debt relief initiatives

Paris Club debt relief

During the evaluation period Zambia went through four PC debt relief operations in the years 1990, 1992, 1996 and 1999 (PC 2002). Except for the 1990 PC debt operation, the Netherlands was not among the participating creditors, although it did act as an observer in the 1992 operation.

In July 1990 Zambia reached an agreement with its PC creditors for debt relief on Toronto terms, involving debt reduction of 33%. The amount treated was USD 963 million. Debt service on pre-cutoff date non-Official Development Assistance (ODA) credits was cancelled to a level of 33%, whereby donors could choose from a menu of options: a debt reduction option, including cancellation of 33% of the debt treated, with the outstanding part rescheduled at the prevailing rate with a repayment period of 14 years including 8 years grace period; a debt service reduction option, whereby a reduced interest rate was applied with a 14 year repayment period and 8 years grace; or a commercial option, involving restructuring of eligible debt at the appropriate market rate over 25 years including 14 years grace. ODA debt was rescheduled at interest rates at least as concessional as the original interest rate applied, with a 25 year repayment period and 14 years grace. The agreement restructured loans which had been committed before the cutoff date of 1 January 1983 and had a maturity of more than one year, as well as restructuring of three consolidation loans agreed upon in 1983, 1984, and 1986. This involved consolidation of 100% of the arrears as per 1 July 1990, and 100% of principal payments of the before-mentioned loans due in the period 1 July 1990 –31 December 1991.

In July 1992 a PC agreement was reached to treat USD 918 million on London terms, which raised the level of cancellation on pre-cutoff date debt service due from 33% to 50%. Debt service on non-ODA credits was cancelled to a 50% level (after topping up of cancellation rates under earlier PC agreements), whereby donors could choose from a menu of options. Options included a debt reduction option, which involved a 50% reduction of treated claims and rescheduling of the rest against the appropriate market rate, with a 23 year repayment period including 6 years grace and progressive payments; and a debt service reduction option, which involved rescheduling of eligible debt at a reduced interest rate with a 23 years repayment period. ODA debts were rescheduled at interest rates at least as favourable as the original concessional levels, with 30 years repayment period and 12 years grace.

In February 1996 PC debt relief on Naples terms was agreed treating USD 566 million, involving a level of cancellation on debt service due of up to 67%. Under the arrangement non-ODA credits were cancelled to a 67% level through a menu of two options. Under the debt reduction option 67% of eligible debt was cancelled (after topping up) while the rest was rescheduled with a 23 year repayment period and 6 years grace. The debt service reduction option involved treatment at reduced interest rates and a 33 year repayment period. ODA credits were rescheduled at an interest rate at least as concessional as the original one, with 40 years repayment period and 16 years grace. Creditors could also undertake debt swaps, without limit on ODA credits, and up to 20% of the outstanding debt or SDR 15-30 million on non-ODA credits.

Finally, in April 1999 another PC agreement on Naples terms was concluded, treating an amount of USD 1,062 million. It concerned treatment of arrears as of June 1999, and of maturities falling due between April 1999 and March 2002. The treatment was implemented in three yearly phases, the third of which still needed to be implemented at

the time of writing of this report. This rescheduling took place in conjunction with a new ESAF-agreement between Zambia and the IMF covering the period 1999-2002.

The PC agreements required Zambia to seek debt relief on comparable terms from other (including non-PC) creditors, to ensure that no creditors would be repaid more than others. The IMF and World Bank were exceptions: in view of their preferred creditor status they had to be paid first.

All PC agreements were flow arrangements. They applied to debt originating from before the cutoff date, which for Zambia is 1 January 1983. As per the mid-1990s about 20% of the debt stock owed to PC creditors was contracted after the cutoff date, and debt service on these debts had to be paid as scheduled (World Bank 1995).

Settlement of World Bank arrears

Early 1991 Zambia had over USD 300 million of arrears to the World Bank. In that year USD 119 million of these arrears were cleared, including USD 100 million with funding raised specifically for that purpose by a Donor Support Group, while Zambia contributed the remaining USD 19 million from its own resources. This operation was followed by a USD 200 million bridging loan from the Bank of England which was used to clear the remaining arrears. Once the arrears were cleared, the World Bank immediately released USD 200 million (including USD 40 million of funds suspended in 1987 and a USD 160 million new IDA credit under the Second Economic Recovery Credit) that was used to pay back the Bank of England (White and Edstrand 1998).

Rights Accumulation Programme (RAP) with the IMF

The RAP applied a similar arrangement as was used for settling the World Bank arrears in 1991, but spread over a much longer period. As Zambia was in arrears to the IMF, it could not draw any IMF funds, nor could it agree on an IMF programme – which was a prerequisite for financial support from other donors. To circumvent this situation, during the period 1991-95 Zambia built up rights under the RAP. To be able to do so, it had to comply with conditionality attached to adjustment programmes and to fulfil an agreed scheme of settling arrears on external debt. In this way Zambia acquired the 'rights to borrow' the funds it could have borrowed had it not been in arrears with the IMF. However, it was not allowed to draw on these funds. In 1995 Zambia had accumulated rights equivalent to the value of arrears to the IMF. A bridging loan of the same amount was then made to Zambia by bilateral donors, which the government used to settle the IMF arrears. As the arrears were now cleared, the IMF could pay the accumulated rights to Zambia, which used these funds to pay back the bridging loans it had received from bilateral donors. To this end Zambia received USD 1,300 million under the new ESAF in 1995, virtually all of which was used to settle arrears. At the end of the transaction Zambia still owed the IMF the same amount as it did before the transaction. However, the difference was that now it concerned new debt instead of arrears. Effectively this meant that the debt was rescheduled (White and Estrand 1998).

Commercial debt buy back

In 1994-95 Zambia benefited from a commercial debt buyback programme under the DRF for IDA-only countries. The immediate objective of the operation was to extinguish a large proportion of commercial debt at a substantial discount. Over time the operation was also to help restore Zambia's creditworthiness, at least in terms of improving access to trade and other short-term credits. All debt eligible under the buy back programme had been in arrears since 1983-85. Under this operation debt was purchased at a price equivalent to 11% of face value. A total of USD 200 million of principal debt was bought back by Zambia out of an estimated USD 251 million of eligible commercial principal debt (World Bank 1995). At the end of the operation commercial debt as a percentage of total long-

term and IMF debt was reduced from 7% to 3%, or from almost USD 400 million in 1992 to about USD 200 million in 1995.

While Zambia was provided with a grant totalling USD 49.6 million to undertake this operation, total costs of the operation proved lower at USD 25.1 million, of which USD 11.8 million was provided by the IBRD, USD 9.8 million by bilateral donors including the Netherlands (USD 2.2 million), Sweden (USD 3.6 million) and Switzerland (USD 3.9 million), while Germany contributed USD 3.5 million for the implementation of the operation.

Of the total debt covered by the operation, 54% was tendered for cash, and 46% for the debt-for-development option available to NGOs. Under the debt-for-development option, NGOs acquired debt titles from creditors and then offered them to the buyback programme. Proceeds were then deposited in an escrow account for disbursement in the debt-for-development programme. As participating Non Governmental Organisations (NGOs) and Zambia mutually identified and agreed upon appropriate development projects in the social sectors, escrow funds were converted into Kwacha at the spot rate. From its own resources the government would then add to the proceeds a premium of 50% in Kwacha. Fourteen NGOs participated in the programme (World Bank 1995, Directorate General for International Co-operation (DGIS) 6 December 1993).

Eligible debt had originally been estimated at USD 500-600 million. As most of this debt had been arrears since 1983, the Bank of Zambia's (BoZ) records were incomplete and difficult to reconcile. Also, the status of many claims was uncertain, as a limited secondary market in commercial debt existed and the government had operated a debt-for-equity exchange programme. Estimates of the debt outstanding decreased as the process of locating creditors and reconciling claims proceeded. Hence, in addition to the USD 200 million actually bought back, another USD 162 million of debt on BoZ's books was not claimed or reconciled in the operation and was therefore considered extinguished. To this could be added USD 208 million worth of accrued interest on these two amounts. As a result, total commercial debt extinguished amounted to USD 570 million (World Bank 1995).

Fifth Dimension Facility

In 1992-93 Zambia benefited from assistance worth USD 38 million under the Fifth Dimension programme. The operation was financed by the World Bank through IDA reflows with co-financing from bilateral donors. It covered almost 100% of interest payments on IBRD debt during that period (World Bank 1995). Additional amounts under this arrangement were allocated in 1994-95⁶.

Highly Indebted Poor Countries Initiative (HIPC)

Zambia reached its Decision Point for the Enhanced HIPC Initiative at the end of 2000 (which is strictly speaking outside the evaluation period), following completion of its interim Poverty Reduction Strategy Paper (I-PRSP) mid 2000⁷. Under Enhanced HIPC Zambia was provided with USD 3,800 million in debt service relief in nominal terms from all creditors, equivalent to USD 2,500 million in net present value (NPV) terms. This corresponds to 63% of the NPV debt outstanding at the end of 1999 after the full use of traditional debt relief mechanisms (IMF/IDA 2000, Gondwe 2000), allowing Zambia to reduce its debt-to-exports ratio in NPV terms to an expected 150% at the end of 1999.

⁶ No information could be found on the total amounts allocated to Zambia under the Fifth Dimension facility in 1994-95, apart from the fact that the Netherlands contributed NLG 30 million.

⁷ A first draft of the full PRSP was completed in September 2001. This is a condition to access HIPC funds at the Completion point.

Of the total, USD 1,300 million (53% of the assistance) was provided by multilateral creditors, USD 1,100 million (46%) by bilateral creditors, and a negligible amount by commercial creditors. The IMF provided USD 602 million in NPV terms. This included USD 452 million of interim assistance soon after the Decision point covering the period 2001-2003, while the remaining USD 150 million was to be provided after the Completion point had been reached. IDA assistance provided was USD 488 million in NPV terms, of which USD 61 million during the interim period, and the remaining USD 427 million after the Completion point. Assistance by the African Development Bank (AfDB) amounted to USD 146 million in NPV terms, of which 40% or USD 58 million would be delivered as interim assistance after the Decision point. Other multilateral creditors would implement debt service relief of USD 90 million in NPV terms. PC creditors were expected to grant a flow rescheduling under Cologne terms starting in January 2001 on pre-cutoff date debt, topping up the flow rescheduling under Naples terms already provided for debt service due until March 2002. However, this had not yet taken place by early 2002. By 2003, PC creditors are scheduled to implement a stock of debt operation under Cologne terms. Non-PC bilateral as well as commercial creditors would provide relief on terms at least comparable to those of PC creditors.

The principle of a floating Completion point was applied to Zambia. It is assumed that this point will be reached in 2003.

Zambia is projected to face a sharp increase in debt service obligations to the IMF after Decision point (2001-2005) due to the expiration of the grace period on principal payments on the ESAF loans Zambia acquired in the mid-1990s to clear its arrears (IMF/IDA 2000d). At the same time, the IMF would continue to make positive net transfers to Zambia during the Poverty Reduction and Growth Facility (PRGF) period 2001-2003. Nevertheless, due to the rising debt service payments, the country's budget would remain as constrained as it was before, posing a credibility problem for the HIPC Initiative and political difficulties for the Zambian government (Department for International Development (DfID) 2000).

Concern existed among bilateral donors with regard to the effect increased debt payments would have on social spending. Zambia requested that creditors front-load interim assistance to allow debt service payments after HIPC to be lower than in the recent past and resulting in cash savings to finance additional poverty reduction interventions. Various bilateral donors agreed to provide additional assistance beyond HIPC to allow savings in debt service payments. The Netherlands provided additional support to the HIPC Trust Fund worth USD 20 million (NLG 52 million) to further alleviate Zambia's debt service burden to the IMF after the Decision point (IMF/IDA 2000, DGIS 2000-a, DGIS 2000-b).

Stated objectives and conditionality

PC debt relief operations aimed at enabling the country to ease the debt burden. HIPC aimed at eliminating unsustainable debt in the world's poorest most heavily indebted countries, with the Enhanced HIPC seeking broader, deeper and faster debt relief. HIPC was designed to improve prospects for a permanent exit from unsustainable debt. It was also to assist Zambia in channelling resources for increased public spending and policy reforms in the social sectors.

During the 1990s conditionality attached to both multilateral and bilateral debt relief consisted of the existence of an appropriate programme supported by the IMF which demonstrated the need for debt relief, and adherence to the policy measures and benchmarks described therein, as well as to the agreed debt service payment schedule. Whereas conditionality was initially restricted to stabilisation and structural reform measures, governance issues became increasingly important and were especially

emphasised by bilateral donors. As part of Economic and Social Adjustment Credit (ESAC) conditions one-third of public expenditure (excluding interest payments) should be allocated to social services.

2.5 Dutch debt relief to Zambia

ODA provided by the Netherlands amounted to USD 250 million in the period 1990-97, or an annual average of about USD 30 million. Dutch programme aid excluding debt relief in the period 1991-98 amounted to USD 38 million, or a share of 1.6 % of total programme aid excluding debt relief of USD 2,400 million (excluding IMF loans) provided to Zambia during that period (White 1999). Hence, the Netherlands was not a major player in providing financial support in the form of programme aid to Zambia. Dutch debt relief during the 1990s amounted to about USD 70 million. While no exact data could be obtained on debt relief provided by each donor, it can be derived that the Netherlands only played a modest role. Dutch programme aid including all debt relief (see below) amounted to a total of about USD 110 million, with which the Netherlands remained a relatively small player in this area in financial terms. Bilateral lending was undertaken by the Netherlands to Zambia only in the late 1970s and early 1980s. Since that time Dutch assistance has been provided solely in the form of grants.

During the evaluation period the Netherlands provided debt relief totalling NLG 137,098,000, or about USD 70 million, in 14 different allocations (Table 2-4). Relief on the bilateral debt service burden was the major focus of Dutch debt relief, namely two-thirds of the total or NLG 88 million. Almost 30% (NLG 40 million) was used for multilateral debt service relief (DGIS 2001), while NLG 9 million or 7% of debt relief was allocated to the commercial debt buyback. All Dutch debt relief during the 1990s was provided in the first half of the decade; none was granted after 1995.

Four bilateral debt relief allocations in 1990-91 totalling NLG 59.3 million were granted under the framework of the PC debt relief operation agreed in July 1990. The Netherlands chose the non-concessional option involving extension of the maturity (DGIS 26 July 1999). A first amount of NLG 18.4 million was agreed including cancellation of principal (DGIS 18 December 1990). Further, debt relief worth NLG 22.8 million was granted in 1990 to cancel outstanding debt (arrears) as per end December 1989 and to relieve Zambia from debt service payments in the year 1990; this concerned loans contracted from the Dutch government between 1976 and 1981 (DGIS 27 November 1990). After the Chiluba government came to power late 1991, an additional NLG 18 million was cancelled covering principal of loans contracted in the period 1977-79 (DGIS 11 December 1991).

In 1991 multilateral debt relief was provided through the Donor Support Group to cover arrears to the IBRD amounting to NLG 10 million. Through this arrangement the Dutch government contributed to clearance of arrears to the IFIs. This was considered the highest priority in 1991 in order to solve liquidity problems and to provide access to the Economic Recovery Credit from the World Bank and the RAP from the IMF, and through this to enable continuation of the economic reform programme (DGIS 28 February 1991). Conditions for Dutch participation in this debt relief operation were that Zambia would also contribute from its own resources and that other donors would participate. Both conditions were fulfilled. Other contributors were the UK, Sweden, Finland and the USA.

Table 2-4 Dutch debt relief to Zambia

Date	Amount (NLG)	Type of debt	Type of relief	Objectives of debt relief	Rationale For debt relief	Account (programme budget)
1 1990	18,439,000	Bilateral	Paris Club relief: Cancellation principal	Not specified	Poverty situation	Unknown (Not specified)
2 1990	5,869,000	Bilateral	Paris Club relief: Cancellation debt service 1990	Support macroeconomic policy	Poverty situation	Unknown (Not specified)
3 1990	16,951,000	Bilateral	Paris Club relief: Cancellation arrears	Support macroeconomic policy	Poverty situation	Unknown (Not specified)
4 1991	18,000,000	Bilateral	Cancellation principal	Not specified	Quality macroeconomic policy	Unknown (BoPS & Debt*)
5 1991	10,000,000	Multilateral	Debt service reduction (arrears) IBRD, in Support Group	Support economic reforms; Restore relations with IFIs	Implementation reform programme; Agreement IMF (implementation); Liquidity problems	Unknown (BoPS & Debt)
6 1992	5,314,000	Bilateral	Cancellation principal	Improve macroeconomic situation; Improve debt situation	Quality macroeconomic policy	KBE 728-2 (BoPS & Debt)
7 1992	2,224,000	Bilateral	Cancellation debt service 1992	Improve macroeconomic situation; Alleviate debt burden	Implementation reform programme; Poverty situation	KBE 728-2 (BoPS & Debt)
8 1993	9 million, (of which only 5.2 used)	Commercial	Contribution to commercial debt buy bank through Debt Reduction Facility	Alleviate debt burden; Improve balance of payments; Increase access to international commercial lending	Implementation reform programme	KBE 762.1 (Southern Africa programme)
9 1993	3,915,000	Bilateral	Cancellation principal	Improve debt position	Severity debt situation	KBE 728-2 (BoPS & Debt)
10 1993	1,687,000	Bilateral	Cancellation debt service 1993	Improve macroeconomic situation	Implementation reform programme	KBE 728-2 (BoPS & Debt)
11 1994	14,357,000	Bilateral	Cancellation principal 1994	Improve macroeconomic situation; Improve debt position	Quality macroeconomic policy; Severity debt situation; Good governance	KBE 728-2 (BoPS & Debt)
12 1994	1,342,000	Bilateral	Debt relief (Netherlands Investment Organisation (NIO) portfolio)	Improve macroeconomic situation; Improve debt position	Quality macroeconomic policy; Severity debt situation; Good governance	KBE 728-2 (BoPS & Debt)
13 1994	15,000,000	Multilateral	Debt service reduction IBRD through Fifth Dimension	Support economic reform; Improve balance of payments	Implementation reform programme; Good governance	KBE 762-1 (Country programme Africa)
14 1995	15,000,000	Multilateral	Debt service reduction IBRD through Fifth Dimension	Support economic reform; Improve balance of payments; Restore relations with IFIs	Quality macroeconomic policy; Agreement IMF (conclusion)	KBE 728-2 (BoPS & Debt)

* BoPS & Debt = Balance of payments support and debt programme.

In 1992 bilateral debt relief in two instalments totalling NLG 7.5 million was granted, including NLG 5.3 million for the cancellation of principal from 1980, and NLG 2.2 million for the forgiveness of debt service 1992 on Dutch loans (DGIS 27 March 1992).

In 1993 the Netherlands was one of the co-financiers of the commercial debt buyback operation carried out through the DRF. Initially the Netherlands contributed NLG 9 million, only NLG 5.1 million of which was eventually needed. The remaining NLG 3.9 million was deposited in the World Bank's Netherlands unallocated balance account. While a Dutch contribution was first agreed to be provided in the form of import support, this was changed as the Zambian government revised the open general license (OGL) systems in 1993 and absorption capacity was reduced, and it rearranged its priorities to debt relief (DGIS 6 December 1993). The funds for this operation originated from the country programme for Southern Africa, which did not receive extra funds for this purpose (DGIS 29 November 1993).

In 1993 two bilateral debt relief allocations were made totalling NLG 5.6 million for cancellation of principal of a 1981 loan (NLG 3.9 million) and of debt service 1993 (NLG 1.7 million). The latter relief operation went further than the PC agreement of July 1992 (DGIS 9 September 1993).

In 1994 NLG 15.7 million of bilateral debt relief (in two instalments amounting to NLG 14.4 million and NLG 1.3 million) was provided covering cancellation of principal repayments for 1994. With this cancellation all Dutch loans to Zambia provided through the Netherlands Investment Organisation (NIO) were cleared off the books (DGIS 12 December 1994).

Finally, multilateral debt relief totalling NLG 30 million was provided in two instalments of NLG 15 million each in 1994 and 1995 under the Fifth Dimension Facility to cover interest payments to the IBRD. The first instalment was drawn from the Southern Africa programme, while the second was drawn from the regular balance of payments support account. A condition of the Dutch government for the provision of this amount was adherence by Zambia to the IMF conditions for completion of the RAP and the start of the ESAF. This condition was fulfilled (DGIS 30 October 1995).

As indicated earlier, in 2000 the Netherlands released another USD 20 million (NLG 52 million) allocated to the HIPC Trust Fund earmarked for Zambia for the purpose of multilateral debt relief to alleviate debt service payments 2001 of Zambia to the IMF after it reached its HIPC Decision point (DGIS 27 July 2000, DGIS 2000-b).

Overall, the documentation supporting and justifying the Dutch government's decisions to undertake debt relief was in many instances limited. This concerns in particular the bilateral debt relief, for which often hardly any documentation was available, including the standard Appraisal Documents ('Beoordelings Memoranda').

The objectives of Dutch debt relief to Zambia most frequently mentioned in the official documentation of the Dutch Ministry of Development Cooperation were to support macroeconomic policy and improve the macroeconomic situation, to alleviate the debt burden, and to improve the balance of payments. The main rationales were the implementation of the reform programme and the quality of macroeconomic policy. The poverty situation was not a major rationale except in the first year. Good governance was mentioned as a rationale in later years (1994-95).

A large amount of Dutch debt relief totalling NLG 72 million was funded from the DGIS 'Balance of payments support and debt programme'. This amount was additional to the

separate budget allocated to the country or region. NLG 24 million (used for the commercial debt buyback and multilateral debt relief) was financed from the Southern Africa programme, and was therefore probably not additional to regular country resources. The account from which NLG 42 million worth of debt relief disbursed in 1991 originated was not specified.

From the records reviewed for the purpose of this desk study, no clear indications of a lead role of the Dutch government in resolving the debt problem of Zambia could be found. Nevertheless, the Netherlands did co-operate as part of a broader group of donors concerned about the debt situation.

2.6 Conclusions

Both bilateral and multilateral debt constituted a major proportion of Zambia's external debt in the 1990s. Multilateral debt including IMF debt became increasingly dominant in the course of the decade: its share in the debt stock increased from 43% in 1990 to 61% in 1999, whereas the share of bilateral debt decreased from 50% in 1990 to 37% in 1999.

Both bilateral and multilateral debt were the focus of relief operations. Several Paris Club debt relief agreements were concluded throughout the 1990s to reduce the bilateral debt burden, focusing on flow arrangements. The bulk of PC relief was rescheduling, while less of it consisted of forgiveness – although the latter still constituted a considerable amount. Several multilateral debt relief operations were undertaken in the first half of the 1990s, including operations to clear arrears to World Bank and IMF as well as relief under the Fifth Dimension Facility to cover interest payments to the IBRD.

On the other hand, no multilateral relief took place in the second half of the decade, even though at the same time the debt problem increasingly became of a multilateral nature. A start with tackling the multilateral debt problem was made only in 2000, i.e. after the evaluation period, when agreement was reached to grant more generous debt relief focusing on the multilateral debt burden under HIPC. Debt relief from all sources combined declined substantially along with other programme aid in the period 1995-1999, as donors grew increasingly dissatisfied with Zambia's policy implementation and governance issues. Commercial debt constituted a small part of total debt throughout the decade, and was reduced to a very small proportion of total debt in 1999 with the help of a successful debt buyback scheme.

Zambia received substantial amounts of aid during the 1990s, easing the balance of payments and government accounts positions, and enabling the country to service its debt. A large part of this new aid concerned loans, mostly from multilateral institutions. The bulk of these loans was on concessional terms, although some non-concessional lending still continued. As a result, the multilateral debt burden increased. Bilateral aid was mostly provided in the form of grants. Programme aid flows decreased in the second half of the decade as donors suspended their support.

The Netherlands played a limited role in the provision of programme aid. It played a somewhat bigger – yet still modest – role in the provision of debt relief, and only in the first half of the 1990s. Almost two-thirds of this relief was bilateral debt relief, and 30% multilateral debt relief. No bilateral debt to the Netherlands remained after 1994. In line with other donors, the Netherlands did not provide funding in the second half of the 1990s to tackle the growing multilateral debt problem. The Netherlands was an active participant in the policy dialogue on debt relief, but did not play a noticeable lead role in tackling the debt problem, especially the multilateral one. The Netherlands provided funds and inputs in the policy dialogue as part of a broader bilateral donor support group.

3 OUTPUTS OF DEBT RELIEF: EFFICIENCY

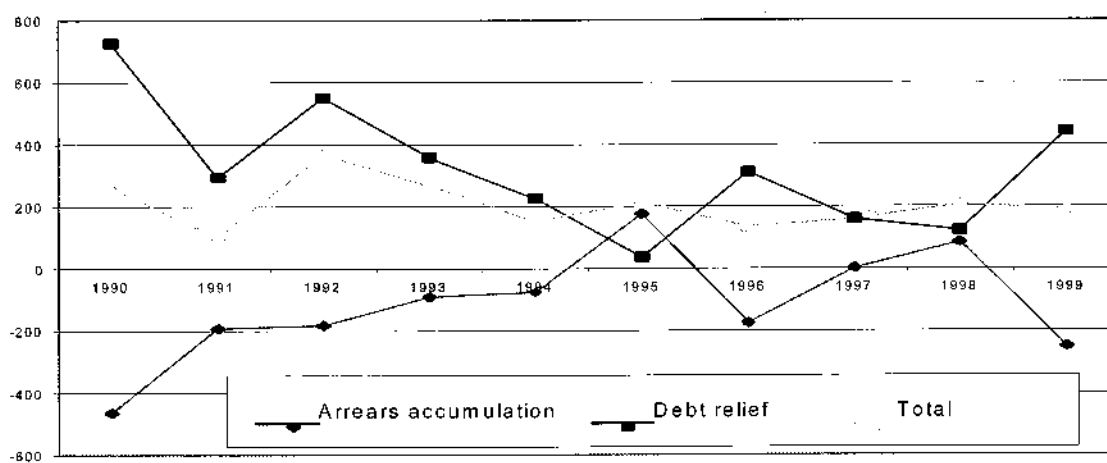
This chapter examines how efficient the debt relief inputs as delivered, have been in reducing the debt burden. The effect of debt relief on the debt stock (stock effect) and on actual debt service (flow effect) are analysed. Further, the effects of debt relief on changes in government policies are assessed. The chapter ends with a review of the effects of debt relief on the external and internal accounts (balance of payments and government accounts).

3.1 Flow effect

An important factor in determining the extent to which debt relief (forgiveness and rescheduling) resulted in a flow effect is how much debt service was actually paid compared to the amount that would have been paid without debt relief. This varies per type of debt relief and per type of creditor, and hence needs to be analysed for the different modalities of debt relief separately.

PC debt relief is registered in Zambia's balance of payments as 'Debt reduction/rescheduling received'. Debt relief through the Fifth Dimension Facility is probably recorded under 'Transfers'. Figure 3-1 shows a (virtually synchronic) inverse relationship between debt relief and arrears accumulation. As was shown in Chapter 1, massive arrears on long-term debt were built up in the second half of the 1980s, reaching a peak of USD 2,200 million in 1990. In 1995 these had been reduced to USD 940 million, and in 1999 they stood at USD 190 million. A substantial amount of PC debt relief in 1990 and 1992 was used to reduce arrears on bilateral debt. World Bank arrears had been cleared through a specific operation in 1991 with the assistance of bilateral donors. The bulk of the arrears on commercial debt payments were cleared through the commercial debt buy-back in 1994-95. Finally, arrears to the IMF were cleared through the RAP that ended in 1995. Arrears outstanding after 1995 concerned mostly bilateral arrears (to PC and non-PC creditors). PC agreements in 1996 and 1999 contributed to further reduction of those arrears.

Figure 3-1 Arrears accumulation and debt relief (USD million)

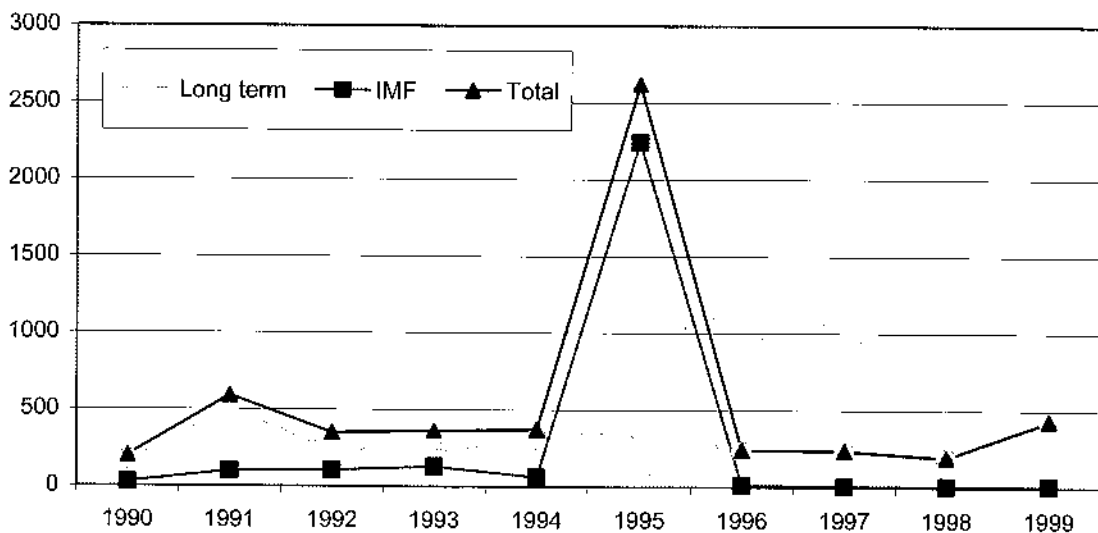


Source: IMF

As debt relief on arrears is less likely to lead to a reduction in actual debt service payments than relief on the current debt service obligations, not much flow effect is likely to have resulted from debt relief used to settle arrears. As was shown in Chapter 2 (Table 2-2) debt relief and the settlement of arrears involved much more rescheduling than forgiveness, with the former leading to higher future debt service obligations, and the latter to lower future obligations. To the extent that arrears were forgiven, a flow effect did result. Rescheduling may also have led to a flow effect where it relieved current payment obligations. However, with rescheduling being dominant, on balance much of the debt service payments was only postponed. Figure 3-1 shows that debt relief exceeded arrears accumulation throughout the 1990s, suggesting a flow effect.

Overall, total long-term and IMF debt service paid declined somewhat in the course of the 1990s, with the exception of 1995 when large payments to the IMF were made⁸ (Figure 3-2). Total long-term and IMF debt service paid was USD 330 million per year excluding the 1995 IMF payment, but stood at a higher level of USD 460 million per year when the 1995 payment⁹ is included.

Figure 3-2 Debt service paid, long-term and IMF (USD million)



Total long-term debt service paid declined somewhat during the 1990s. It averaged USD 290 million per year, fluctuating between about USD 200 million and USD 500 million (Figure 3-3). The most important component of the long-term debt service paid was multilateral debt excluding IMF¹⁰, averaging USD 160 million per year, compared to average annual bilateral and commercial debt service paid of USD 65 million and USD 70 million respectively. Peaks in debt service paid occurred in 1991, due to an upsurge in multilateral debt service after normal relations with the IFIs resumed, and in 1995 due to a simultaneous increase in bilateral debt service paid and a slight increase in multilateral debt service. In 1992-95 bilateral donors covered part of the multilateral debt service payments to the World Bank/IBRD under the Fifth Dimension. From 1995 onwards

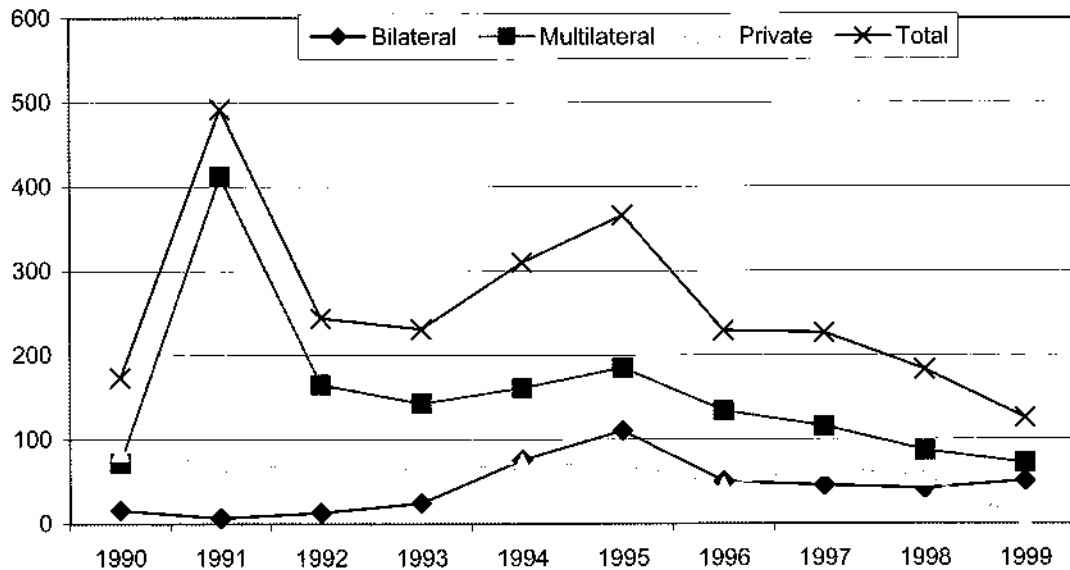
⁸ These repurchases of USD 2,244 million were accompanied by purchases at USD 2,253 million.

⁹ The level of debt service paid to the IMF in 1995 used here is USD 1,300 million, instead of the USD 2,300 million quoted in the GDF data base. This issue was explained in Chapter 2.

¹⁰ This includes debt owed to World Bank and other multilateral creditors. It excludes debt service owed to the IMF.

multilateral debt service showed a decline from almost USD 200 to under 100 million at the end of the decade, reflecting increased concessionality of loans. Commercial debt service paid remained at a steady and relatively low level, with some decline in the second half of the decade after the conclusion of the commercial debt buyback. Bilateral debt service paid was low in the years with a PC agreement, and increased in 1994-95, probably as a result of the terms of earlier PC agreements.

Figure 3-3 Debt service paid (long-term) by type of creditor (USD million)



Source: GDF.

Debt service paid to bilateral creditors increased during the 1990s. As PC debt constituted a substantial proportion of total debt (about 40% of long-term and IMF debt combined and 50% of long-term debt), debt relief agreements with these creditors were an important way of reducing the country's total debt service burden. As a substantial part of PC debt relief was used to settle arrears to bilateral creditors, it only partly led to a reduction of debt service actually paid. Nevertheless, a reduction of bilateral debt service paid could be observed in the years with PC agreements. These agreements usually cover pre-cutoff date debt only, and as the bulk of Zambia's outstanding bilateral debt indeed concerned pre-cutoff date debt, much of PC debt service was covered by the agreements. Improved terms of subsequent PC agreements, with higher cancellation proportions, led to increased alleviation of bilateral debt service payments. On the other hand, the fact that within the evaluation period Zambia did not obtain debt relief beyond Naples terms limited cancellation levels.

The importance of the multilateral debt service burden becomes more pronounced when adding IMF debt service to multilateral PPG debt service paid. Total multilateral debt service including IMF amounted to an annual average of USD 325 million including 1995 IMF payments and USD 210 million excluding 1995 payments, although it was considerably lower after 1995 with USD 115 million per year. Total multilateral debt service paid including IMF fluctuated between 50% and 93% of total debt service paid during the period 1990-95, indicating the more than proportional burden of multilateral debt service compared to the multilateral debt stock. Especially the debt service burden

related to IMF debt was high relative to the amount of IMF debt stock¹¹. Like multilateral debt service excluding IMF, multilateral debt service including IMF declined, although there was an important exception in the year 1995.

In general, relief on multilateral debt service reduces the debt service burden and has a flow effect as this debt service is usually paid. However, as the multilateral debt relief in 1991 involved settlement of arrears, this did not have a direct flow effect (but it did lead to new disbursements). Relief provided by bilaterals on multilateral debt service through the Fifth Dimension Facility did have a direct flow effect, as indeed this debt service was usually paid after World Bank arrears were settled. Although this did not reduce the figures for multilateral debt service paid, it did relieve its burden. Most programme aid had this effect as it concerned freely spendable resources which could be used by the government to pay debt service. The RAP effectively involved a rescheduling, and while IMF debt service paid was low during the second half of the 1990s due to the grace period in the ESAF loan, IMF debt service obligations are projected to rise steeply after 2000. As a result, while HIPC relief in the year 2000 is expected to lead to a reduction in the debt service burden compared to what it would have been without HIPC relief, debt service would in practice still be higher than before HIPC relief. Additional bilateral donor support beyond HIPC was required to reduce this burden. Apart from this, HIPC is expected to have a substantial flow effect on future debt service payments in the future.

The flow effect of the commercial debt buyback was negligible, as it almost entirely concerned the settlement of arrears.

The flow effect also becomes clear when considering the amounts involved in debt relief and arrears accumulation (Figure 3-1) as well as Fifth Dimension relief, and comparing these with the debt service actually paid¹². The value of debt relief and arrears accumulation including Fifth Dimension relief was about three-quarters of total long-term debt service paid.

While debt relief led to some reduction in debt service actually paid, it led to a much larger reduction in the debt service due from USD 3,300 million in 1990 to about USD 1,000 million in 1999 (Figure 3-4). Indeed, as noted earlier, debt relief was to a large extent used to settle arrears, and the reductions in arrears and in debt service due moved in tandem. This is confirmed by the fact that in the years with PC agreements the debt service paid-to-debt service due ratio declined while the debt relief to debt service due ratio showed a largely inverse trend. However, GDF data do not take into account multilateral debt relief funded by bilateral donors under the Fifth Dimension Facility, so that in reality the flow effect can be expected to have been somewhat larger than is shown by GDF data.

¹¹ Multilateral debt (PPG + IMF) was an important debt component, but accounted for less than half of total debt in the first half of the 1990s; only after 1995 did it exceed 50% of total debt, reaching 60% in 1999. IMF debt service paid averaged USD 85 million per year during the period 1990-94. The culmination of the RAP in 1995 resulted in a huge debt service payment to the IMF, in 1995 amounting to USD 1,300 million as all IMF arrears were cleared. During the remainder of the decade IMF debt service paid was at a very low level due to the terms of the ESAF loans which included a grace period until 2001.

¹² No exact figures for total Fifth Dimension relief were available. It is assumed here that it amounted to about USD 20 million per year during the period 1994-95, based on the USD 38 million of relief provided in 1992-93.

Figure 3-4 Debt service due and composition (USD million)

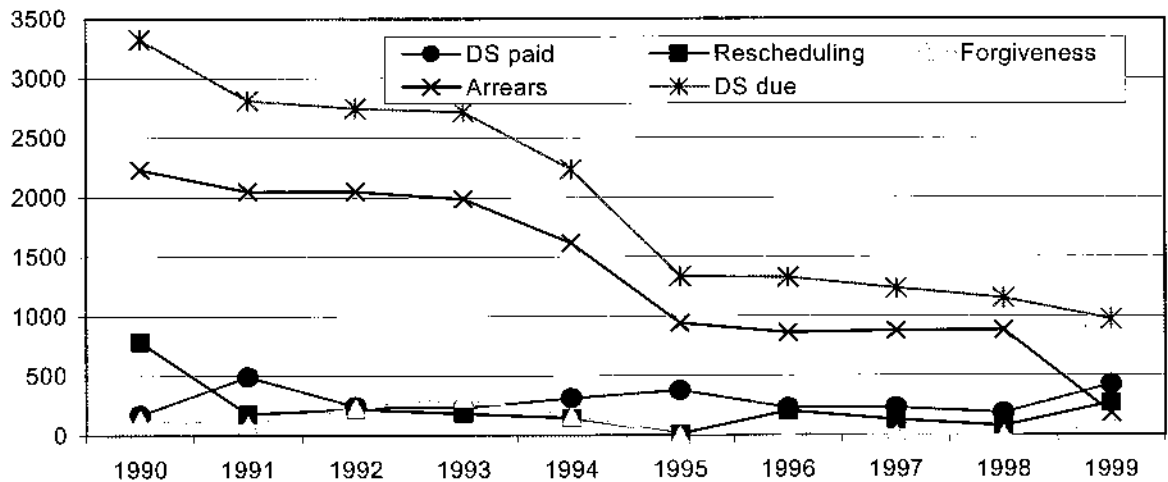
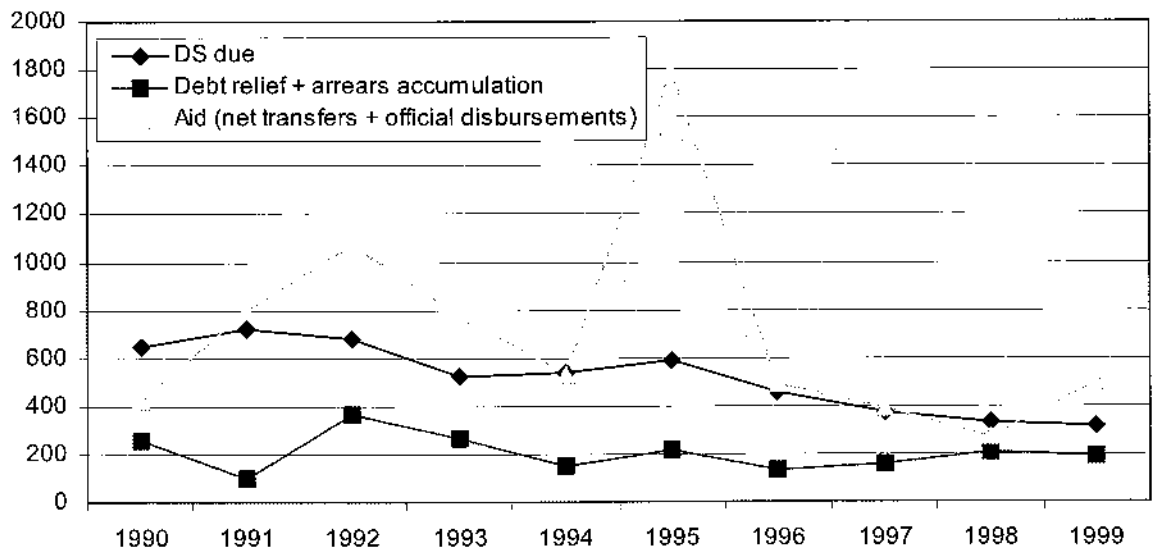


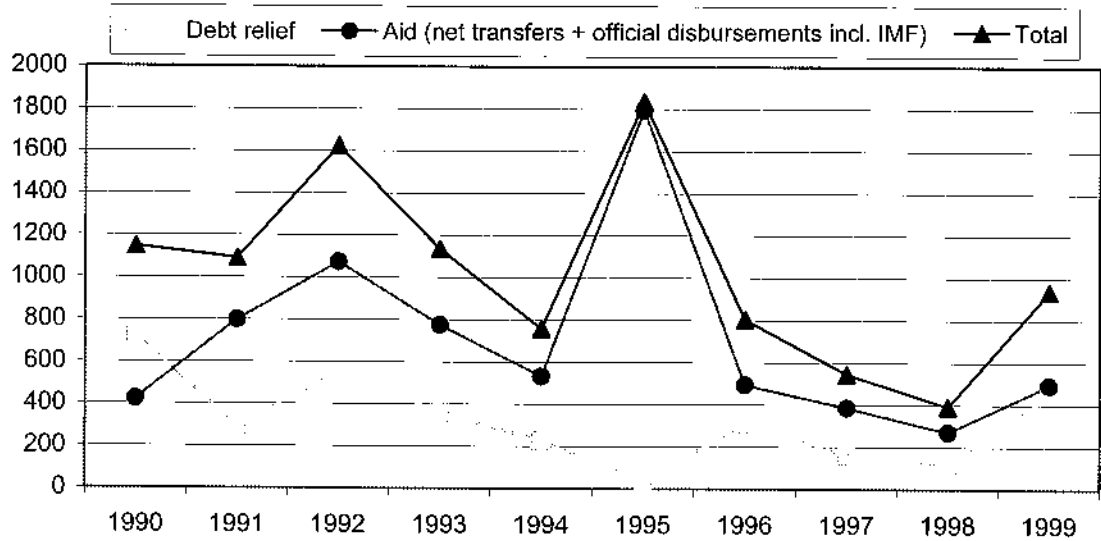
Figure 3-5 shows that debt service due was financed through debt relief as well as other aid, without which Zambia would not have been able to pay its debt service obligations. Arrears accumulation was not a major mechanism of financing debt service payments.

Figure 3-5 Debt service due and financing (USD million)



The degree to which debt relief is additional to other aid flows also affects the size of the flow effect. IMF balance of payments statistics show that debt relief was largely additional to other aid flows, since the two lines move parallel to each other in most years (Figure 3-6). This is confirmed by GDF data.

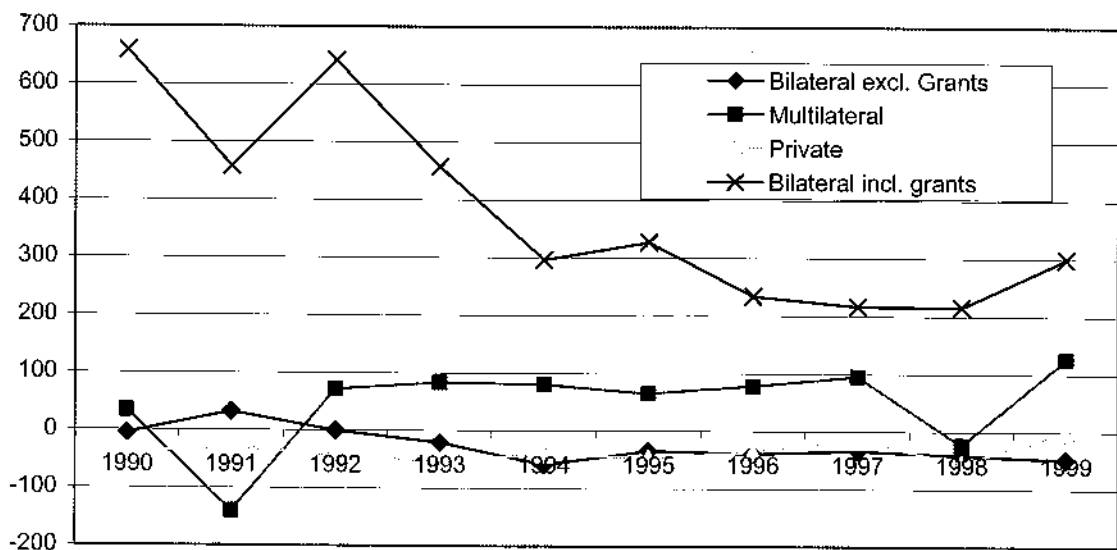
Figure 3-6 Additionality of debt relief to aid (USD million)



Source: IMF

Figure 3-7 presents the net transfers on long-term debt for different types of creditor, providing insight into the extent to which bailouts occurred. Private net transfers on debt were negative during the whole decade, as Zambia paid back more to commercial creditors than it received in new loans from them. Multilateral net transfers were positive most of the decade, with the World Bank/IDA putting in more funds than it was taking out in most years. Bilateral donors increasingly provided aid in the form of grants rather than loans. Hence, when grants are included, bilateral net transfers were far above those of the other creditors, including the multilaterals, especially during the first half of the decade. This confirms that multilateral donors were bailed out by bilaterals, such as through the Support Group arrangement in 1991 and through Fifth Dimension relief.

Figure 3-7 Net transfers on long-term debt by type of creditor (USD million)



3.2 Stock effect

During the 1990s Zambia's total nominal debt stock fluctuated between USD 6,400 million and USD 7,000 million. It did not increase compared to the level in 1990; it was slightly lower in most years, and declined somewhat at the end of the decade (Figure 1-1). While long-term and IMF debt increased, this was compensated by a decrease in short-term debt.

With regard to bilateral debt, the rescheduling component of PC agreements was overall more substantial than their forgiveness component. Rescheduling did not lead to debt stock reduction. As part of the forgiveness component settlement of arrears on past debt service obligations took place, which led to some stock reduction. As is borne out by the close inverse relationship between debt relief and arrears decumulation, PC debt relief led to some ex-post debt stock reduction. Expected future debt payments were reduced as interest payments on arrears no longer continued to build up. Within the evaluation period, no PC agreement beyond Naples terms was concluded, not enabling Zambia to benefit from more generous debt stock reduction. While some decline in the bilateral debt stock took place in the period 1991-93, it increased thereafter and remained steady at about USD 3,000 million, although it declined in 1999.

Relief provided by bilateral donors on multilateral debt service through the Fifth Dimension Facility involved only relief on debt service flows, and had no stock effect. Settlement of World Bank arrears through the 1991 operation co-funded by bilateral donors led to some debt stock reduction. The RAP concerned a rescheduling operation, without effect on the debt stock.

The commercial debt buyback in 1994-95 was very effective in reducing the commercial debt stock, virtually all of which concerned arrears. Commercial debt declined from over USD 400 million in 1990 to USD 113 million in 1998. However, as commercial debt constituted only a limited proportion (7%) of long-term debt at the beginning of the evaluation period, the stock effect of this operation on the total amount of debt remained limited.

Debt relief under HIPC is limited to relief on debt service flows. However, as this relief was guaranteed for the next 15-20 years, debt service relief under HIPC corresponded to a 63% reduction of the NPV of debt outstanding in 1999, effectively resulting in a stock effect. Zambia only benefited from this arrangement after the evaluation period.

Total forgiveness during the 1990s amounted to USD 1,100 million, which is equivalent to 23% of the total long-term debt stock in 1999 (World Bank 2001-a, see Table 2-2). When the debt stock reduction of USD 475 million is taken into account, the combination of forgiveness and stock reduction amounted to one-third of the 1999 long-term debt, representing a considerable stock effect. At the same time, the nominal long-term and IMF debt stock increased due to new lending. Nevertheless, as these loans were largely at very low interest rates, the NPV of debt stock probably decreased.

3.3 Effect of conditionality on government policies

Zambia proved a very problematic case with regard to conditionality. After the MMD government came to power in 1991, irreversible policy shifts took place and far-reaching economic reforms were followed through (White 1999, World Bank 1999). During the 1990s Zambia went from an approach of heavy state control over prices and other aspects of the economy to a market-based economic model. Initial measures focused on radical fiscal adjustment, price decontrol, exchange rate and capital account liberalisation, and trade liberalisation. During the first two years progress was substantial with removal of virtually all price controls and rapid trade liberalisation. Problems were encountered in

the area of fiscal and monetary policy. The IMF often revised its monetary benchmarks to accommodate slippage. The cash budget, introduced in 1993, was not sufficiently enforced. The record on privatisation, the area of economic reform where donors applied most pressure, was mixed: as in most countries the process took off much later than planned, although considerable privatisation was eventually undertaken from 1995 onwards. Still, the government dragged its feet on the privatisation of two major parastatals – Zambia Airways and Zambia Consolidated Copper Mines (ZCCM) – which formed a heavy drain on the public budget. ZCCM was sold only in 2000. Public sector reforms also proceeded very slowly.

Major problems related to governance emerged. Governance first became a major issue in 1993, focusing on corruption and the state of emergency. The second time governance emerged was in the run-up to the 1996 presidential elections. Constitutional amendments barring the former president from running as a candidate, followed by the boycotting of the elections by the opposition, led donors to suspend assistance. The World Bank, however, continued disbursement, which undermined a joint donor position. As bilateral donors were preparing for a resumption of aid, in 1997 an attempted coup followed, resulting in arrests and alleged human rights abuses. Bilateral donors therefore continued to withhold their financial assistance, this time joined by the IFIs. Together with domestic political pressure this forced the government to comply with a number of political conditions (White 1999).

Overall, while there was policy change, its nature and pace were not in conformity with the agreed conditions. Considerable slippage on conditionality occurred, and the donor community became increasingly disillusioned from 1993 onwards as it felt government showed insufficient commitment to reform. In response to non-compliance in the area of economic policy reform measures donors generally did little (White 1999). Instead of formal waivers the IFIs rather 'accommodated' the government's position and in this way avoided signalling that the reforms were off-track. The bilaterals usually followed the lead of the IFIs in this subject area. Donors did cut aid in 1998 in relation to problems over the privatisation of ZCCM. Whereas traditionally bilateral aid conditions linked up with the conditionality of the IMF and World Bank, during the 1990s the bilateral donors exercised a leadership role in the political aspects of the reform agenda. They increasingly took an independent stance in their view of the implementation of the reforms especially concerning governance, including in some cases setting their own conditions (White 1999). Discrepancies between the position of bilateral donors and that of the World Bank occurred at certain instances, with the bilaterals judging the World Bank as 'going soft' on Zambia.

In the area of social policy and expenditure, the government met the social sector-spending target of one third of total public expenditure. However, not much happened in terms of redirecting these expenditures to services used most by the poor. The inclusion of social spending targets in conditionality was exceptional as it was not done in most other countries. It was a rather heavy condition in the context of zero economic growth. Apart from this condition, there was relatively limited attention, also from the donors' side, for a poverty orientation of the reform programme and the distributional impact of the policies supported by them. Reforms in the health and education sectors were undertaken but at the end of the evaluation period had not yet led to improvements in access to and quality of services. Later in the decade, in the run-up to HIPC, attention for poverty reduction increased, with the government adopting poverty reduction as its primary development objective.

After Zambia enjoyed high levels of aid and debt relief in the first years of the reform programme, aid and debt relief declined in the second half of 1990s. Very limited balance

of payments support in 1996-97 and negligible support in 1998, largely in response to the breaching of political conditionality, made programme implementation difficult. Resumption of multilateral and some bilateral support took place in 1999, but later in that year problems related to delays in the privatisation of ZCCM led to delays and shortfalls in balance of payments support, which again constrained programme implementation (World Bank 1999).

After the evaluation period, perspectives appeared to improve somewhat. ZCCM was finally sold; an Interim PRSP was completed, followed by the preparation of a draft full PRSP in 2001; and renewed agreement on economic policy measures with the IFIs was reached, with prospects for debt relief under Enhanced HIPC. Further, a good governance programme was launched.

3.4 Effect on the balance of payments

Another element of the outputs of debt relief concerns the extent to which debt relief led to increases in imports of goods and services, through which it may have contributed to economic growth.

As we already saw in section 3.1 a substantial part of PC debt relief was used to settle arrears, limiting its flow effect. This also seems to be suggested by the data in Table 3.1 on the balance of payments and Table 3-2 on the sources and uses of foreign exchange (based on a rearrangement of the balance of payments).

In addition, the flow effect of total aid (including debt relief) on the country's import capacity is also an important factor to consider. The effect of multilateral debt relief on imports is similar to that of other programme aid. As they all concern freely spendable resources for the government and external accounts, there is no difference between the flow effect of debt relief and programme aid in general. The effect of debt relief on imports is therefore assessed through an analysis of programme aid in general.

Table 3-1 shows that neither imports nor exports showed any particular trend during the 1990s, leading to a relatively stable, slightly negative, trade balance. Net services, also with a negative balance, did not show a clear trend either. Net transfers were an important source of financing the current account but declined, first from 1993 onwards compared to the years 1991-92, and then further in 1996. Interest payments on debt declined as well, but as this was not sufficient to offset the decrease in transfers, the current account deteriorated. The capital account and financing were marked by the large IMF loan at the end of the RAP which was used to settle IMF arrears. Arrears to other creditors were also settled. Other donor support, including debt relief and loans, which formed an important source of financing the current account, also dropped, as did transfers. On the other hand, private capital flows became more important as a source of financing in the second half of the decade.

Table 3-1 Balance of Payments Zambia (USD million)

	1990	1991	1992	1993	1994	1995	1996	1997	1998
Exports (goods)	1263	1085	1133	994	1066	1186	993	1110	816
Metals	1150	998	1033	870	910	984	754	806	520
Other	113	88	100	124	157	202	239	304	296
Imports (goods)	-1084	-952	-1351	-1019	-1003	-1194	-1055	-1056	-971
Metal sector	-346	-285	-323	-242	-287	-271	-237	-289	-221
Other	-738	-667	-1028	-777	-716	-923	-818	-768	-750
Trade balance	179	133	-218	-24	64	-8	-62	54	-155
Net services (non-factor)	-206	-222	-201	-100	-99	-194	-141	-189	-394
Interest on official debt	-329	-381	-320	-216	-233	-252	-198	-195	-192
Other factor services	10	-3	-2	-10	-4	10	-8	-10	0
Transfers (net)	253	481	606	321	319	298	287	182	179
Current account	-93	8	-138	-30	46	-146	-122	-158	-562
Official disbursements	169	317	467	455	212	234	206	190	91
Official amortisation	-318	-337	-358	-306	-309	-338	-255	-181	-136
Private capital (net)	-112	-79	-250	-186	85	27	98	157	198
Capital account	-261	-99	-141	-37	-12	-77	49	166	153
Errors and omissions	0	0	18	-115	-106	-13	-8	-135	-27
Overall balance	-354	-91	-258	-182	-72	-236	-81	-127	-436
IMF (net)	97	-39	-39	-73	-18	0	0	14	0
Purchases	0	0	0	0	0	1264	0	14	0
Repurchases (scheduled)	-113	-59	-6	-3	-18	0	0	0	0
Change in overdue obligations	210	21	-33	-70	0	-1264	0	0	0
Other foreign assets (net)	-3	28	-70	-14	-63	23	-53	-46	246
Central Bank (net)	-4	28	-91	26	-141	69	-31	-38	246
Assets	7	10	-23	-5	-80	90	-3	-27	194
Liabilities	-11	18	-68	31	-61	-21	-27	-11	52
Commercial banks	1	0	21	-40	78	-46	-22	-8	0
Net change in arrears (decrease= -)	-465	-192	-183	-90	-76	176	-176	0	85
Debt reduction/ rescheduling rec'd	725	293	551	359	227	37	310	159	122
Financing	354	90	259	182	70	236	81	127	436

Source: IMF Selected issues and Statistical Appendices 11 March 1999 and 18 July 2000

As can be seen in the overview of sources and uses of foreign exchange in Table 3-2-a, foreign aid was at a high level. It did not show a clear trend in the first part of the decade, but decreased in the second half of the 1990s. This was especially the case when debt relief is included. As a proportion of total foreign exchange, income aid declined from an average of 37% in the years 1991-93 to 22% in 1998 (Table 3-2-b). Aid including debt relief, was higher than exports during most of the first half of the 1990s, but was less than exports after 1995. With the fall in both aid and exports, the balance of payments position deteriorated. In the meantime there was no substantial buildup of the foreign exchange reserves, which remained at a low level (less than two months worth of imports) throughout the decade. A study on programme aid to Zambia concluded that aid did play a role in supporting imports and maintaining debt service payments, and possibly also in avoiding a reversion to foreign exchange controls. Imports, while not increasing, would have been lower in the absence of aid, and programme aid was essential in enabling Zambia to continue its debt service payments and stay on-track with the reform programme as a prerequisite for continued donor support (White 1999).

Table 3-2-a Sources and uses of forex (USD million)

	1990	1991	1992	1993	1994	1995	1996	1997	1998
Sources									
Exports of goods	1263	1085	1133	994	1066	1186	993	1110	816
Aid*	422	798	1073	776	531	532	493	372	270
IMF	0	0	0	0	0	1264	0	14	0
Debt relief	725	293	551	359	227	37	310	159	122
Total	2410	2176	2757	2129	1824	3019	1796	1655	1208
Uses									
Import of goods	-1084	-952	-1351	-1019	-1003	-1194	-1055	-1056	-971
Services (net)	-206	-222	-201	-100	-99	-194	-141	-189	-394
Other factor services (factor incl.)	10	-3	-2	-10	-4	10	-8	-10	0
Debt service due (incl. IMF)	-760	-777	-684	-525	-560	-590	-453	-376	-328
Interest on official debt	-329	-381	-320	-216	-233	-252	-198	-195	-192
Official amortisation	-318	-337	-358	-306	-309	-338	-255	-181	-136
IMF repurchases	-113	-59	-6	-3	-18	0	0	0	0
Change in arrears	-255	-171	-216	-160	-76	-1088	-176	0	85
Net private capital	-112	-79	-250	-186	85	27	98	157	198
Other foreign assets	-3	28	-70	-14	-63	23	-53	-46	246
Errors and omissions	0	0	18	-115	-106	-13	-8	-135	-27
Total	-2410	-2176	-2756	-2129	-1826	-3019	-1796	-1655	-1208
Aid + Debt relief	1147	1091	1624	1135	758	569	803	531	392

* Aid = net transfer + official; disbursements

Table 3-2-b Sources and uses of forex (per cent)

	1990	1991	1992	1993	1994	1995	1996	1997	1998
Sources									
Exports of goods	52	50	41	47	58	39	55	67	68
Aid*	18	37	39	36	29	18	27	22	22
IMF	0	0	0	0	0	42	0	1	0
Debt relief	30	13	20	17	12	1	17	10	10
Total	100	100	100	100	100	100	100	100	100
Uses									
Import of goods	45	44	49	48	55	40	59	64	80
Services (net)	9	10	7	5	5	6	8	11	33
Debt service due (incl. IMF)	32	36	25	25	31	20	25	23	27
Change in arrears	11	8	8	8	4	36	10	0	-7
Net private capital	5	4	9	9	-5	-1	-5	-9	-16
Other**	0	-1	2	7	9	-1	4	12	-18
Total	100	100	100	100	100	100	100	100	100

* Aid = net transfer + official; disbursements

** Other = other factor services + errors and omissions + other foreign assets

Source: IMF Selected issues and Statistical Appendices 11 March 1999 and 18 July 2000

The impact of aid on imports can be determined by means of an assessment of the level of imports that would have resulted in the absence of aid, i.e. the counterfactual imports.

Table 3-3 gives these counterfactual imports expressed as a proportion of the actual imports according to four scenarios. In scenarios 1 and 2 it is assumed that there is no aid and no debt relief, and there is no arrears decumulation. In scenario 1 debt service is reduced by 50% (i.e. by USD 230 million, or half of the average annual debt service paid of USD 460 million, reflected in an increase in arrears accumulation of USD 230 million), and arrears are increased with half the amount of actual debt relief. In scenario 2 the debt service is as actual. In scenario 3 and 4 there is no aid, but debt relief remains as actual. In scenario 3 debt service is reduced with USD 230 million, while in scenario 4 debt service paid and arrears accumulation remain as actual. Further, it is assumed in every scenario that all other flows on the balance of payments remain the same. For detailed calculations under the different scenarios, see Annex

Table 3-3 Counterfactual imports of goods as percentage of actual imports in four scenarios

	1990	1991	1992	1993	1994	1995	1996	1997	1998
Scenario 1	49	25	17	29	58	-33	60	78	91
Scenario 2	18	3	-4	4	32	38	41	48	61
Scenario 3	82	40	38	46	70	-31	75	85	98
Scenario 4	61	16	21	24	47	-50	53	63	74

Scenario 1 = no aid, no debt relief, debt service USD 230 million lower, arrears increase with half of debt relief, no arrears decumulation

Scenario 2 = no aid, no debt relief, debt service as actual, no arrears decumulation

Scenario 3 = no aid, debt relief as actual, debt service USD 230 million lower than actual

Scenario 4 = no aid, debt relief as actual, debt service as actual.

Reduction of debt service paid is done by adding USD 230 million to arrears accumulation, while keeping debt service due at the same level (BoP figures give debt service due instead of debt service paid).

The scenarios show that in the absence of aid, imports would be lower than actual imports. The degree to which counterfactual imports were lower varied considerably depending on the scenario and the year¹³. Generally, there was less difference between counterfactual imports and actual imports in the second half than in the first half of the decade. This coincided with the reduction in aid and debt relief disbursements since 1995, and hence confirms the impact of aid. Overall, counterfactual imports were significantly higher in scenarios where debt service was reduced compared to otherwise similar scenarios (i.e. comparing scenario 1 with scenario 2, and scenario 3 with scenario 4). This means that besides aid including debt relief, debt service was also an important factor in determining import capacity.

While imports could be sustained at a higher level due to aid, the composition of those imports is also important when assessing its effects on economic growth. After a sharp decrease in the early 1990s, the share of capital imports increased, while the trend for intermediate imports was the opposite (Table 3-4). The share of consumer goods on balance also increased somewhat, but this does not seem to have been excessive so as to have been a major cause for concern (White 1999). Overall, the trend in the composition of imports was rather favourable to the promotion of economic growth.

¹³ 1995 was an atypical year in view of the large arrears decumulation to the IMF.

Table 3-4 Composition of imports

	1988-90	1992	1993	1994	1995	1996	1997
Consumer	14	12	10	16	9	16	20
Intermediate	41	66	61	53	59	55	47
Capital	45	22	29	31	32	29	34
Total	100	100	100	100	100	100	100

Source: White 1999

3.5 Effect on government accounts

Finally, the effect of debt relief on the government accounts, especially on public investment and social expenditure, is analysed. As debt relief has the same effect as other foreign programme aid that is disbursed as freely spendable resources, its effect on the government accounts will be analysed by examining the effects of programme aid more generally. As it was found that debt relief was additional to other aid resources in most years, its effect was additional to that of other aid, contributing to a further freeing of resources.

Table 3-5 presenting the government accounts shows that government revenue as a percentage of GDP did not follow any particular trend during the 1990s, remaining stable at about 20% of GDP. However, grants, while they first went up, then went down after 1995. Government expenditure was considerably lower as a percentage of GDP in the second compared to the first half of the decade, declining from 40% to 29%. Both interest and non-interest expenditure declined after 1995. The budget deficit was fluctuating accordingly and was somewhat lower after 1995, although it remained rather high. Hence expenditure was squeezed, coinciding with the reduction of the deficit and a decline in grants. If government would not have received aid and debt relief and would have had to pay all debt service obligations from its own resources, non-interest expenditure is likely to have been squeezed further and the deficit been higher. The fact that the decline in grants coincided with the fall in expenditure suggests a relation between the two.

In 1993 a cash budget was installed to prevent deficit financing. Domestic financing was negative and hence no monetary financing of the deficit took place in 1993, 1996 and 1997, but in the other years monetary financing of the deficit did take place, preventing inflation to come down below 20%-25%. Nevertheless, inflation did decline from over 100% earlier in the decade, and inflationary financing and inflation would have been higher in the absence of aid and debt relief. At the same time, higher expenditure was made possible by aid than would have been possible without it. Throughout the 1990s dependence on foreign aid was high.

While expenditure was higher than it would have been in the absence of aid, the composition of expenditure also matters to assess the extent to which it would foster growth. Capital expenditure, which is used here as a proxy for public investment, amounted to about 28% during most of the decade, after which it went up to 35% at the end of the decade. The bulk of it was covered by external financing. A close relationship existed between aid and capital expenditure (IMF Selected issues and Statistical Appendices 11 March 1999 and 18 July 2000). Foreign aid played an important role in maintaining public investment, but this may to an important extent have been due to project aid.

Table 3-5 Government accounts in billions of Kwacha (unless otherwise indicated)

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999
Total revenue and grants	28	72	188	390	676	871	1058	1282	1529	1921
Revenue	23	41	105	235	450	596	817	1023	1131	1324
Grants	5	31	84	155	227	275	242	260	398	597
Total expenditure & net lending	37	88	212	531	854	1000	1214	1407	1943	2194
Recurrent expenditure	30	64	155	390	625	727	869	1017	1263	1404
Wages	6	13	34	71	115	178	221	324	327	402
Interest	9	18	49	183	260	259	322	326	421	482
Other recurrent	15	33	72	136	250	290	326	367	515	520
Capital expenditure	7	24	57	141	230	273	345	390	680	790
External			47	123	193	215	304	320	567	666
Domestic			10	18	37	58	41	70	113	124
Net lending and investment	0	0	0	0	0	0	0	0	0	0
Overall balance (Deficit)	-9	-16	-24	-140	-178	-129	-155	-124	-414	-273
Financing	9	16	24	140	178	129	155	124	414	273
External financing (net)	7	5	23	152	125	122	199	217	265	226
Domestic financing (net)	2	11	1	-11	53	8	-43	-93	150	46
Percentage of financing										
Foreign	78	31	96	109	70	95	128	175	64	83
Domestic	22	69	4	-8	30	6	-28	-75	36	17
Percentage of GDP										
Revenue and grants	25	33	33	26	30	29	27	25	25	26
Revenue	20	19	18	16	20	20	21	20	19	18
Grants	4	14	15	10	10	9	6	5	7	8
Expenditure	33	40	37	36	38	33	31	27	32	29
Interest	8	8	9	12	12	9	8	6	7	6
Non-interest	25	32	29	23	27	25	23	21	25	23
Deficit	-8	-7	-4	-9	-8	-4	-4	-2	-7	-4
Percentage of total expenditure										
Recurrent expenditure	81	73	73	73	73	73	72	72	65	64
Development expenditure	19	27	27	27	27	27	28	28	35	36
Memo: GDP	113	218	570	1482	2241	2999	3951	5141	6033	7517

Source: IMF Selected issues and Statistical Appendices 11 March 1999 and 18 July 2000

With the start of the ESAC I in 1994 government committed itself to allocating one-third of total expenditure to the social sectors, a target that was met (Table 3-6). Table 3-7 shows that the share of social sector expenditure in total domestic expenditure increased during the 1990s. However, as total expenditure declined sharply as a proportion of GDP, social expenditure stagnated at about 5% of GDP. According to several sources there was a decline in non-wage social sector spending in real terms (GoZ 1997b, World Bank 1999). After a long-term decline in real social spending since the early 1980s (which largely fell on the education sector), since 1994 the social sectors were protected in the sense that they did not suffer disproportionately from expenditure cuts. Aid, including debt relief, contributed to this development, without which government would have had less to spend on these sectors. However, there seems to have been much less success in reorienting expenditure toward those services used most by the poor (White 1999). With HIPC the

attention for development of the social sectors is expected to become more pronounced. Defence expenditure was not a major issue: Zambia reduced its defence expenditure as proportion of its total budget, with part of these funds used for the social sectors (World Bank 1996).

Table 3-6 Share in social expenditure of domestically financed discretionary spending* (per cent)

	1996	1997	1998	1999
Education	18	18.3	17.4	18.5
Health	13	12.9	13.1	13.7
Social security and welfare	1.3	1.6	1.1	1.2
Water and sanitation	3.1	1.6	2.4	2
Other social expenditure	0.3	0.1	0.2	1.1
Total social expenditure	35.6	34.4	34.2	36.4
Discretionary expenditure in % of total expenditure	57	64.3	49.6	52.9

Share in domestically financed discretionary government expenditure. Social expenditure is defined as current and capital expenditure on health, social safety net, water and sanitation and disaster relief.

Source: World Bank/IDA 2000-b.

Table 3-7 Social sector expenditure shares (per cent)

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999
Share of domestic expenditure										
Education	7	11	9	10	10	11	14	16	14	12
Health	11	5	6	8	9	9	9	11	11	10
Social security and welfare	2	4	2	4	4	4	4	8	2	3
Housing and comm. Services	1	1	0	0	1	2	3	3	2	2
Total social sectors	21	21	18	22	24	27	30	37	29	27
Share of GDP										
Education	2	3	2	2	2	2	2	3	2	2
Health	3	1	1	2	2	2	2	2	2	2
Social security and welfare	0	1	1	1	1	1	1	1	0	1
Housing and comm. Services	0	0	0	0	0	0	1	0	0	0
Total social sectors	5	5	4	4	5	5	5	6	5	4
Total expenditure	24	25	23	20	22	20	18	17	17	15

Source: IMF Selected issues and Statistical Appendices 11 March 1999 and 18 July 2000

3.6 Conclusions

Debt relief to Zambia resulted in a stock effect. However, this did not prevent the debt from remaining very high, amounting to USD 6,900 million in 1999. There was some effect of PC debt relief on the bilateral debt stock: nominal bilateral debt initially increased, and then stabilised. The stock effect of multilateral debt relief was limited, and together with the supply of new lending the multilateral debt stock continued to increase substantially during the 1990s. The commercial debt buyback had a stock effect as it led to a large decrease in the commercial debt stock. Nevertheless, as commercial debt did not constitute a major element in the total debt stock, the stock effect of the buyback on the total debt remained limited. As a result the total nominal long-term and IMF debt stock increased. Despite this, total debt decreased somewhat in the 1990s due to a large decrease in short-term debt (probably to a large extent arrears). As forgiveness and debt

stock reduction amounted to a considerable proportion (one-third) of the 1999 debt stock and new loans were contracted on very concessional terms, the NPV of the debt probably declined. HIPC, which was initiated only after the evaluation period, is expected to result in a substantial future stock effect.

Debt relief had a flow effect, although overall this effect was modest. At the same time, debt relief was additional to other aid resources. While debt service paid on long-term and IMF debt stood at a higher level than in the second half of the 1980s, it showed a declining trend during 1990s. However, this probably reflects an increase in grants and concessionality of loans rather than a flow effect. PC debt relief resulted in a limited flow effect, as part of the operations involved settlement of arrears and as arrears probably would have accumulated in the absence of agreements. As PC agreements involved more rescheduling than forgiveness, bilateral debt service paid went up during the 1990s. On the other hand, multilateral debt service paid decreased. This reflected an increase in the concessionality of multilateral loans. As a substantial part of multilateral debt relief involved settlement of arrears, this did not lead to a large flow effect. Although Fifth Dimension relief did not lead to a decline in debt service paid, it did relieve its burden and had an important flow effect. Terms of the IMF loans in the mid-1990s led to low debt service payments on these loans, but will translate into a high increase in debt service after 2000. No flow effect resulted from the commercial debt buyback. Debt relief resulted in a larger decline in debt service due than that in debt service paid. HIPC is expected to have a substantial flow effect in the future.

With regard to the external accounts, while imports did not increase in view of declining exports and aid flows, aid including debt relief did allow imports to be sustained at a higher level than would have been possible without these resource inflows, and to maintain debt service payments. It benefited both the import of investment goods and that of consumption goods. Further, aid including debt relief allowed government expenditure to be higher than would have been possible without aid and debt relief, and government deficits would have been higher without it. As such it helped to sustain public investment and social expenditure at a higher level than would otherwise have been possible. It also helped to dampen inflation.

Donors exercised influence on policy through conditionality and the policy dialogue. Most of the reforms that were implemented were those supported by them. On the other hand, many planned reforms were only slowly or not properly implemented. Withdrawal of support in reaction to non-compliance with targets was less applied with regard to economic reforms than in relation to governance problems. While bilateral donors followed the lead of the IFIs with regard to economic policy, in the area of governance and political reforms they took a more independent and leading stance. Donors became increasingly disillusioned with Zambia, as expressed in substantial cutbacks in aid and debt relief after 1995.

4 OUTCOMES OF DEBT RELIEF: EFFECTIVENESS

This chapter assesses the effectiveness of debt relief, i.e. the extent to which debt relief inputs and outputs have contributed to desired outcomes. This includes analysis of the extent to which debt relief through its stock and flow effect contributed to increased debt sustainability, the extent to which it stimulated investment and improved creditworthiness, and whether it contributed to an improvement of social indicators.

4.1 Debt sustainability

From a liquidity perspective, debt remained unsustainable throughout the 1990s, although substantial progress towards sustainability was made.

The debt service ratio stood at a higher level in the 1990s than in the late 1980s (Figure 1–6). Virtually throughout the decade the ratio remained above the sustainability threshold of 20%, with a peak of over 40% in 1991 when relations with the IFIs were resumed and World Bank arrears were settled, and a very high peak of 180% in 1995 when an IMF facility was paid back. Nevertheless, the debt service ratio declined in the second half of the decade to what seemed to be a sustainable level, although it exceeded the 20% threshold again in 1999. The debt service due-to-exports ratio was very high, well above 200% during the first half of the decade, after which it improved to about 100% as a massive reduction of scheduled debt service took place due to settlement of arrears (Table 4–1). The proportion of debt service due that was actually paid fluctuated substantially and was overall somewhat higher in the second compared to the first half of the decade.

As a large volume of unpaid arrears is another indication of a lack of liquidity, the sharp decline in arrears from its peak of USD 2,200 million in 1990 testifies to improved sustainability in this respect. Aid including debt relief was instrumental in facilitating this decline. Nevertheless, arrears remained high during most of the decade, amounting to USD 800 million in 1998 or 18% of the total long-term debt stock. According to preliminary figures, they declined further to USD 190 million in 1999.

The level of debt service paid was the dominant factor in determining the trend of the debt service ratio. While negligible or negative export growth rates (based on current dollar prices) from 1993 onwards put upward pressure on the debt service ratio, this was more than compensated by the decline in debt service paid, resulting in a reduction of the debt service ratio in the second half of the decade. Debt service paid on long-term and IMF debt combined declined throughout the 1990s. However, while the flow effect from debt relief measures played a role in this development, the relatively low debt service paid after 1995 was partly due to the terms of the IMF's ESAF loans which include a grace period until 2001; after 2001 IMF debt service payments will rise again sharply, which will negatively affect the debt service ratio. A major factor that adversely affected exports was the decline in the world market price for copper, Zambia's major export product. The failure to privatise and restructure the sector in a timely manner also contributed to this development. Besides the price, the volume of copper exports also declined. As a result the value of copper exports declined from USD 1,000 million in 1990 to USD 370 million in 1999, and its share in total exports fell from 83% in 1990 to 49% in 1999. Although non-metal exports increased substantially, and their share in total exports increased from 9% in 1990 to 38% in 1999, this could not offset the sharp decline in metal exports.

The interest paid-to-exports ratio, another measure of liquidity, was below its sustainability threshold of 15% during most of the decade. It declined in the second half of the decade, amounting to 7% in 1998. This trend occurred despite adverse developments in exports,

and was driven by the substantial decrease in interest payments from USD 300 million in 1991 to USD 70 million in 1998.

Table 4-1 Debt sustainability indicators

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999
Amounts (USD million)										
Debt service due (I-t debt)	3327	2813	2748	2720	2237	1335	1326	1236	1150	974
Debt service paid (I-t debt)	173	492	244	233	312	378	231	229	187	425
Debt service due (I-t debt + IMF)	3354	2913	2853	2849	2299	2579	1337	1242	1156	980
Debt service paid (I-t debt + IMF)	199	592	350	363	374	2622	242	235	193	431
Interest payments (I-t debt)	72	237	98	92	127	136	75	65	55	131
Interest payments (total debt)	77	305	168	152	169	556	95	81	70	144
Debt stock (I-t debt)	4554	4708	4528	4411	5188	5298	5379	5257	5348	4571
Debt stock (total debt)	6916	6968	6709	6485	6804	6952	7054	6654	5865	5853
Exports	1362	1266	1301	1140	1285	1445	1227	1454	1034	940
Imports	2336	1811	2119	1661	1727	1962	1702	2026	1659	1491
GNP	3008	2993	2867	3019	3111	3228	3065	3706	3025	2994
Investment	568	372	378	492	276	553	420	570	530	550
Savings	545	283	1	295	248	423	173	367	126	-35
Ratios (I-t debt + IMF) (per cent)										
Debt service due/Exports	246	230	219	250	179	248	109	85	112	104
Debt service paid/Exports (DSR)	15	47	27	32	29	182	20	16	19	46
Interest payments/Exports	6	24	13	13	13	39	8	6	7	15
Debt service paid/Debt service due	6	20	12	13	16	73	18	19	17	44
Debt service due/GNP	111	97	100	94	74	111	44	34	38	33
Debt service paid/GNP	7	20	12	12	12	81	8	6	6	14
Interest payments/GNP	3	10	6	5	5	17	3	2	2	5
Investment/GNP	19	12	13	16	9	17	14	15	18	18
Savings/GNP	18	9	0	10	8	13	6	10	4	-1
Debt (LDOD)/Exports	334	372	348	387	404	367	439	361	517	486
Debt (EDT)/Exports	508	551	516	569	529	481	575	458	664	622
Debt (LDOD)/GNP	151	157	158	146	167	164	175	142	177	153
Debt (EDT)/GNP	230	233	234	215	219	215	230	180	227	195
Longer-term sustainability										
Average interest rate new loans	8.1	0.9	1.1	0.7	1.9	1.8	2.0	1.7	0.8	0.8
Growth of GNP	14.8	30.1	14.3	-3.1	-0.7	2.4	0.8	8.9	0.1	-1.3
Growth of exports	16.3	19.3	12.8	-2.1	-4.0	1.3	-1.6	0.8	-5.6	-10.5

Growth rates are based on five-year rolling averages

Source: World Bank 2001-a and World Bank 2001-b

Zambia continued to experience serious solvency problems during the 1990s. Solvency indicators such as debt-to-GNP ratio and debt-to-exports ratio remained far above their sustainability thresholds of 50% and 200% respectively during the 1990s, pointing at a continued highly unsustainable debt burden (Table 4-1, see also Figures 1-4 and 1-5). The debt-to-GNP ratio ranged between 200% and 250% with a slight decline later in the decade. The debt-to-exports ratio fluctuated around the 550%, and increased to over 600% towards the end of the 1990s. The continued high debt was a major factor driving the debt-to-GNP ratio: while debt relief did have a stock effect, the long-term and IMF debt continued to grow, largely due to new lending, and although this was compensated by a decline in short-term debt, the debt burden continued to be highly unsustainable.

However, the positive development in GNP growth (measured in current dollar prices) in the early 1990s and again in 1996-97 put downward pressure on the debt-to-GNP ratio. On the other hand, the deterioration of the country's export performance (in current dollar prices) together with an increase in the long-term and IMF debt were responsible for continued high and increasing values of the debt-to-exports ratio.

Another measure of the longer-term sustainability of the debt burden concerns the comparison between the interest rate on debt and growth rates of GNP and exports. GNP growth (measured in current dollar prices) was on and off below or above the interest rate on new loans. Export growth was systematically below the interest rate since 1993, indicating unsustainability in the longer run (Table 4-1). On the other hand, the much more favourable interest rates in the 1990s compared to a decade earlier meant a positive development for debt sustainability.

Debt relief under Enhanced HIPC through its stock and flow effect is expected to contribute to bringing the debt burden down to sustainable levels. It is projected that as a result of HIPC the NPV debt-to-exports ratio will decline to 150% (the HIPC sustainability threshold for this indicator), compared to the 400% registered in 1999 before HIPC and after implementation of traditional debt relief mechanisms. The debt service ratio is expected to fall below 20%. To what extent these results will indeed materialise remains to be seen and will also depend on developments in key indicators such as exports.

4.2 Effect on investment and creditworthiness

An important implication of the reduction in the debt stock in NPV terms is a reduction in expected future debt service payments. This may have had beneficial effects on private investment, either directly through a reduction of the tax on future profits, or indirectly by increasing the government's incentives to pursue good policies. In addition, it may have had beneficial effects on the country's creditworthiness for foreign investors and lenders.

The reduction in the debt stock as a result of debt relief was not sufficient to help Zambia achieve a favourable private investment response during the 1990s, which was also held back by a range of other factors. The share of domestic investment in GDP did not show a clear trend, and stood at about 13%-14% during most of the decade (Table 4-2). By and large, public and private investment were at the same level and neither showed a clear trend. Gross national savings were generally insufficient to finance domestic investment, especially in the second half of the 1990s.

According to Botchwey e.a., the large debt overhang was an important factor hindering private investment, as it formed a potential tax on future profits (Botchwey e.a. 1998). It was concluded in Chapter 3 that debt relief reduced the stock of debt. Nevertheless, the debt remained very high, perpetuating a substantial debt overhang. Several other factors also had an adverse effect on private investment. Among these were inadequate infrastructure (roads, electricity, water etc.), a weak financial sector, delays in the privatisation programme (in particular the failure to privatise ZCCM at an earlier stage in the programme), and corruption (World Bank 1999). In addition, sequencing errors in economic reforms¹⁴ resulted in high inflation, which, combined with liberalised interest rates, led to a credit crunch. This in turn squeezed private investment, as the private sector faced serious liquidity problems (Botchwey e.a. 1998). Further, despite far-reaching structural reforms and tight fiscal policy with large expenditure reductions, private investment was adversely affected by a lack of credibility. This was related to the continued high inflation rates which could be seen as a lack of government commitment to

¹⁴ Errors in sequencing included in particular the liberalisation of foreign exchange and financial markets before stabilisation had been completed.

the reforms. Continued sluggish or negative economic growth also did not create a positive business climate and was detrimental to credibility.

Table 4-2 GDP by type of expenditure at current prices (per cent)

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999
Resource balance	-1	-3	-13	-4	-1	-4	-8	-5	-13	-19
Exports goods & services	36	35	37	34	36	36	31	30	27	22
Imports goods & services	-37	-37	-49	-37	-37	-40	-39	-35	-39	-41
Consumption	84	92	101	89	93	88	95	91	96	101
Private	69	75	83	76	80	72	76	73	80	88
Public	15	16	18	13	13	16	18	18	16	13
Investment	17	11	12	15	8	16	13	15	16	18
Gross fixed capital formation	17	11	11	15	11	13	11	13	15	16
Private	10	6	7	11	1	6	5	8	7	9
Public	7	6	4	3	11	7	6	5	8	7
Change in stocks	1	-1	1	0	-3	4	2	2	2	2
Gross domestic savings	17	8	-1	11	7	12	5	9	4	-1
Private	11	6	-1	8	1	9	3	6	2	-4
Public	6	3	0	3	6	4	3	3	2	2
Resource gap	-1	-3	-13	-4	-1	-4	-8	-5	-13	-19
Gross national savings	15	11	8	14	10	12	9	9	8	4

Gross national savings = gross domestic savings + net factor income and net current transfers from abroad.
Source: IMF Selected Issues and Statistical Appendices 11 March 1999 and 18 July 2001

On the other hand, public investment benefited from the extra resources brought by aid and debt relief, and would have been lower without it. Also, the absence of aid including debt relief would have reduced foreign exchange availability for imports, with consequent adverse effects for investment. Indeed the import of capital goods increased during the 1990s. In the absence of high levels of aid, including debt relief, the government would not implement the full adjustment programme, and would not be able to meet its debt service obligations from its own resources. In this regard, the absence of aid and debt relief would have had direct and indirect adverse effects on investment (White and Estrand 1998).

Overall, the signs with regard to developments in creditworthiness appeared mixed. Important indicators of the creditworthiness of a country include the debt service paid-to-debt service due ratio and new financial inflows. The debt service paid-to-debt service due ratio increased somewhat, pointing at an increase in creditworthiness (Table 4-1). With regard to new inflows into Zambia, the bulk of lending was done by multilateral institutions, mostly on concessional terms (Table 4-3). Bilateral lending was limited, and largely replaced by grants. Nevertheless, some lending on non-concessional terms by multilateral as well as (to a lesser extent) bilateral creditors continued, which became negligible only toward the end of the decade. New foreign private lending to the public sector, while still amounting to a total of USD 180 million or an annual average of USD 30 million per year between 1990 and 1995, fell back to zero at the end of the decade. This is probably primarily related to Zambia's policy to avoid non-concessional borrowing as part of its debt strategy, rather than a decline in creditworthiness. New long-term loans to the Zambian private sector remained negligible, indicating low creditworthiness, although they

increased at the end of the decade, presumably in connection with the privatisation programme. Foreign direct investment increased substantially from USD 30 million in 1991 to USD 160 million in 1999 (World Bank 2001-a). However, FDI levels remained relatively low, and Zambia was still considered a risky place for investment (White 1999). Nevertheless the trend was positive, which is confirmed by IMF balance of payments statistics showing that new private capital inflows increased from being negative to over USD 150 million towards the end of the decade (Table 3-1). Portfolio equity flows remained nil.

It transpires that in general Zambia was not regarded as a very creditworthy country to invest in. The before-mentioned lack of credibility of the government's commitment to reforms and continued bad economic performance are likely to have been crucial factors adversely affecting creditworthiness. This was exacerbated by the withdrawal of donor support at several instances and the general decline in aid provision to the country. The continued high debt stock – despite a stock effect of debt relief – did not help to boost creditworthiness, although neither does it appear to have taken an excessive toll on foreign private investment and lending. The advent of HIPC, which is expected to substantially reduce the NPV of debt, should lead to improved perspectives, although it remains to be seen whether it will be sufficient to solve Zambia's debt problems.

Table 4-3 New inflows into Zambia (USD million)

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999
PPG – Total disbursements	162	356	272	240	292	351	232	272	64	200
Official	117	311	250	229	259	327	224	222	64	200
Bilateral	11	39	13	4	18	76	11	12	0	3
concessional	9	21	9	4	11	72	0	3	0	2
non-concessional	2	19	4	0	7	5	11	8	0	1
Multilateral	106	272	237	226	242	251	213	211	64	198
Concessional	41	262	204	201	207	237	205	207	59	192
Non-concessional	65	10	34	25	35	14	8	4	5	6
Private	46	45	23	10	33	24	8	50	0	0
PNG – Total disbursements	2	2	10	1	2	1	5	0	20	50
Disbursements – Total	164	358	283	241	294	352	236	272	84	250
Long-term debt	0	0	0	0	0	1235	0	14	0	14
IMF	164	358	283	241	294	1606	236	286	84	264
Net resource flows on I-t debt*	63	102	136	99	109	110	80	108	-49	-44
Net transfers on I-t debt**	-9	-135	38	7	-18	-25	5	42	-103	-175
FDI (net)	203	34	45	52	56	97	117	207	198	163
Portfolio equity flows	0	0	0	0	0	0	0	0	0	0
Grants (excl. techn. Coop.)	663	426	642	478	355	362	273	250	257	347
Aid (loans excl. IMF + grants)	828	783	924	719	650	714	509	522	341	597
Aid (loans incl. IMF + grants)	828	783	924	719	650	1967	509	536	341	611
% grants of total aid (excl. IMF)	80	54	69	67	55	51	54	48	75	58
% grants of total aid (incl. IMF)	80	54	69	67	55	18	54	47	75	57

Net resource flows on debt – loan disbursements – principal repayment.

Net transfers on debt = loan disbursements – debt service

Source: World Bank 2001-a

4.3 Effect on social indicators

During the period 1976-1990 social indicators deteriorated, due to a decline in incomes (GDP per capita declined by one fourth) in tandem with a sharp decline in health and education spending as a proportion of GDP (Botchwey e.a. 1998, World Bank 1999). Zambia's social indicators moved from being much superior to the Sub-Saharan African average in 1976 (the start of reforms) to below-average in 1990. Primary education was particularly hard hit.

As Table 4-4 shows, the evidence on social indicator trends in the 1990s is mixed. Access to health services improved, no major changes in access to primary education occurred (with a slight improvement in rural attendance but a slight deterioration in urban attendance), while malnutrition increased, which is likely to have been related to declining incomes as well as drought. Life expectancy declined substantially, which was partly caused by the impact of the country's severe HIV/AIDS epidemic. While overall no substantial continued deterioration in social indicators took place in the 1990s after the sharp decline in the 1980s, there was a failure to recover (White 1999). Despite relatively high budget allocations for the social sectors compared to other sectors, outcomes were disappointing, and social indicators generally remained below the average for Sub-Saharan Africa.

Table 4-4 Social indicators 1990s

	1991	1998
Primary school enrolment (net, %)	68	68
Secondary school enrolment (net, %)	20	23
Illiteracy rate (% of population 15+)	37	38
Immunisation rate (measles / DTP)	77	87
Nutrition (% of under 5 chronically malnourished)	39	53
HIV infection rate (% of adults)	..	20
Access to safe water (% of population)	50	50
Infant mortality rate	107	109
Life expectancy at birth (yrs)	51	44

Source: IMF/IDA 2000

There are several reasons for this development. During the 1990s public spending on health and education as a share of total expenditure increased, in which the supply of aid funds and conditionality are likely to have played a role. However, social expenditure as a proportion of GDP stagnated due to the overall public expenditure cuts. At the same time the output of social services fell, just as demand for such services (especially in health due to AIDS) went up (Botchwey e.a.1998). Further, the reorientation of expenditure to those services used most by the poor did not appear very successful (White 1999). Other important factors impacting on social performance were declining incomes, low public sector efficiency in service delivery, low quality of services, and failures in social safety net design for those adversely affected by adjustment (IMF/IDA 2000, Botchwey e.a. 1998). Cost recovery measures in the social sectors had been put in place in 1989, and were extended in 1993. However, the timing of such measures in rural areas was not appropriate, as the population's cash resources were depleted due to high inflation while the effects of drought and the breakdown of the agricultural marketing system made it difficult for them to replenish these.

Although it is difficult to make a direct link from debt relief to trends in social indicators, it can be inferred that there is likely to have been some beneficial effect on social indicators through the flow effect of aid including debt relief, mainly as it freed resources which allowed government expenditure (public investment and social expenditure) to be higher than it would otherwise have been. However, this effect remained limited, and did not allow social indicators to substantially improve.

4.4 Conclusions

From a liquidity perspective, debt remained unsustainable in the 1990s. Nevertheless, improvements in this area were recorded. Arrears were dramatically cut back, which was made possible by large amounts of aid including debt relief. While the debt service ratio stood at a higher level compared to the late 1980s, and stood above the sustainability threshold of 20%, it declined in the second half of the 1990s; this was driven by a reduction in the debt service paid at a time of adverse export performance. Again, debt relief contributed to this improvement through a positive flow effect. On the other hand, high IMF debt service obligations will become a particularly severe problem when the grace period on IMF ESAF loans expires. Zambia continued to have serious long-term sustainability problems. Solvency indicators remained very high, as the debt stock remained very high despite a stock effect of debt relief, while adverse performance of the exports sector also contributed. The debt-to-GNP ratio stood at 200%-250% and the debt-to-exports ratio at about 550%-600%, far above the sustainability thresholds for these indicators. HIPC, the implementation of which started only after the evaluation period, aims to achieve sustainable liquidity and solvency indicators.

Zambia did not achieve a favourable private investment record in the 1990s. The debt overhang, which continued to be high despite a stock reduction through debt relief, was one of the factors impacting on this development. A range of other factors also affected private investment, such as problems in the design of reform programmes, lack of credibility of government policies and perceived lack of government commitment to reforms, and weak infrastructure. On the other hand, public investment benefited from extra resources brought by aid and debt relief, without which it would have been lower. Aid also eased the foreign exchange shortage, positively impacting on imports, and through this on investment. Evidence with regard to developments in creditworthiness was mixed. While Zambia was generally not seen as a very creditworthy country to invest in, it is not clear to what extent this was caused by the high debt overhang. Factors such as the lack of credibility of government policies and government commitment to reforms, compounded by a withdrawal of donor support as well as continued bad economic performance, may have been more important factors in determining creditworthiness.

Developments in social indicators showed a mixed record. Overall, social indicators remained at a very low level and failed to recover from the decline that had taken place in the 1980s. Aid and debt relief, through its flow effect and social conditionality, are likely to have played some – albeit a limited – role in enabling an increase in expenditure in the social sectors. However, other factors prevented this from leading to a substantial improvement in social indicators, including a public expenditure squeeze resulting in stagnating or declining real social expenditures, declining output of social services, and a failure to properly redirect spending to services for the poor, among other things.

5 IMPACT OF DEBT RELIEF: RELEVANCE

In this final chapter the impact of the different modalities of debt relief will be examined. Based on the findings of the preceding chapters an assessment is made of the extent to which the inputs, outputs and outcomes of debt relief and the conditionality attached to it affected economic growth and poverty reduction.

5.1 Impact on economic growth

After dramatic economic decline between 1976 and 1990, Zambia's overall macroeconomic performance during the 1990s continued to be weak (Table 5-1). Real GDP declined by an average 0.7% per year during the 1990s (IMF 2001). In the first half of the decade the effect of the stabilisation and adjustment programmes on GDP was negative, with per capita GDP falling by 22% (Botchwey e.a. 1998). Growth resumed in 1996 and 1997, when Zambia registered two consecutive years of growth for the first time since 1989, but became negative again in 1998. Most sectors experienced negative growth in at least part of the 1990s, and it appears that there was no sector that drove growth. The share of agriculture in GDP remained on average at about 20%, although it showed some fluctuation. The share of the manufacturing sector in GDP declined sharply from 33% in 1990 to 11% in 1999, while wholesale and retail trade increased from 10% to 19% and financial institutions and insurance increased from 3% to 9%. The share of mining fluctuated between 4% and 17%.

Table 5-1 Selected macroeconomic indicators

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999*
Real GDP growth (%)	0.3	-0.4	-2.5	6.4	-3.4	-2.3	6.4	3.5	-2	1.3
Real GDP growth per capita (5)			-5.1	3.4	-6.1	-4.9	3.8	0.9	-4.3	-1
Inflation (%)	117	93	165	184	54	35	46	25	25	27
Government deficit (% GDP)	-8	-7	-4	-9	-8	-4	-4	-2	-7	-4
Current account balance			-4.1	-0.9	1.4	-4.2	-3.7	-6.1	-8.2	-13.9
Gross forex reserves (months imp.)	1	1.3	..	1.4	1.9	1.4	1.6	1.4	0.5	0.4
Terms of trade (1990 = 100)	100.0	105.9	94.5	82.4	89.1	99.5	99.5	93.4	83.8	74.4

* preliminary data

Source: IMF statistical Appendices, World Bank 2001-a

Inflation was very high in the first part of the decade with a peak of 184% in 1993. Thereafter it came down, but continued to be at a high level (25% at the end of the decade). The government deficit was brought down, largely due to restrictive monetary and fiscal policy which led to an expenditure squeeze, but it still remained rather high. The external position remained weak, with current account deficits in virtually all years which were growing towards the end of the 1990s. On the other hand, progress was made in structural change, with the rapid removal of market distortions and movement (albeit slow) towards an increased role of the private sector.

Several factors of an internal and external nature impacted on growth. Aid including debt relief was an important factor throughout the decade, although it became less important after 1995 as donors were less willing to disburse aid to Zambia. Aid contributed to maintaining public investment and imports at a higher level than would otherwise have been possible. In the absence of aid the foreign exchange availability for imports would have been constrained, with adverse consequences for investment. Aid and debt relief resources also allowed settlement of arrears and continued servicing of debt obligations,

without which Zambia would not have been able to reach agreement on adjustment programmes, and hence would not have been able to obtain access to donor financing.

Economic reforms impacted on growth, although not always in the desired way, especially during the earlier reform years. In particular, it has been argued that there were mistakes in the sequencing of reforms, as certain economic reforms were introduced before stabilisation was achieved, making stabilisation more difficult, preventing inflation from coming down and initially even further fuelling inflation despite high fiscal stringency (Botchwey e.a. 1998). Other factors that fuelled inflation were the bailout of a domestic bank, the failure to privatise ZCCM in an early stage of the reform programme, and a shortfall of balance of payments support which required BoZ to print money to service the debt. Inflation reduced real revenue, and this in combination with the cash budget suppressed government expenditure and led to a credit crunch, with adverse effects on private investment, economic restructuring and liberalisation of agricultural marketing.

Nevertheless, as a result of reforms distortions in the economy were removed and the private sector was accorded a greater role. There were signs of considerable structural change, such as crop diversification in the agricultural sector, although this may not have been sufficient (Botchwey e.a. 1998, White 1999). The effects of expansion released by liberalisation were bound to be relatively weak in Zambia, due to the restricted size of the private sector following Kaunda's long-term economic policies dominated by state-control, the dismal state of infrastructure due to neglect, the long-standing emphasis on maize growing without much diversification, and subsidisation of the agricultural sector which was dismantled with liberalisation.

On the other hand, it can be questioned how committed government was to implementing some of the reforms, as it delayed important economic policy measures, especially in the area of privatisation and public service reform (although it should be noted that implementation of these reforms was also problematic in other comparable countries), and had a questionable attitude in the area of governance. As a result relations with donors became strained, leading to a suspension and substantial reduction of aid inflows, including debt relief. This again had a negative effect on the credibility of government policies, which was also under pressure as a result of the continuing inflation, and created uncertainty which adversely affected production and investment. The continued large debt overhang was a factor in deterring private investment in view of the future tax liability on the economy it potentially formed.

Other factors which adversely affected growth were the falling copper revenues in particular due to the fall in the copper price but also negative developments in the production volume, unfavourable weather conditions (drought), and problems with the restructuring of the copper sector, in particular the privatisation of the copper mines (ZCCM).

5.2 Impact on poverty reduction

Debt relief can impact on poverty reduction via various channels: via the effect of debt relief on government income leading to higher public investment beneficial to the poor and more social sector spending; via increased private investment and economic growth which benefit the poor; and via the impact of policy conditions attached to debt relief which changes the effects of growth on poverty.

Poverty increased during the 1990s (Table 5-2). It first increased between 1991 and 1993, then eased somewhat in the years towards 1996, after which it increased again. In 1998, almost three-quarters of the Zambian population was living in poverty, as the incidence of poverty increased somewhat from 70% in 1991 to 73% in 1998. On the other

hand, data suggest that the depth of poverty (measured as the distance from the poverty line) declined, as did the severity of poverty, with the proportion of extremely poor declining from 47% in 1991 to 32% in 1996. Income distribution became somewhat more equitable, as testified by the decline in the Gini coefficient from 0.59 in 1991 to 0.53 in 1998 (IMF/IDA 2000, World Bank 1999).

Table 5-2 Poverty trends 1991-1998

	1991	1993	1996	1998
National incidence(%)	69.7	73.8	69.2	72.9
Depth of poverty*	62.2	60.6	53.2	57.9
Severity of poverty (core poor)	46.6	40.5	32.3	..
Rural poor (% of rural population)	88.0	92.2	82.2	83.1
Urban poor (% of urban population)	48.6	44.9	46.0	56.0
Female headed households	76.9	81.1	73.2	..
Income distribution (Gini coefficient)	0.59	0.51	0.50	0.53

* Average distance from poverty line
Source: IMF/IDA 2000, World Bank 1999

Rural poverty was more prevalent and deeper than urban poverty and was closely associated with geographical isolation, with higher poverty and a greater lack of basic services in areas further removed from the rail corridors linking the Copperbelt with the capital Lusaka and the rest of Southern Africa. The most distant provinces (Western and Luapula) had the highest incidence of poverty.

Much of the deterioration in poverty incidence fell on the urban areas. In the first years of the reform programme (1991-93) rural poverty increased somewhat while urban poverty decreased. However, since 1993 a reverse pattern occurred: the proportion of the rural population living in poverty declined from 92% to 83%, while that for the urban population increased from 45% to 56%. While urban formal wages did not decline, the deteriorating poverty situation in urban areas was largely related to the decline in mining activity, public sector layoffs, and adverse developments in the manufacturing sector (IMF/IDA 2000). The increase in rural poverty at the start of the decade was partly related to the severe drought that ravaged the country and impacted heavily on rural smallholders who were already among the poorest, while social safety nets did not adequately protect this group against these effects. Rural incomes declined by 30% between 1991 and 1994 (Botchwey e.a. 1998). Further, smallholders were affected by initial adverse effects of agricultural marketing reforms (the removal of the public marketing system met with an interval in which there were insufficient private marketing agents) and removal of subsidies which had benefited them prior to the reforms. The subsequent decline in rural poverty since 1993 did not prevent rural poverty from continuing to be very widespread and at a much higher level than that in urban area because of isolation, poor physical infrastructure and low agricultural production and income.

Private investment and growth performance were weak, and no poverty reduction through this channel was to be expected. However, in the absence of aid including debt relief, this performance might have been worse still. Failure to sufficiently curb inflation, which despite a substantial reduction from very high levels in the early reform years remained at a high level, affected the poor as they suffered most from price increases. To the extent that aid and debt relief (through the flow effect) allowed public expenditure including social sector spending to be higher than would have been possible otherwise,

this may have played some role in preventing social indicators from turning out worse than they were. Larger amounts of the government budget were allocated to social sector spending, and the social conditionality attached to programme aid played a role in this as well. However, due to the big overall expenditure squeeze social spending as a proportion of GDP stagnated. Combined with such factors as a failure to adequately redirect social spending to those services used most by the poor, a decrease in social service output, and low public sector efficiency in service delivery, this did not make for better social indicators and a reduction of poverty. While measures to protect the poor were a deliberate component of adjustment programmes, social safety net design problems and insufficient resource allocation for this purpose did not allow effective cushioning of the poor from the adverse effects of the reforms, and did not contribute to substantial poverty reduction.

Towards the end of the decade more attention was paid to poverty issues in the run-up to the qualification for HIPC debt relief. However, before that time, besides (rather ineffective) social safety net arrangements and social spending targets attached to programme aid, it appears that relatively little attention was paid by the government and donors alike to poverty reduction and the distributional effects of the adjustment programmes (White and Estrand 1998). Poverty reduction did not become a primary objective of government policy until the end of the decade.

5.3 Conclusions

Economic performance continued to be weak in the 1990s. Aid including debt relief through its flow effect probably made some contribution to growth by freeing resources for public investment and imports, and easing foreign exchange scarcity, while allowing continued debt service payments. The continued high debt despite a substantial stock reduction was not conducive to improvement of the private investment record, which remained weak. Economic reforms which were part of conditionality had several adverse consequences, largely due to inadequate sequencing of reforms. One of the consequences was higher inflation at the same time that a great expenditure squeeze was brought about, negatively impacting on growth. Doubts about government commitment to the reforms and credibility of government policies strained relations with donors as of 1995, especially related to governance issues. Adverse external developments such as a decline in the copper price and drought also negatively affected growth.

Poverty increased during the evaluation period. Aid and debt relief through its flow effect and social conditionality probably played some role in the nominal increase in social expenditures. However, this effect was limited and could not offset the adverse effects of the decline in per capita income, the general squeeze in public expenditure and the declining output in social services, whereby social indicators remained at dismal levels. Weak private investment and economic growth were detrimental to poverty reduction, although it can be argued that without aid this performance would have been even worse. Continued high inflation disproportionately affected the poor. Generally insufficient attention to poverty reduction issues seems to have been given in government and donor policies until changes occurred only later in the decade with the advent of HIPC. Poverty increased in urban areas and decreased in rural areas, but the incidence of poverty remained far higher in rural areas. While the poverty situation remained dire, the proportion of extremely poor declined, while the income distribution became somewhat more equitable.

ANNEXES

ANNEX A: REFERENCES

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TERMS OF REFERENCE FOR COUNTRY CASE STUDIES

The evaluation of Dutch debt relief policy and expenditures aims to answer the following research questions:

- to what extent were the political and financial interventions (the inputs) **efficient** in terms of outputs such as debt and debt service reduction (DDSR) and increases in imports and government expenditure?
- to what extent were these inputs and outputs **effective** in producing desired outcomes such as improvement of debt sustainability, improvement of creditworthiness and investment?
- to what extent were these inputs, outputs and outcomes **relevant** by contributing to the longer-term impacts of economic growth and, ultimately, poverty reduction?

Country case studies

In the 8 country case studies, the evaluation questions of efficiency, effectiveness and relevance will all be addressed (see attached Table 1: evaluation matrix). In addition, an in-depth analysis is to be made of the nature of the country's debt problem and therefore of the relevance of debt relief as compared to, for example, new loans or grants.

Debt relief is defined as any action that leads to a reduction in the net present value of the debt. The basic assumption for this evaluation is that IF debt relief contributes to economic growth it does so via a reduction of the debt burden. Two effects are possible:

- The reduction of the net present value of the debt *stock* will increase creditworthiness of the country (according to the debt overhang hypothesis), and thereby lead to more private investment and inflows of private capital. This will enhance economic growth.
- The reduction of the debt *flows* (actual debt service) will lead to additional imports and government expenditure. Increased imports may include investment goods or intermediate goods leading to increased use of existing capital stock, and government spending may imply higher public investment and/or more social expenditure.

Since the effects of *Dutch* debt relief cannot be separated from those of debt relief by other actors, the object for the case studies consists of *all* debt relief received by the country, both from official and commercial sources. Where possible and relevant, special attention will be given to Dutch debt relief. The evaluation period covers 1990-1999, but the analysis of the debt problem has to start earlier, in the 1970s.

The country studies seek answers to five broad questions, each of which is to be dealt with in a separate chapter of the report, with chapters 2 to 5 corresponding to the different levels of the evaluation matrix (inputs, outputs, outcomes and impact), while chapter 1 will provide an introduction and background. In addition to the sources mentioned in the Evaluation matrix, the researcher carrying out the case study is expected to take into account the relevant academic literature on the country as well as pertinent previous evaluations. A minimum selection will be provided by the co-ordinator and her assistant, but the consultation of additional material at the researcher's own initiative will, of course, be welcomed.

1. Debt problem analysis: nature, causes and consequences.

Why had the debt burden become unsustainable by the beginning of the evaluation period, 1990, and what have been the consequences of this unsustainability? Answering these questions involves analytical descriptions of:

1. The build-up of the country's debt, going back to the 1970s, including major creditors, interest rates, degree of concessionality in real terms, that is including any adverse exchange rate effects (see Mistry, 1996: 25-6), etc.
 2. Conditionality attached to loans granted before 1990, and degree of compliance (short overview).
 3. Trends in GDP, exports, fiscal revenues; causes of slow growth rates: review of important factors such as developments in terms of trade, inflows of foreign aid, loans and FDI, political instability, natural and man-made disasters, adverse policies, etc.
 4. Trends in poverty and social indicators before 1990.
 5. Debt sustainability indicators: trends in debt/GDP, debt service *due*/exports versus debt service *paid*/exports.
 6. Public and private shares of external debt, and changes over time; government take-over of private debt.
 7. Extent to which the external debt situation was exacerbated by a domestic debt problem.
 8. Net transfers on debt before 1990, and how these compared to aid flows (grants, new loans).
 9. Debt relief, if any, provided before 1990 and its influence on debt sustainability indicators. Any bail out of private creditors by official creditors/donors (see Demirgüç-Kunt & Huizinga, 1993).
 10. The nature of the debt problem in 1990, in particular, whether the country's inability to pay was caused by insufficient liquidity (short-term problem) or a lack of solvability (long-term problem). Any difference between this ex-post assessment result and the common perception of the debt problem at the time.
 11. The consequences of the debt problem in 1990, in particular whether it affected growth rates:
 - through too high transfers on debt leading to lower imports and lower government expenditure;
 - and/or leading to lower growth rates through a heavy debt overhang (high debt stock, so high expected tax on private profits lowering private investment and inflows of private capital).
-

2. Inputs: amounts and modalities of debt relief in the period 1990-1999

What were the inputs into the debt relief process in terms funding, modalities and conditions? Answering this question requires the following data:

1. Overview of amounts and modalities of debt relief: by creditor, by type of debt, by framework for debt relief activities (Paris Club, Multilateral Debt Funds, 5th and 6th dimension, HIPC, etc.), extent of forgiveness, interest subsidy, buy-back, etc.
2. Stated objectives of debt relief.
3. Any conditions attached to the different modalities of debt relief, including assessment of *track records* (see attached Table 2 for possible contents of conditions and track records)

4. Special attention to Dutch modalities, motives, conditions, and objectives for debt relief.
5. The extent to which debt relief was *additional* to other inflows (loans or grants); in general, and for Dutch debt relief in particular; according to the HIPC initiative, debt relief should be additional (Andrews et al., 2000: 16) but practice may be different.
6. Amounts and modalities of new loans and grants 1990-99. Dutch loans and grants.

Assessment:

Was the combination of new funding and debt relief modalities consistent with the perceived and the actual nature of the debt problem (as described in 1.10)? Were these inputs suitable for the improvement of debt sustainability (see Cline, 1995: 29 and Hanlon, 2000)?

3. Outputs of debt relief: efficiency analysis

To determine how efficient the inputs were in producing the intended outputs the following data are to be collected and analysed:

1. Debt service *due* during 1990-1999 as compared to debt service *actually paid* and accumulation versus payment of arrears.
2. The share of (total as well as Dutch) debt relief that effectively relieved the debt burden in that it led to a reduction of actually paid debt service (see Annex 1).
3. The effect of the different modalities of debt relief on actual payment of debt service on the reduced as well as on other debt. Since debt relief usually increases ability and/or willingness to pay other debts, other creditors may benefit. This may be an unintended side-effect and has been established for debt buy-backs (Bulow & Rogoff, 1988), or it may be an intended result: in the context of HIPC agreements, countries may be obliged to start or resume servicing debts that they ignored before.
4. Extent to which debt relief freed resources for the government, with special attention to Dutch debt relief. This follows from 2.6, 3.2 and 3.3. Compare to the amounts of new loans and grants received during the period 1990-1999 (see 2.7).
5. Extent to which debt relief benefited the creditor itself or other creditors (bailing out), with special attention to Dutch debt relief. This follows from 3.2-3.4. Specify whether official or private creditors benefited.
6. Effect of debt relief on the reduction of the nominal debt stock and the net present value (NPV) of debt.
7. Compliance with debt relief conditionality, changes in policies, changes in governance (see Table 2 and Annex 2).
8. To the extent that debt relief was additional and freed resources (3.4): trace its effects in the government accounts (on public investment and social expenditure, in particular) and in the balance of payments (increased imports, if possible broken down by destination: capital goods, intermediate inputs, consumer goods), according to the accounting framework outlined in Annex 3.

Assessment:

How efficient were the chosen modalities of debt relief in reducing the debt burden, in terms of both NPV of debt and actual debt service?

4. Outcomes of debt relief: Effectiveness

The effectiveness of debt relief is to be assessed by collecting / analysing the following data:

1. Trends during the evaluation period 1990-1999 in the debt sustainability indicators: debt/GDP, debt service due/exports, NPV of debt/exports. We focus on trends as most relevant issue for this evaluation. However, the absolute values of these indicators will be compared to subjective sustainability criteria (limits) according to the IFIs (from HIPC documents) but also according to other sources, e.g. Hanlon (2000).
2. Extent to which change in sustainability can be attributed to debt relief. Both the numerators and the denominators of these indicators are not only the result of debt relief, but also of new loans and grants during the period and of the concessionality of those loans (see Annex 4). In addition, the trends in GDP and exports (the denominators) depend on many other factors: policies, political stability, weather conditions, international prices, etc. The possible causes for the developments in the debt sustainability indicators will be analysed.
3. Improvement, if any, of social indicators (see Annex 5) as a result of debt relief leading to policy changes and changes in governance (as analysed in 3.6) .
4. Improvement, if any, of social indicators as a result of debt relief freeing government resources for more public investment and social expenditure (3.7).
5. Increase, if any, in private investment as a result of debt relief freeing resources for more public investment: crowding in.
6. Increase, if any, in private investment as a result of debt relief lowering the debt stock, thereby reducing the debt overhang.
7. Improvement, if any, in the creditworthiness of the country leading to new private capital inflows, as a result of a reduction of the debt stock. This implies an analysis of creditworthiness according to ratings, and of figures on private capital inflows (distinguishing between loans, portfolio investment, FDI). It must be born in mind that other factors such as (expected) economic growth, credibility of government policies, and even conditionality attached to debt relief efforts may also have led to improvements in ratings and increases in flows. Debt relief may, on the other hand, have reduced creditworthiness by lowering expectations on future debt service by the country. According to a recent literature review and additional empirical evidence, policy-based lending and the attached conditionality have only limited effect on private flows (Bird & Rowlands, 2000).

Field studies:

In the field studies, the trends in social indicators (4.3-4.4) and in private investment and private capital inflows (4.5-4.7) can be analysed and explained more thoroughly by having interviews with government officials, NGOs, donors and representatives of the private sector.

Assessment:

How effective has debt relief been in increasing debt sustainability, stimulating private investment and improving social indicators, both via the attached conditionality and via the stock and flow effects of debt relief?

5. Impact of debt relief: Relevance

Assessment:

Based on the analysis under 1-4, the final impact of the different modalities of debt relief on economic growth and on poverty reduction is to be assessed.

1. Economic growth was already briefly analysed in 4.1 and 4.2 as denominator for one of the debt sustainability indicators, but the analysis can now be broadened, taking into account the other outcomes under 4 (4.3-4.7).
2. For poverty, trends in the usual poverty indicators (P_0 , per cent of population below poverty line), and P_1 , the poverty gap (total shortfall of income of the persons below poverty line) will be collected (if available). For the analysis, it is important that poverty reduction may be achieved through economic growth, through an improvement of the income distribution or (in the longer run) through an improvement in social indicators.

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Table 1. Evaluation matrix Debt relief

OBJECTIVES-MEANS	INDICATORS	SOURCES	EVALUATION CRITERIA
INPUT Debt relief expenditures and modalities; Policy dialogue.	Amounts spent, assigned and contributed; Conditions.	Documents for Dutch Parliament "Macro-exercise", assessment memos for debt relief; Global Development Finance; National statistics; WB/IMF country reports.	
EFFICIENCY			
Comparison outputs and inputs →			
OUTPUT Reduction debt and debt service; Increase imports and government expenditure; Policy change and change in governance.	Total debt (nominal and net present value); Interest payments and amortisation; Balance of payments; Government accounts.	Global Development Finance; World Development Indicators; IMF; National statistics; WB/IMF country reports.	
EFFECTIVENESS			
Extent to which inputs via outputs contribute to outcomes →			
OUTCOME Reduction debt burden; Improvement creditworthiness; Investment.	Debt/GDP; Debt service/Exports; International credit ratings; I/GDP; I _p /GDP.	Global Development Finance; World Development Indicators; IMF; National statistics; Moody's; Standard & Poor; WB/IMF country reports.	
RELEVANCE			
Extent to which inputs via outputs and outcomes contribute to impact →			
IMPACT Economic growth	Change in GDP	World Development Indicators; National statistics.	
Sustainable poverty reduction			

**Table 2. Possible aspects of the track record
possible policy conditions for debt relief**

Area	Policy / target
Macro-economic	Stock of international reserves Government deficit (% GDP) Government expenditure (% GDP) Exchange rate policies (devaluation)
Economic reforms	Tax reforms Public sector reform/civil service reform Composition of expenditure (defence) Privatisation of SOEs, public utility enterprises Liberalisation of goods markets: prices, domestic trade Liberalisation of foreign trade Liberalisation of labour market Financial liberalisation Other sectoral reforms
Political reforms	Elections Multiparty system Human rights observance Independent judiciary Free press
Governance	Transparency of budgeting Transparency of budget execution Accountability, to parliament, local councils, civil society Anti-corruption measures/sanctions Establishment of and respect for Audit Office Decentralisation
Poverty reduction	Social expenditure Social sector reforms Quality of social service delivery PRSP

Effective debt relief

Effective debt relief (DR_e) is debt relief that reduces actual debt service (DS_a)

To be computed from:

$$DS_a = DS_d - AA \quad (1)$$

$$DR_e = DR - PA \quad (2)$$

Where:

DS = Debt Service

DR = Debt Relief

Subscript a = "actual"

Subscript e = "effective"

AA = Accumulation of Arrears

PA = Payment of Arrears

Subscript d = due

DR_e is still an approximation, since debt relief covering debt service due that would never be paid in the same year, is still included. This often the case with Dutch debt relief on Dutch aid loans. If known, it must be subtracted from the figure for DR_e .

The effectiveness of conditionality

To the extent that debt relief was accompanied by conditionality on future policies, or by conditions regarding past policies or policy outcomes ("track record") the extent of compliance with these conditions must be assessed (with respect to changes in policies and changes in governance, see Table 2). The track record has become important for Dutch debt relief decisions since 1996. The evaluation must therefore investigate whether and to what extent the conditions mentioned in the "macro exercise" were fulfilled in the case of the involved country. A second issue is whether changes in country's policies or governance can be observed since 1996 that go in the direction of improving the "conditions" stipulated in the macro exercise. Evidence for this can be looked for in HIPC documentation on the country, Policy Framework Papers, Implementation Completion Reports of SALs and SECALs of WB.

In field studies, information can also come from interviews. Interviews should also shed light on the issue of whether the fact that the Dutch have used this track record as basis for decision making on debt relief, has to any extent *influenced* governance and policies (see below).

In the context of the HIPC initiative, the track record has become important since 1998 and involves an assessment of whether conditions stipulated in earlier IFI programs have been complied with satisfactorily. This can be found in HIPC documents on the country, but an independent assessment by the evaluator is also necessary. For example, earlier evaluation research showed that countries were not always treated equally. As of 1999, the HIPC conditions include the setting up of a Poverty Reduction Strategy Paper (PRSP). For the desk studies it is too early to investigate whether the HIPC track record or the requirement of a PRSP have induced a change in the country's policies or governance. In the field studies, donor influence on policies and governance can be examined.

Donor influence (field studies only)

One thing is to establish that countries have complied (or not) with conditions set by the donor; another is to conclude on effective influence of donors. An earlier evaluation concluded that domestic political factors are most important in policy changes but there is also some room for donor influence, especially if we take other dimensions of the "policy dialogue" into account, i.e. other than the formal, directive conditions laid out by the IFIs and directly imposed on the recipient country's government (White, 1999).

This means, first, that we have to take on a broad political economy perspective in explaining why reforms have come about. Donors usually tend to overstate their roles. Second, it means that we have to consider the policy dialogue as a process with four dimensions as discovered in the previous evaluation: the degree of formality, the channel of influence (directly to government, indirectly through IFIs or indirectly through contact with other donors), whether conditionality is directive (policy monologue) or non-directive, and which instrument is used (White, 99: 53-54; see also a useful table of possible channels and degree of formality on p. 37).

Instruments can be debt relief, budget support, project aid or technical assistance. The earlier evaluation has shown that there may be some influence from donors, but that this is usually carried out through less formal means, non-directive approaches and often using other channels.

The study of donor influence consists of two parts: i) examining Dutch influence, and ii) examining the impact of the HIPC conditions, in particular, the requirement that countries elaborate a Poverty Reduction Strategy Paper (PRSP) and do so in a participatory manner. On the first, field studies can first investigate whether the Dutch Embassy has an influence strategy that takes the different dimensions into account, and on which particular issues it focused. Second, by having interviews with government officials and with other donor representatives, the effectiveness of that influence strategy can be assessed. Since this may lead to subjective and not very exact statements, the approach will be to single out one or two issues (from the Dutch "track record") on which the Dutch had or have a strong opinion – different from the government's opinion – and examine what happened with this "conflict". For the second aim, the same interviews with donor representatives and government officials can be used to assess the progress in coming to a PRSP. On this topic, interviews with representatives of NGOs and private sector (civil society) will also be necessary. If possible, also for this part a particular issue on which opinions differ will be singled out and followed, in order to improve the judgement on the extent of influence.

The marginal effect of debt relief: the accounting framework

The approach proposed here is similar to the one described for the Sida Evaluation of Programme Aid (see White, 1999: 94-6). It focuses on the marginal impact of debt relief. This is different from the often used "gap approach" which is considered not very helpful (White, 1999: 89-93). It means that we analyse the influence of effective debt relief (free resources) on balance of payments, internal accounts and on government accounts (a subset of the internal accounts), on the basis of accounting identities.

For the external account, the identity is the following:

$$M = AID + PCT + DR_e - DS + X + OKI + \Delta R + EO \quad ^{15} \quad (3)$$

If DR_e (see Annex 1) increases, one or more of the other items must change. The fact that DR_e is positive, implies that the absolute value of DS (debt service) has reduced (as established in 3.1). The impact of DR on other DS has been established in 3.2 and can be used here. Similarly, it has already been established whether DR was additional, i.e. did not lead to a reduction in aid (2.6). From all these, we can compute the net effective debt relief. It will now be examined whether this net DR_e leads to higher imports and/or reserves, which are the preferred responses for donors. This depends on the effects on OKI , ΔR , EO (often capital flight), X , and PCT . A reduction in X could be a negative effect of AID and net DR_e , for example due to Dutch disease effects. Decreases in PCT , OKI and EO (if capital flight) would also be negative responses to DR_e . Increases in PCT and OKI could be positive second round effects of DR_e .

A next step is to look at the composition of imports. Does the composition of imports change as a result of net DR_e ? The preferred outcome would be that imports of capital goods and intermediate goods would increase more than imports of consumer goods. This would point to a higher propensity to invest as opposed to to consume.

For the internal account, the identity is the following:

$$I = AID + DR_e - DS + OKI + \Delta R + EO + S \quad ^{16} \quad (4)$$

The analysis for AID , DS , OKI , ΔR and EO is the same as above. The marginal effect of net DR_e on I depends on what happens to S , domestic savings.

¹⁵ M = Imports
 PCT = Private Capital Transfers
 DR_e = Effective debt relief
 DS = Debt service
 X = Exports
 OKI = Other capital inflows
 ΔR = Change in reserves
 EO = Errors and Omissions

¹⁶ I = Investment
 S = Savings

If savings diminish as a result of the additional free resources (as claimed by Easterly, 1999, for example¹⁷), this would be a negative effect of debt relief. Ideally, DR_e would be accompanied not only by higher I but also by higher S .

The internal account can be broken down further, allowing for separate government income and expenditure. A change in domestic savings is the sum of changes in private saving and changes in government revenues. Investment can be broken down into government expenditure and private investment (see schemes in White 1999: 95).

According to the "fiscal response" literature (White, 1998), the marginal effect of aid (in this case, net effective debt relief) can be to reduce revenues. The analysis of government accounts must therefore begin by looking at what happens to government revenues. A second possible effect that must be examined is the effect on the deficit. If revenues and deficit remain unchanged, the whole effect of net DR_e is on increased expenditure, which is the intended effect of donors (resources should be freed for other – social – expenses). The third step is to look at the composition of expenditure. Does the freeing of government resources lead to increased priority for social expenditure or for public investment? The trends in the share of these sectors within total expenditure will be examined.

¹⁷ Easterly (1999) does not distinguish between debt relief and effective debt relief, however; and his model that stresses "perverse incentive effects" also overlooks that the continued lending by HIPC countries is probably as much the result of (lending) supply factors than of demand factors such as a high discount rate.

Debt sustainability

In the long run, debt service can be sustainable if the following holds (Gillis et al., 1996: 414):

$$D/X = a/(g_E - i) \quad (5)$$

Where D = debt, X = exports, a = the trade gap $(M - X)/X$, M = imports, g_E = the growth rate of exports, and i = the average interest rate on debt.

This means that as long as the growth rate of exports is higher than the interest rate, a sustainable debt/exports ratio can be accompanied by a trade gap a (i.e. by increasing debt). A first issue to be examined is therefore whether the growth rate of exports is higher or lower than the average interest rate of the debt stocks over 1990-99 (as computed in 2.7). If it is lower, it can be argued that the country had a solvability problem and not a liquidity problem, and that new loans would not lead to a sustainable debt service.

The next component to analyse is the trend in the trade gap. This trade gap a is constant if the growth rate of imports is equal to the growth rate of exports, but this is not necessary for the analysis. In our study, the trade gap that leads to this increase in debt $a = (M - X)/X$ must be adjusted for the non-loans part of aid (i.e. grants, A) and for net effective debt relief (DR_e , see Annex 1), so we will look at what happens to

$$\frac{M - (X + A + DR_e)}{X}$$

If the growth rates of exports is lower than the interest rate, D/E is only sustainable if there is a surplus, so $M - (X + A + DR_e) < 0$.

Similarly, the debt/GDP ratio can be sustainable in the long run if (Gillis et al., 1996: 415):

$$D/Y = (v - s)/(g_Y - i) \quad (6)$$

Where Y = GNP, g_Y = the growth rate of Y , $v = I/Y$, the investment ratio, and $s = S/Y$, the savings ratio.

As long as g_Y is above the interest rate, a sustainable debt/income ratio can be accompanied by a continuing and constant savings gap ($v - s > 0$). This savings gap leading to increased debt must also be adjusted for grants (A) and for net effective debt relief (net DR_e), so we look at:

$$v - s - A/Y - DR_e/Y$$

If g_Y is below the interest rate, there must be a savings surplus. The evaluation will examine the trends 1990-99 in g_Y as compared to i , and of v , s , A/Y and DR_e/Y

For the government, we can assess sustainability in relation to the tax capacity (Fishlow, 1988: 220-21). In the long run, the debt burden is sustainable if:

$$D/T = \{(G - T)/T\} / (r_t - l) \quad (7)$$

Where T = tax income, G = government expenditure, r_t = growth rate of taxes.

In this part of the analysis, the sustainability of the debt burden for the government is not only determined by the external public debt, but also by the internal debt. This is a problem for Jamaica, for example. An average interest rate on total public debt will have to be computed. This average interest rate must then be compared with the growth rate of taxes. The latter will probably be related to the growth rate of GDP, but there can also be an independent effect due to, for example, tax reforms. If the interest rate is higher than the growth rate of taxes, the government must have a surplus $(G-T) < 0$ for debt service to be sustainable.

Annex 5

Social indicators

Social indicators to be analysed could be taken from the OECD/DAC indicators for social development (Nos. 4-15 of the 21 Indicators for sustainable poverty reduction). These are:

Indicator	Measure	Source
Children under 5 with underweight	%	WDR (WDI)
Enrolment in primary education (%)	%	WDR (WDI)
Share of people with fourth grade	% of adults	HDR (WDI?)
Alphabetisation	% of adults	HDR (WDI?)
Gender equality in primary enrolment,	F/m, in %	UNFPA or WISTAT
Gender equality in secondary enrolment	F/m, in %	UNFPA or WISTAT
Gender equality in alphabetisation	F/m, in %	HDR
Infant mortality rate	%	HDR
Child mortality rate	%	WDR (WDI)
Maternal mortality rate	%	WDR (WDI)
Deliveries under expert supervision	% of total	UNFPA
Use of contraceptives	% of married women	HDR
HIV ratio	% of adults	UNAIDS

ANNEX C: COUNTERFACTUAL IMPORTS OF GOODS AS % OF ACTUAL IMPORTS IN FOUR SCENARIOS

SCENARIO 1:	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999
Sources:										
X of Goods	1263	1085	1133	994	1066	1186	993	1110	816	755
Aid (incl. IMF)	0	0	0	0	0	0	0	0	0	0
Debt relief	0	0	0	0	0	0	0	0	0	0
Total	1263	1085	1133	994	1066	1186	993	1110	816	755
Uses:										
Imports of Goods	-530	-238	-234	-294	-587	391	-637	-821	-887	-375
Services (net)	-206	-222	-201	-100	-99	-194	-141	-189	-394	-366
Debt service due (incl. IMF)	-760	-777	-684	-525	-560	-590	-453	-376	-328	-318
Change in arrears	338	206	290	250	268	-840	209	310	376	201
Other	-105	-54	-304	-325	-88	47	29	-34	417	103
Total	-1263	-1085	-1133	-994	-1066	-1186	-993	-1110	-816	-755
% Import Scen 1/ Original Imp	49%	25%	17%	29%	58%	-33%	60%	78%	91%	43%

SCENARIO 2:	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999
Sources:										
X of Goods	1263	1085	1133	994	1066	1186	993	1110	816	755
Aid (incl. IMF)	0	0	0	0	0	0	0	0	0	0
Debt relief	0	0	0	0	0	0	0	0	0	0
Total	1263	1085	1133	994	1066	1186	993	1110	816	755
Uses:										
Imports of Goods	-192	-32	56	-44	-319	-449	-428	-511	-596	-174
Services (net)	-206	-222	-201	-100	-99	-194	-141	-189	-394	-366
Debt service due (incl. IMF)	-760	-777	-684	-525	-560	-590	-453	-376	-328	-318
Change in arrears	0	0	0	0	0	0	0	0	85	0
Other	-105	-54	-304	-325	-88	47	29	-34	417	103
Total	-1263	-1085	-1133	-994	-1066	-1186	-993	-1110	-816	-755
% Imports Scen 2/ Original Imp	18%	3%	-4%	4%	32%	38%	41%	48%	61%	20%

SCENARIO 3	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999
Sources:										
X of Goods	1263	1085	1133	994	1066	1186	993	1110	816	755
Aid (incl. IMF)	0	0	0	0	0	0	0	0	0	0
Debt relief	725	293	551	359	227	37	310	159	122	443
Total	1988	1378	1684	1353	1293	1223	1303	1269	938	1198
Uses:										
Imports of Goods	-892	-384	-509	-473	-700	372	-792	-900	-948	-596
Services (net)	-206	-222	-201	-100	-99	-194	-141	-189	-394	-366
Debt service due (incl. IMF)	-760	-777	-684	-525	-560	-590	-453	-376	-328	-318
Change in arrears	-25	59	14	70	154	-858	54	230	315	-21
Other	-105	-54	-304	-325	-88	47	29	-34	417	103
Total	-1988	-1378	-1684	-1353	-1293	-1223	-1303	-1269	-938	-1198
% Imports Scen 3/ Original Imp	82%	40%	38%	46%	70%	-31%	75%	85%	98%	68%

SCENARIO 4:	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999
Sources:										
X of Goods	1263	1085	1133	994	1066	1186	993	1110	816	755
Aid (incl. IMF)	0	0	0	0	0	0	0	0	0	0
Debt relief	725	293	551	359	227	37	310	159	122	443
Total	1988	1378	1684	1353	1293	1223	1303	1269	938	1198
Uses:										
Imports of Goods	-662	-154	-279	-243	-470	602	-562	-670	-718	-366
Services (net)	-206	-222	-201	-100	-99	-194	-141	-189	-394	-366
Debt service due (incl. IMF)	-760	-777	-684	-525	-560	-590	-453	-376	-328	-318
Change in arrears	-255	-171	-216	-160	-76	-1088	-176	0	85	-251
Other	-105	-54	-304	-325	-88	47	29	-34	417	103
Total	-1988	-1378	-1684	-1353	-1293	-1223	-1303	-1269	-938	-1198
% Import Scen 4/ Original Imp	61%	16%	21%	24%	47%	-50%	53%	63%	74%	42%