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Tanzania's External Debt Burden in the Context of HIPC Initiative: Is an Exit Strategy in Sight?

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Introduction

The external debt stance of Less Developed Countries (LDCs) has concerned many analysts and policy makers, both in debtor and creditor nations. The creditor community, represented by various credit lending institutions in North America and Western Europe, was worried that the heavily indebted countries would not be able to repay either the principal extended to them or the accumulated interests (Sachs and Warner, 1997). This concern was further intensified in the early 1980s when some Latin American countries (e.g. Mexico, Argentina and Brazil) threatened to declare a unilateral moratorium that would, in turn, lead them to stop honouring their outstanding external debt obligations.

The creditor community was further concerned that the failure of the indebted countries to repay loans would disrupt the lending and profitability objectives of their financial institutions to the extent that it would jeopardize their future operations. Apart from lending and profitability matters, the creditor community feared that if the heavily indebted countries were allowed to default on their debt, this would unleash a "band wagon" effect which would encourage other indebted countries to follow suit. Given this background, it was critical for the creditor community to pressurize Latin American countries not to default.

The pressure thus exerted managed to persuade Mexico and other Latin American countries to continue to honour their external debt obligations. However, Mexico, like other indebted LDCs, was concerned about the overwhelmingly large magnitude of its debt in the midst of other malaise, including deteriorating terms of trade. Furthermore, the servicing of the debt was constraining the budgetary operations in indebted countries to the extent that it threatened the provision of basic social services.

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Currently, the LDC debt problem has acquired new dimensions. Indebtedness co-exists with a myriad of other socio-economic problems, the most prominent of which is poverty. The depth and intensity of poverty in poor countries, especially those in Sub-Saharan Africa, necessitated International Financial Institutions (IFIs), including the World Bank and the International Monetary Fund, to devise the Highly Indebted Poor Countries (HIPC) initiative, which is an exit strategy for indebtedness.

The HIPC initiative, which became operative in 1996, targets overall debt sustainability on a case-by-case basis, thus providing an exit strategy from the rescheduling process. Indebted countries were expected to get support when they demonstrated, through track records, their ability to put external support to good use. The HIPC initiative is, in this sense, not a new strategy; it builds on existing mechanisms, particularly those provided under the Paris Club and non-Paris Club arrangements. The new external finance for countries qualifying for this initiative is supposed to be on "appropriately concessional" terms.

This article reviews the external debt stance of Tanzania in the context of the HIPC measures. Working from the country's current debt stock, the article analyses whether the implementation of the HIPC will make the debt burden more bearable and finally be the "true exit" to the debt problem. It begins with a theoretical note, albeit briefly, linking a country's indebtedness to the income growth effects on a poor and indebted country.

The Debt-Growth-Poverty Nexus: a Brief Theoretical Expose

Models analysing the effect of debt and debt service on economic growth and poverty have employed neoclassical growth models in which income growth is influenced by various factors, including debt service (Degefe, 1992; Kruger, 1987; Iyoha, 1995). These models usually stem from a neoclassical production function where output (Y) depends on Hick's neutral technical change (A), labour (L), capital (K) and foreign capital (Q). According to this model, imports of foreign capital are assumed to be financed by the current account surplus and net capital inflows. Thus;

$$Y = A(t)\ f\ (K,\ L,\ Q) \qquad \text{.......... (1)}$$

Where the function (f) is assumed to be twice differentiable. Other variables are as defined earlier. Taking the time derivative and dividing by Y the following is obtained:

$$\frac{\Delta Y}{Y} = \frac{\Delta A}{A} + \frac{A\delta\Delta K}{\delta KY} + \frac{A\delta\Delta L}{\delta LY} + \frac{A\delta\Delta Q}{\delta Y} \qquad \text{..........(2)}$$

Letting $g_y = \frac{\Delta Y}{Y}$ and $\lambda = \frac{\Delta A}{A}$ we have

$$\varpi L = \frac{\delta Y.L}{\delta L.Y} = \quad \text{relative share of labour in output}$$

$$\varpi K = \frac{\delta Y.L}{\delta L.Y}.\frac{K}{Y} = \quad \text{relative share of capital output}$$

$$\varpi Q = \frac{\delta Y}{\delta Q}.\frac{Q}{Y} = \quad \text{relative share of technical change in output} \qquad \text{..........(3)}$$

Equation 2 can be simplified to;

$$g_y = \lambda + \frac{wK}{K} + \frac{wL\Delta L}{L} + \frac{wQ\Delta Q}{Q} \qquad \text{..........(3)}$$

Letting the labour force grow at a constant rate equivalent to (n), and, abstracting from depreciation, we may set K=1. Furthermore, let domestic capital stock be roughly proportional to output where the factor of proportionality () is the incremental capital-output ratio (ICOR). Since it is assumed that the indebted country being analysed is both poor and capital deficient, the most plausible assumption is that its rate of technical change is approximately zero. Hence equation 3 becomes:

$$g_y = W_{Ln} + Wk\frac{1}{\delta_y} + \frac{wQ\Delta Q}{Q} \qquad \text{..........(4)}$$

The increase in foreign capital inflow will normally be financed by the export surplus and net capital inflows made up mainly of direct foreign investment and new borrowing. Subtracting debt service payments made up of repayments of principle and interest on outstanding debt we obtain:

$$\Delta Q = (X\text{-}M) + DFI + B - - I(1\text{-} D \ldots\ldots \qquad (5)$$

Where represents the proportion of debt repaid

i	is the average interest rate on debt
X	is exports
M	is imports
DFI	is direct foreign inflows
B	is new borrowing
D	is outstanding debt stock.

It is further assumed that the export surplus (X-M) is determined mainly by export growth (gx). From equations 4 and 5 it is possible to summarize the factors determining income growth in an indebted country as follows:

$$gy = (n, \quad), DFI, B, D, DBS, gx) \ldots\ldots \qquad (6)$$

where $f_1 > 0$, $f_2 < 0$, $f_3 > 0$, $f_5 > 0$, $f_6 < 0$, $f_7 < 0$ and $f_8 > 0$.

This briefly says that an increase in industrial labour force, (n) investment ratio $\left(\frac{I}{Y}\right)$ direct foreign investment, new borrowing (B) and export growth (gx) tends to increase the rate of economic growth of an indebted country. The increase in debt stock (D), incremental capital-output ratio ( ) and the debt service burden will tend to reduce the rate of economic growth.

It is possible to begin with a general proposition that if a country is to benefit from external borrowing, its economy must be such that an adequate amount of new resources can be available to service its maturing debt obligations. In particular, the growth in income must be sufficient to provide increased consumption and debt service. Another way to state this is that debt and debt service will be less burdensome with faster growth of income (relative to debt growth and debt service).

In order to establish empirically the verifiable relation between external debt and economic growth, we begin with the fundamental identity that the increase in debt less the change in international reserves is equal to debt service less interest income from international reserve assets plus the import surplus, i.e.;

$$(D_t - D_{t-1}) - (R_t R_{t-1}) = iD_{t-1} - iR_{t-1} + n_t - X_t \ldots\ldots \qquad (7)$$

where R = stock of international reserves and other variables are as defined earlier.

However, equation 7 ignores the capital flight phenomenon which could be quite significant in some African countries, including Tanzania. Since the interest income on reserves is often small in African countries, we may set iR_{t-2} at equal to zero. Ignoring changes in reserve stock and simplifying equation 7 we obtain:

$$D_t = M_t - X_t + (1 + i)\, D_{t-1} \ldots\ldots \qquad (8)$$

Consider further an identity which relates the demand for final products to the uses of income.

That is:

$$Y = C + I + G + X - M = C + S + T \ldots\ldots \qquad (9)$$

Where C	=	consumption
I	=	investment
S	=	savings
T	=	taxes
G	=	government expenditure.

Other variables are as defined earlier.

Re-arranging and simplifying the identity in equation (9) gives:

$$M - X = (I - S) + (G - T) \ldots\ldots \qquad (10)$$

Equation 10 gives the import surplus as the sum of the investment-savings gap and the budget deficit (G-T). Combining equations 2 and 4 and suppressing the time subscript we obtain:

$$D = (I - S) + (G - T) + (1 + i) D_{t-1} \quad (11)$$

Where D_{t-1} is the lagged value of the debt stock.

At this point, it is timely to introduce the ability of the country to service its debt, as this has an effect on the debt burden and, by extension, the stock of external debt. The major factors to consider are the growth rate of income and the degree of exchange rate overvaluation (ER). The exchange rate overvaluation variable (ER) is important in the debt stock equation, since it affects the export performance of an indebted country. Given this background we may now specify the determinants of debt stock, subject to empirical verification, as follows:

$$D = g(SG, FD, ER, GI, D_{t-1}) \quad (12)$$
$$G_1 > 0,\ g_2 > 0,\ g_3 > 0,\ g_4 < 0,\ g_5 > 0.$$

Where SG = investment-saving gap
FD = fiscal deficit
GI = income growth.

This suggests that the higher the investment-saving ratio, the fiscal deficit and the degree of exchange rate overvaluation; the higher will be the stock of debt. However, the higher the rate of income growth (GI), the lower the debt and debt service burden.

This conclusion, as we show in the following section, is important for LDCs, such as Tanzania, in designing exit strategies to foreign indebtedness. At this juncture, we can analyse closely the HIPC framework and its relevance to Tanzania. The main focus is to analyse the possibilities for the HIPC initiative to improve income growth to a level which will reduce the debt and the burden of servicing it.

HIPC: Essential Features and Tanzania's Indebted Stance

The HIPC initiative was proposed by the International Monetary Fund (IMF) and the World Bank in 1996 as "an appropriate basis" to resolve external debt problems of heavily indebted poor countries. To qualify for HIPC, eligible countries must go through several stages. At the first stage, the Paris Club and other bilateral and multilateral donors agree to provide flow rescheduling (as per current Naples terms) on a net present value basis. The country concerned establishes a three-year track record of good economic performance.

The first stage is then followed-up by a decision point at which an assessment is made on whether the Paris Club and other interventions have been adequate to enable the country to attain debt sustainability at the completion point. The second stage is reached when additional concessional flow rescheduling is still required for the country's debt to be sustainable. Like in the first stage, a country is required to have a second track record of good performance. At the completion point, the Paris Club and other institutions provide deeper stock-reductions of debt reduction to enable a country to reach a sustainable level of debt.

The World Bank (IMF and World Bank 1996) defines debt sustainability for HIPC purposes in terms of three indicators.

(a) The ratio of the net present value of debt-to-exports should be within a range of 200-250 per cent or below.
(b) The debt service to exports is expected to fall within a range of 20-25 per cent or below.
(c) Consideration of other debt sustainability indicators including the stress of debt service on the government budget, the diversity of the country's export base, reserve coverage, and resource base.

Besides the sustainability aspect, the HIPC initiative has other important building blocks including eligibility, performance criteria and participation by all relevant creditors (IMF and World Bank, 1996).

Only International Development Assistance member countries are eligible for the HIPC initiative. The criteria for good performance is based on indicators like progress on key structural reforms, macroeconomic indicators and social welfare.

This initiative has been well received in most LDCs including Tanzania. Indeed, in line with a good performance track record, Tanzania has prepared the National Poverty Reduction Strategy Paper (PRSP) in consultation with a broad spectrum of stakeholders. The PRSP spells out Tanzania's objectives and strategies for combating poverty with the help of debt relief funds. The first progress report on the implementation of the PRSP shows that there are prospects that Tanzania is on the right track for implementing the PRSP.

Apart from the PRSP, the government has since 1993 put in place an elaborate 'External Debt Management Strategy' with the objectives of restoring orderly relations with all creditors, reducing contractual debt service to a manageable level and halting the continued build-up of debt and debt obligations in the future.

The next logical concern emerging from the HIPC, PRSP and the Debt Management Strategy is whether they constitute a necessary and sufficient exit strategy for the country's indebted stance. For example, will the HIPC initiative improve income growth sufficiently enough to lessen the debt problem and put the country on a sustained growth path?

As an insight into this concern we take a critical look at some indicators of the magnitude of the debt problem in Tanzania.

Table 1: Some Indicators of External Debt in Tanzania: 1986-2000

	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000
Total Debt 92 (% of GNP)	..		..	122	128	161	151	143	156	179	141	114	97	95	98
Debt Service ratio (%exports)	35.2	39.2	32.0	32.9	32.9	40.3	40.4	26.9	19.0	17.9	18.9	13.0	14.3	15.2	14.5
Concessional debt (% of total)	52.9	49.7	53.1	54.2	53.8	54.5	57.5	59.0	60.1	59.8	60.5	70.9	71.2	72.5	69.0
Multilateral Debt (% of total)	26.2	26.8	24.9	30.9	33.0	34.4	35.6	36.7	37.7	39.1	41.0	42.1	43.1	48.3	49.8
Arrears (US $ m)	531	766	845	1050	1215	1486	1518	1815	2090	2421	2532	1995	1820	1885	2022
Rescheduled debt (US $ m)	657	59	385	77	185	7	348	58	9	0	33	761	..	..	..

Notes: .. indicates data not available.
A. Bigsten and A. Danielson (2001) p. 52.

The magnitude of Tanzania's external debt has been a subject of review by many authors (see for example Danielson and Mjema, 1995 and Danielson and Mjema, 2001(a) (b)). There is some convergence in terms of the critical findings from these studies. Most of the debt is public or public guaranteed; only a small proportion of the total outstanding debt has been serviced. While in the 1970s and 1980s bilateral creditors were important, currently multilateral institutions are also significant in extending loans to Tanzania. There is also consensus among the studies that despite the fact that loan conditions (average interest rate, average grace and maturity periods) were favourable compared to those subjected to other sub-Saharan recipients, the country's initiative to reduce the debt burden is still unsustainable. The bench mark for this assessment is the current rate of income growth and export performance.

For example, from 1993 onwards, the debt-to-GDP ratio trend has been negative due to the fact that GDP growth increased significantly in the mid 1990s. Furthermore, in 1995 the government introduced a strict cash budget system in which the servicing of external debt was given top priority (Danielson and Mjema, 2001(a)(b); Bigsten and Danielson, 2001) in government expenditure. There is no doubt that these economic reform measures have managed to arrest the declining GDP growth rate, which has put the economy on the right footing. As a result, export growth has now picked up. The sound macroeconomic environment and political stability in Tanzania have contributed to the current surge in foreign direct investment. Hopefully, all these measures will have an impact at the grass-roots level, since there is willingness and commitment on the part of the government to see that the positive effects of the reforms are felt at the lower levels of the society.

Is HIPC the Exit Strategy for Tanzania's Debt Problem?

In Tanzania, like in most highly indebted countries, the HIPC initiative has been well received. Tanzania qualified for the HIPC eligibility in April 2000 and should have no significant problems at the decision point for its debt repayment rate to be categorized as sustainable. This somewhat good news invites one to question whether this is the exit strategy for the debt problem in Tanzania.

Whether the HIPC initiative is sufficient to deal with Tanzania's debt problem will depend on various factors. First, the initiative must have a significant impact on income growth. Thus it must help the country to revive its economic activities, especially in such

sectors like agriculture, agricultural marketing and the construction of roads, which have a high propensity to generate incomes in the rural communities. Furthermore, there will still be new (multilateral and bilateral) loans. The reason for this is that the country does not have sufficient domestically generated resources to enable it to undertake the kind of investments it desires. Besides investment requirements, there are other socio-economic programmes which cannot be undertaken without foreign loans and aid. Table 2 shows external debt developments in Tanzania in the period between 1994/1995 and 2000/2001.

Industries	219.00	245.06	257.41	276.74	292.70	426.50	322.00	329.90
Social Welfare & Education	215.10	192.08	184.81	167.33	215.50	122.80	119.40	125.70
Finance and Insurance	89.90	92.73	92.40	77.23	80.20	84.10	83.20	83.80
Tourism	815.90	814.67	937.24	881.70	851.90	850.20	942.00	951.00
Others								
5. Total Debt Service (Actual)	**180.10**	**212.00**	**218.70**	**204.60**	**187.90**	**190.89**	**211.20**	**211.50**
Principal	115.60	140.10	122.60	138.00	112.20	140.53	211.20	211.50
Interest	61.70	71.80	95.50	66.40	75.20	49.56	0.00	0.00
Others	2.80	0.10	0.60	0.20	0.10	0.80	0.00	0.00
6. Total Arrears by Creditors Category	**2,636.20**	**2,813.70**	**2,443.20**	**2,357.60**	**2,660.50**	**2,239.0**	**2,176.60**	**2,310.20**
Principal	**1,549.90**	**1,682.90**	**1,465.00**	**1,408.80**	**1,571.10**	**1,152,50**	**1,114.90**	**1,178.10**
Bilateral	1,230.50	1,367.20	1,173.10	1,134.10	1,235.40	81.70	762.60	800.00
Multilateral	18.40	29.60	14.60	10.30	23.00	0.00	0.00	0.00
Commercial	120.70	100.80	83.50	91.90	132.40	185.00	189.50	211.90
Other Private	180.30	185.30	193.80	172.50	180.30	156.8	162.80	166.20
Creditors	**1,086.30**	**1,130.80**	**978.20**	**948.80**	**1,089.40**	**1,086.5**	**1,061.70**	**1,132.10**
Interest	747.70	827.50	705.00	654.30	740.00	739.5	717.80	763.10
Bilateral	6.70	29.30	4.20	6.00	8.30	0.00	0.00	0.00
Multilateral	195.50	155.20	156.20	163.90	204.30	261.1	259.00	278.60
Commercial	136.40	118.80	112.80	124.60	136.80	85.9	84.90	90.40
Other Private								

Source: Bank of Tanzania, Economic Bulletin (2000).

Table 2: External Debt Developments: Millions of USD

Item	1994/95	1995/96	1996/97	1997/98	1998/99	1999/2000	2000/2001	
							Sept.	Dec.
1. Overall Total Debt Committed	**8,440.70**	**7,933.00**	**8,100.80**	**7,901.70**	**7,972.90**	**7,595.70**	**7,588.20**	**7,603.20**
2. Disbursed Debt by Creditor category	**6,917.50**	**6,623.30**	**6,600.30**	**6,435.80**	**6,580.30**	**6,538.30**	**6,382.90**	**6,428.20**
Bilateral debt	3,426.26	3,216.30	3,044.90	2785.79	2,791.78	2,514.10	2,409.90	2,383.70
Multilateral debt	3,022.39	2,989.50	3,142.50	3,179.41	3,330.10	3,571.50	3,529.00	3,573.30
Commercial debt	226.69	211.70	214.90	270.60	251.50	264.90	259.30	285.50
Other private creditors	242.16	205.80	198.00	200.00	206.92	187.80	184.70	185.70
3. Disbursed Debt by Borrower category	**6,917.50**	**6,623.30**	**6,600.30**	**6,435.80**	**6,580.30**	**6,538.30**	**6,382.90**	**6,428.20**
Central Government	6,523.00	6,264.80	6,233.80	6,017.40	6,168.20	6,092.60	5,946.40	5,981.60
Public Corporations	220.50	171.50	167.80	171.80	165.10	183.20	177.40	178.90
Private Sector	174.00	187.00	199.50	246.60	247.00	262.50	259.10	267.70
4. Disbursed Debt by use of funds	**6,917.50**	**6,623.30**	**6,600.30**	**6,435.80**	**6,580.30**	**6,538.30**	**6,382.90**	**6,428.20**
Balance of payment support	1,889.40	1,688.94	1,524.67	1,493.11	1,512.20	1,648.10	1,625.60	1,602.90
Transport &	1,325.10	1,291.54	1,339.86	1,306.47	1,337.80	1,067.40	1,027.20	1,064.90
Telecommunication	1,017.30	967.00	950.44	913.88	963.80	1,040.20	1,013.20	1,014.10
Agriculture	691.80	721.94	745.83	791.60	821.80	869.00	832.30	834.80
Energy & Mining	654.00	609.34	567.63	527.74	504.40	430.00	418.00	421.10

The external debt trend in Table 2 suggests that for HIPC to be an exit strategy from the country's indebtedness, much will depend on the effective utilization of foreign loans. A lot of debt analysis has focused on debt relief and debt rescheduling. Much less attention has been paid to concerns like how best to utilize loan resources. Most highly indebted countries in Africa, including Tanzania have difficulties addressing the question: where did all the borrowed funds which are a result of the current debt problem go? It is ironic to see grossly indebted countries in Africa in the midst of poverty, yet without some sentiment that the improper utilization of the loans was part of the problem.

If the HIPC initiative is to be the exit strategy for the debt problem, it should help to change the image of "improper" to "proper" utilization of loan resources. The emphasis put by IMF and World Bank on eligible countries to utilize the funds on programmes that improve social services (e.g. health, education and water) is positive. Similarly, Tanzania's effort to use the debt relief funds for social services, which is explicitly spelled out in the PRSP, is a positive step in the right direction. What remains to be seen is the proper implementation of the PRSP strategies.

Besides the strategies for utilization of debt resources, Tanzania, and other countries in similar situations, need to develop a coherent institutional capacity for debt management. Fortunately, Tanzania has already made positive progress in this direction. It has enacted laws which empower only the Minister for Finance to contract loans on behalf of the government. This measure will help to monitor and co-coordinate the debt strategy. However, the Ministry of Finance has to put in place an efficient database for monitoring external debt trends. In the past, criticisms in handling the debt problem were based on the fact that almost all external debt data were classified (Lyakurwa, 1990; Mjema, 1996). Nowadays, external debt data is both public and current. This is a credit to the Finance Ministry. What is required now is that the ministry use the data to prepare an alternative external debt strategy with a view to convincing the creditor community that the HIPC initiative needs to be supplemented with debt forgiveness, so as to make it a true exit from the debt problem.

It is at this point where the caution made by Ross (1997, 93) is important and worth quoting at length:

> "All debt initiatives that I know of look to reduce debt to a level where it is sustainable for you to fund it in the future. I do not know of any serious proposal out there where creditors have considered where they are going to write off your debt in totality. The HIPC initiative is welcome because it brings multilateral debt into the picture for some reduction. Do not expect that automatically 80 per cent of your debt is going to be written off any time soon. Your goals are to get the debt down to a serviceable amount to promote investment and development in your country."

This caution is important, as it warns countries like Tanzania, which are likely to get debt relief from the HIPC initiative, to utilize the funds in investment undertakings where returns from investment will be higher than interest on loan borrowing. In this way, the initiative will pave the way for the solution of the debt problem and allow for sustainability in income growth.

Final Remarks

The external debt burden in Tanzania is still unsustainable. This is because the magnitude of the debt, relative to the country's capacity to service it, is unbearable. A number of initiatives have been put in place to address this problem. The latest strategy, the HIPC initiative, has been well received in Tanzania and in other heavily indebted countries. The expectation among these countries is that it will provide a true exit to the debt problem.

The analysis in this article shows that it is undeniable that the HIPC initiative will provide some relief to the debt problem in most countries, including Tanzania. However, a lasting solution for the debt problem will be found when the HIPC initiative and other debt relief measures help to improve the incomes in such a way that it is possible to service the debt without constraining economic growth.

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