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*The G8 Agreement on Debt Relief Beyond HIPC – What can debtor countries expect?

By Jürgen Kaiser

*The views and opinions expressed herein do not necessarily state or reflect UNDP policy

Since the 2004 Annual Meetings of the IMF and the World Bank, the British and the US governments promoted competing proposals for what both called "100% debt relief for the poorest countries". The prestigious "100%" label, however, was all the two concepts had in common. It hid substantial differences in the two countries' political agendas, which became manifest in the design of their proposals:

- The UK government's interest was a substantial and spectacular boost of financial support to Africa, which could produce immediate and visible effects on the continent's development. Britain therefore suggested refinancing the current debt service of eligible countries until 2015 out of donors' pockets.
- The US pursued their long-standing agenda of moving the poorest countries out of the international credit business, confine them to grant-support and to that end do away with their old debt. The Bush administration favoured a debt stock write-off, which however, was to be refinanced through reductions in disbursements to the debtor countries.

Both approaches shared the idea that action was to be taken immediately, i.e. starting with the G8 Finance Ministers' meeting in June and having a new relief scheme operational after this year's Annual Meetings of the IMF and the World Bank end-September.

This bipolar set-up was intermediately disrupted by a competing joint French/German/Japanese proposal to base enhanced relief on countries' individual needs - as expressed in their respective debt sustainability analyses. As we shall outline below, this proposal carried the potential for a more adequate relief effort than the "100%" proposals. However, it was so poorly elaborated and based on flawed World Bank definitions of debt sustainability, that, if it had been carried out, it would have hardly resulted in any relief.[1] As this proposal is now off the table - it will not be further considered here.

At the G7 Finance Ministers' Meeting in London on June 11th 2005, the British and US proposals were merged into a "compromise", which then became the joint G8 proposal. The following commentary on the compromise between the UK and the US proposal assumes that the framework approved at the G8 Finance Ministers' Meeting in London on June 11th and endorsed by the Gleneagles summit will be implemented without any substantial changes by the Governors of the IMF and the World Bank at their annual meetings in September 2005. The paper will touch upon current lines of discussion on implementation as of this writing.

[1] Kaiser,J.: Commentary on the joint French/German/Japanese Proposal on debt relief to be discussed ahead of the G8-summit Gleneagles July 2005-06-07; June 8th 2005. The joint proposal in turn had been a watered-down version of an original proposal from the German Ministry of Economic Cooperation, which has been the farthest-reaching proposal for a sustainability-based relief scheme among the G8; see: BMZ: Discussion paper for further Multilateral debt relief for low-income countries; Berlin April 2005. An even more ambitious proposal had been tabled by Norway shortly before; see: Government of Norway: Debt Sustainability Mechanism – A Norwegian draft compromise proposal" April 14th 2005

1. The G8 compromise and its merits

The G8 compromise[2] proposes the cancellation of all debt owed by post-completion point HIPC countries to IDA[3], the IMF and the African Development Fund. Creditors assume a reduction of 17 billion US-$ in present value terms over the whole repayment period for the 18 Post-completion point HIPCs, which are expected to qualify immediately. In their public statements the G8, of course, prefer to mention the nominal debt service relief, which is expected to be in the range of 40bn US-$ and looks far more impressive. Calculations by EURODAD[4] suggest an annual debt service reduction of 1.047billion US-$ for all 18 countries on average.

This looks like a substantial relief at first sight. However, in terms of cash flow it is not. The IDA and the AfDF modalities are in line with the US-proposal. For every dollar of current debt service relief, IDA and AfDF will reduce disbursements to these countries by one dollar. Debtor countries will thus pay for their own relief. While new funding will be made available to ensure that the Development Banks' lending volumes are maintained – these new resources will be *allocated to all IDA- and AfDF recipients based on existing IDA- and AfDF performance-based allocation criteria.*[5].

The actual effects of the scheme thus need to be discussed as a two-step process: The debt relief itself is a zero-sum game in cash flow terms at best. Countries, which have not been able to service their obligations to IDA and AfDF in the past – particularly the interim-period and pre-decision point countries – will have less resources available than before, because an un-serviced debt is now being paid out of resources which they otherwise would have received on a grant or loan-basis. To accommodate this concern, the IFIs claim that all post-completion point HIPCs have been on track with their payments since their completion points, and implicitly assume that they would have remained so over the whole repayment period. Though this can certainly not be taken for granted, as we shall see in some country cases below, it would indeed mean that countries would neither win nor loose from the relief. Fresh money can then, in the second step, be expected to come forward from those resources, which the G8 have vowed to provide in order to

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[2] G8 Finance Ministers Statement on Development and Debt; London June 10-11th 2005

[3] The Finance Ministers' statement is unequivocal regarding the inclusion of IBRD claims: While it speaks of „cancellation of outstanding obligations of HIPCs to the IMF, **World Bank** (all emphasis JK) and African Development **Bank**" in its introduction, it later only mentions „100 per cent **IDA**, AfD**F** and IMF stock relief". The G8 heads of state communiqué only speaks of the cancellation of IDA claims, however, „as set out in the Finance Ministers' communique". After past operations to eliminate IBRD claims on the poorest countries, including through IDA-financed buy-back operations, IBRD holds only minor claims on some countries. G-8 Ministry officials interviewed by the author, do not expect IBRD claims to be covered by the agreement. The same goes for the African Development Bank: Though the AfDB has been mentioned in the first paragraph of the Ministers' statement on HIPC and debt cancellation, only AfDF claims are meant to be covered by the scheme. G8 government officials consulted over the inclusion of non-concessional World Bank and AfDB claims, suggested that the scheme would be limited to cancelling IDA- and AfDF claims. Therefore calculations of relief effects will be based on the cancellation of concessional claims only.

[4] EURODAD-Briefing on multilateral debt cancellation proposals ahead of G8 summit July 2005; June 9th 2005

[5] G8 Finance Ministers Statement on Development and Debt; London June 10-11th 2005

safeguard the two institutions' lending portfolios. These resources are not confined to the (former) debtor countries, but will be made available to all 81 IDA recipients, with the explicit aim to not reward poor debt management in the past, but rather benefit those countries which have pursued prudent lending policies and sound debt management, while HIPCs are assumed to have not. Due to this broader spread of the new resources each of the 18 beneficiary countries well theoretically get on average about US-$ 8 million in fresh money per annum.[6]

The situation looks brighter regarding the IMF. It is a minor, but not insignificant, victory for the British to have forced the IMF into the scheme against the will of the US. Unlike with the other two institutions, there will be no dollar-to-dollar reduction in disbursements. The IMF is to finance the relief from its own resources at first. However, the statement notes that once countries with huge IMF arrears are approved to obtain relief[7], the G8 and eventually other donors will provide additional funding.

The clearest winners of the Gleneagles deal are the two development banks, which can move substantial bad loans off their books and compensate for lost revenue by reducing disbursements. Their medium term viability will meanwhile be guaranteed by fresh commitments from the richest countries on earth.[8]

An additional improvement is also worth mentioning, namely the G8's commitment to provide 300-500m US-$ in additional funds, to cover *difficult-to-forecast-costs*. What kind of expenses this may actually mean is subject for guessing, as, unlike with HIPC, no hard-to-forecast medium-term income or variable sustainability thresholds are involved in the calculation of the actual relief for each individual country. Eventually these funds may contribute to the inclusion of interim period HIPCs, where data reconciliation may still imply some potential for unforeseen costs or to bringing other multilateral creditors on board. As the most positive interpretation of this contingency clause, it may be assumed that the G8 has learned a lesson from the sometimes huge discrepancies between the calculated costs for HIPC relief at their decision points and the ultimate costs at and beyond completion points. Sometimes costly adjustments via the topping-up of relief at the completion point were due to wrong projections or outright errors by the IFIs.[9]

Finally, real good news is the acknowledgement that additional costs may be involved for relieving other countries, which may still enter the HIPC initiative based on their end-2004 debt burdens. Opening HIPC, as the only "comprehensive" framework for debt relief for countries, which may not have been on the list, when it was originally set up in 1996, nor

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[6] 650m reduction volume by IDA and AfDF, divided by 81 presently IDA-eligible countries; this calculation is indicative only, as, of course, AfDF resources are divided among a smaller number of recipients and there will be huge variations between countries, depending on size and performance.

[7] The notorious Sudan, Somalia and Liberia combined owe 1bn US-$ to the IMF.

[8] This positive outlook, does however, not prevent Bank management from ringing alarm bells regarding resource availability in three years time, in order to already win additional support for itself. See below.

[9] Countries that needed and were granted topping-up were Burkina Faso, Niger Ethiopia and Rwanda. Technical mistakes by the IFIs were among the reason for excessive remainders of debt in Uganda and Rwanda.

were among the lucky few, which had made it on board in the meantime, is a long overdue step into the right direction. However, from those countries' – and eventually also the IFIs' staff – perspective it may be a strange exercise to work on detailed debt sustainability analysis in order to define debt sustainability and hence the need for relief, in order to then have an arbitrary portion of debt cancelled additionally (see next section).

2. Conceptional flaws

Even if the scheme had provided additional resources rather than stealing with one hand what the other hand has given, it would have implied substantial conceptual flaws:

- **Arbitrary amounts of relief.**

  Before 1996, relief from official creditors was only available to countries on the basis of fixed relief quota defined by the Paris Club, in response to decisions taken by the G7 at their various summits: 33% Toronto Terms, 50% London Terms or 67% Naples Terms. These quotas were applied to countries irrespectively of their absolute or relative debt burdens, formally presuming that the quotas defined would be sufficient to provide sustainable or even "exit" solutions to the debtor countries. This absurd set-up did hardly lead to an exit anywhere but rather laid the foundations for repeated rounds of rescheduling, enhancing, topping-up and topping-up of the up-topped. Ultimately HIPC introduced the concept of debt sustainability into the renegotiation process, by defining a "sustainable" debt level, above which any outstanding claims would have to be eliminated. Unfortunately HIPC had to buy the unavoidable flaws of a scheme which has neither been designed nor is run by an independent entity but by either of the parties, in this case the creditors: the notoriously biased definition of debt sustainability and its equally biased application. Like the Paris Club schemes, over which it was meant to be an improvement, it led to another series of reforms and improvements, which turned out to be ever insufficient. This new mission creep certainly contributed to laying the foundations for the sweeping solution, which has now become the result of Gleneagles. However, the baby, which the G8 have thrown out with the bath, is the concept of debt sustainability. The present G8 proposal singles out an arbitrary portion of countries' external payment obligations – in this case debt owed to three institutions – and cancels them without any regard to how much debt will remain, to whether this is sustainable, or whether the country may have been in need of more or perhaps less relief in order to reach fiscal and external sustainability.

  In the case of Zambia for example, the IMF/IDA completion point document[10] had identified a financing gap after the full implementation of HIPC relief from 2006. Looking at the benefits, which the new scheme will now provide, one finds that it will not be enough to cover this financing gap:

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[10] IDA/IMF: Zambia Completion Point Document under the Enhanced HIPC Initiative; Table 12; for a critical assessment of Zambia's relief through Gleneagles see:: Kaiser,J.: Zambia after the „Gleaneagles Debt Relief"; UNDP background paper; July 25th 2005

Table 1: The remaining financing gap in Zambia

Mio US-$	2006	2007	2008	2009	Average 2014-2023
Post-HIPC Financing gap	117	109	169	183	153
Gleneagles relief	**-32**	**-62**	**-96**	**-95**	**-66**
Remaining gap	85	47	73	88	87
Reduction in disbursements	23	24	25	25	66
"Gleneagles gap"	108	71	98	113	153

In other countries the outlook may have been less bleak. However, the country example shows that arbitrarily singling out portions of debt tends to not lead to debt sustainability. In that sense the Gleneagles arrangement clearly falls back behind the HIPC concept.

This is the more unfortunate, as only recently the IFIs have started to make reference in their completion point documents to the financing needs for MDG attainment. Although so far this has been just rhetoric, because no MDG financing needs whatsoever have actually appeared in the calculations of the necessary relief, this reference carries the potential of a more serious consideration of MDG financing in the context of sovereign debt management in the future. This, however, would presume that a serious and MDG-based sustainability analysis is undertaken and applied as the basis for actual debt relief. The quota-system is by definition unable to build this crucial link.

- **100% is actually not 100%.**

  The proposal refers to only three multilateral creditors, which are indeed the most important ones for African HIPCs. However, one of them is irrelevant for the four Latin American HIPCs, and also the two "big shots", IDA and IMF, are not as dominant in Latin America as in Africa, due to the strong role of the IDB and regional development banks like the Cooperación Andina de Fomento (CAF) and the Banco Centroamericano de Integración Economica (BCIE). Latin American relief will therefore fall behind African relief for no other reason than the British and G8 special interest in supporting Africa in 2005. Not even African HIPCs will be relieved of all their foreign debt, as there are 19 multilateral creditors (including some who refused to cooperate under the existing HIPC framework). Debt owed to bilateral official and private foreign creditors is completely unaffected by the new scheme. As these

creditors are neither named nor shamed by the G8, and given the debtors' newly improved solvency, they are unlikely to follow the example of the three institutions.

Additionally, the burden of some countries' high domestic debt is not considered in the framework, either. This contrasts with some IFIs' strong call to not ignore the growing domestic problem any longer[11]. Of course, domestic debt cannot be brought to a solution by the G8. However, any deal, which aims at restoring fiscal sustainability must at least take the magnitude of the problem into account in its assessment of the needs for relief.

3. Who can expect what? Some country examples

We have seen that the Gleneagles agreement will certainly not free the eligible countries completely from their external debt burdens. The real relief effect will depend on a lot of variables, which need to be subject for estimation and may change over time. Surprisingly a group of African Fund EDs seems to assume that the relief will allow beneficiary countries to finance MDG attainment[12]. Neither do the authors of the proposal claim that the proposal will mobilise enough resources for full MDG financing, nor does our own analysis suggest such a positive outcome.

In this section we therefore undertake an evaluation of the foreseeable debt reduction effect of the agreement in some randomly selected countries, four of them African and one Latin American, which is more or less in line with the intercontinental distribution pattern of the 18 post-completion-point HIPCs, which will immediately benefit from the scheme:[13]

Table 2: Debt service reduction in selected post-C.P. HIPCs

%	2006	2007	2008	2009	Average 2014-2023
Bolivia	25	35	37	33	n.a.
Ethiopia	17	14	20	20	32
Niger	54	57	60	49	34
Rwanda	69	65	64	74	18
Zambia	39	54	67	75	63

Source: Completion Point Documents for selected countries

[11] Prominently: Global Development Finance 2005; Vol 1, p.76ff.

[12] Office Memorandum July 5th to the IMF Managing Director from EDs Ondo Mañe, Gakunu and Mirakhor. It needs to be noted that this particular bold claim has been made by the African EDs in an effort to resist a substantial change in the conditions of the new scheme, suggested by a Northern colleague. See a detailed discussion of the controversy on the IMF Board below.

[13] More detailed analysis on each of the selected countries is available in country analysis papers.

With the exceptions of Ethiopia and eventually Bolivia it shows that relief tends to be frontloaded. Debt service relief is between 15% and 75% in the selected countries during the rest of the decade. It is not surprising that Niger, Rwanda and Zambia (with the exception of 2006) will benefit relatively more than the Latin American HIPC Bolivia, where debt relief from the African Development Bank logically does not matter. The big surprise is the limited effect, which the scheme will have on Ethiopia. This is due to the extra ordinarily high levels of new debt that Ethiopia will have to take out in order to cover the remaining financing gap – and which is not subject to debt reduction.

Remaining debt of the 18 countries, not covered by the proposal, includes:

- Debt to other multilaterals such as BADEA, Arab Fund, Nordic Fund, OPEC, CAF or IDB;
- Debt to bilateral official creditors which have not committed to full cancellation as they have not been part of the Paris Club negotiations;
- New debt to bilaterals after the tentative cut-off date (for most countries) of June 20th 1999 and to multilaterals after the still to be defined cut-off-date for the multilateral cancellation; this will be defined at the 2005 Annual Meetings of the World Bank and the IMF; likely dates are January 1st 2004 or January 1st 2005.
- Remaining debt to commercial creditors, occasionally already under litigation.

A closer look at the selected countries shows that in each of them considerable risks remain even after a substantial reduction of current payment obligations:

- **Niger** will enjoy a substantial reduction, but a considerable amount of old debt will remain unless other multilaterals can be brought on board. As a result of the relief from debt owed to IDA, AfDF and IMF the debt service ratio falls well below 5%. It remains to be seen, if, given the present threat of famine in large parts of the country, servicing this remainder can be considered as socially and economically sustainable. The most sincere threat to debt sustainability meanwhile comes from the likelihood of further external shocks. IMF/IDA's base case scenario, from which this debt service ratio has been calculated, is – as always under HIPC – very optimistic regarding overall growth, and particularly the country's export performance. The completion point document provides some stress tests, which simulate less favourable new lending conditions with subsequently higher borrowing costs, and in a second scenario a reduced overall growth rate. Both assumptions, which are considered as "shocks", are still slightly more positive than the country's historical records. We have therefore taken both "shocks" together and assessed the resulting debt service burden in relation to the country's economic potential. The resulting debt service ratio will cross the 5%-threshold in 2009 and approach 10% on average between 2013 and 2022.

  Niger's remaining debt after full extinction of existing claims by IDA, AfDF and IMF divides between nine multilateral creditors, which hold 89.6m US-$ in 2003 present value terms, the biggest one being BADEA with 21.9m. Paris Club creditors hold an additional 11.6m, nearly all of which is post-cut-off-date debt. Finally, eight non-Paris

Club creditors hold 82.4m, the biggest chunks being owed to Taiwan (31.8m) and Libya (19.6m). There are no indications as of yet that any of these creditors will follow the example of the three multilateral institutions. Given their concessions, however, and in the face of the current human catastrophe in Niger, one might rightfully ask why these lenders have to be serviced at all.

- In **Zambia** the debt service ratio under the completion point document's base line scenario remains well below 5%. This is largely due to a questionable calculation of future export income in the completion point document. Export income had fallen short of decision point projections through the first years of the new millennium until 2003. Then an exceptional rise in copper prices in 2004 had boosted income from copper, traditionally the country's single most important export product. The authors of the completion point document have then simply updated expected export income from this rise in copper prices with an ongoing year-on-year growth rate of 5% until 2023, assuming neither negative quantitative effects after the exceptional price rise nor any return to "normal", i.e. pre-2004, price levels. Therefore the positive future debt service ratio is dependent on copper prices remaining high. A more conservative calculation building on an expected 25% reduction in copper prices in 2006 – rather than a continuous rise - as expected by some commodity trade experts, would bring the debt service ratio on remaining debt again closer to the 5% threshold.

  An additional critical issue regarding Zambia's debt sustainability meanwhile is the closure of the financing gap, which the IMF has foreseen from 2006 onward (see above). Gleneagles debt relief does only provide a limited contribution, while closing it through less concessional loan financing would be likely to kick the fragile debt sustainability won under the scheme, off-track.

- Though certainly welcome, relief for **Bolivia** will only have a limited effect, particularly considering the huge domestic debt service obligations. Even after the Gleneagles deal will the debt service ratio remain above 10% and the debt-to-revenue ratio above 20%. Like in Niger, the financing gap forecasted at completion point will not be overcome by the additional relief. Thus the dilemma between urgent social investment needed for MDG attainment and the threat of newly ballooning debt ratios remains.

- **Ethiopia** is the most surprising case, as its percentage of relief hardly goes beyond Bolivia's and the debt service ratio must be expected to remain well above HIPC averages, as forecasted by the World Bank. Due to the persistent external trade deficit Ethiopia is forced to finance an equally persistent financing gap. Until 2012/3 this gap amounts to 334m US-$ annually on average. Until 2023, it will broadly remain in this range. Less than 10% of this gap will be financed from the Gleneagles debt relief, while total debt service, including on new debt, will come close to the amount of the financing gap by the end of the projection period. It therefore seems advisable that either new lending will be reduced drastically and substituted for by grants, or that the

country will receive the opportunity to forego debt service payments on new debt in the future, if the financing gap persists.[14]

Two factors in particular limit the effects of the Gleneagles relief in Ethiopia: the huge relative share of new debt in the future overall debt stock; this is due to the above mentioned persistent financing gap. And the relatively low grant element in Ethiopia's new borrowing, which will not exceed 50% according to the IFIs' forecasts under HIPC.

Given these factors the additional relief will not manage to bring the debt service ratio below 5% in Ethiopia until the end of the decade. If the again quite optimistic assumptions under the base line scenario are replaced by an only slightly more conservative "shock" scenario, which is outlined in the completion point document, the debt service ratio remains above 5% until the end of the forecast period.

- In **Rwanda** the heavily frontloaded Gleneagles relief has the strongest relief effect among all countries in the panel. Thus the country has a good chance of maintaining a sustainable debt position over the foreseeable future. This will, in part depend on decisions regarding new lending. If under IDA-14 Rwanda becomes a "green light country" due to its reduced debt ratios after this year's annual meetings of the Bank and the Fund, it may indeed re-enter into a critical debt situation. If, instead, the British proposal to consider countries on the basis of their pre-Gleneagles indicators[15] is pursued, Rwanda may stay out of the debt trap for a while.

  More than elsewhere has the sweeping cancellation in the Rwandan case helped creditors to cover up the traces of HIPCs impressive failure. At Rwanda's recent completion point the IFIs had not only to acknowledge that practically all decision point forecasts for Rwanda's economic development had been missed. Partially this was even due to technical mistakes committed by the IFIs, while calculating the necessary NPV reduction.[16]

No country among the 18 beneficiaries can expect to reach investment grade through the Gleneagles relief. Standard & Poor's rates nine out of the eighteen, but all of them stable below investment grade, with only Mocambique having a positive and Bolivia a negative

[14] Though certainly innovative in present-day sovereign debt management, such a „contingency clause" to accommodate the threat of future stress in terms of cash flow, would not have to be invented from scratch. It has been included – though never invoked – into the London Debt Agreement of 1953, through which Germany was relieved from about half of its pre- and post- World War II debt.

[15] The British government has informally suggested to assign IDA-14 resources to countries in line with the new debt sustainability framework, as if the Gleneagles relief had never happened, in order to avoid the quick building up of a new debt problem.

[16] In this case the application of a the US-$ discount rate instead of the one for SDR while calculating the present value of Rwanda's foreign debt, which then determined the amount of write-off necessary to attain the HIPC threshold.

outlook. Over-indebtedness is a major factor contributing to the low rating, but nowhere does the impact of relief fundamentally alter the outlook.[17]

4. Further political implications

The proposal has only been broadly outlined as of yet. The World Bank and the IMF are busy hammering out their own proposals, how to implement it, and only after formal approval by the Boards and Governors of the World Bank and the IMF at the annual meeting next September will the proposal become operational[18]. Many details remain to be worked out. However, on the basis of the Finance Ministers' communiqué, some far reaching consequences for the sovereign debt landscape can already be identified:

- As debtor countries are only receiving minor additional resources, they will most likely balance their current budget and external balances through new lending. With only limited new money from concessional sources, governments are likely to take recourse to domestic as well as non-concessional external financing at near-market conditions.
- HIPC, as a WB/IMF driven instrument, has received the third class funeral it deserves. HIPC Finance Ministers find themselves in a strange situation as they are expected to continue making payments based on HIPC sustainability calculations, while they can already look forward to the cancellation of current obligations as well as arrears under the new scheme. Creditor representatives on the IMF Board are obviously aware of this dilemma and have stated that they expect debtor countries to stick to their respective payment obligations as long as no other formal agreement has been reached and the Managing Director has echoed this concern.[19] HIPC debt sustainability thresholds, which through years have been presented to the public as the ultimate wisdom towards fiscal and external viability, have ceased to be relevant over night. Obviously, creditors and important IFI shareholders have become tired of the mission creep of HIPC-I - HIPC-II additional bilateral relief – topping-up…etc.
- The freshly created and formally still to be introduced Debt Sustainability Framework (DSF) of the IMF and IDA has equally been deemed irrelevant for an important group of countries. Although the communiqué speaks about *utilizing appropriate grant-financing as agreed to avoid the piling-up of new debt*, the DSF will not be able to provide the basis for "informed lending decision". The DSF defines grant-eligibility through potential debt distress due to an existing debt overhang and through the quality of governance. Even if new debt relief is not 100%, most countries are likely to fall below present eligibility thresholds. Creditors will either have to fundamentally overhaul the DSF towards substantially lower thresholds – which would indeed make

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[17] *Debt pledge by G8 ministers offers limited respite for beleaguered African states;* S & P Commentary Report; July 7th 2005

[18] Starting implementation immediately after the meetings, is currently one option under discussion; starting on Jan. 1st 2006 is another one.

[19] See next para for quote and background.

sense, also with a view beyond the 18 countries – or they will have to move along the British proposal to simply ignore the Gleneagles relief while categorizing countries in terms of their likelihood of debt distress.

- Related to this latter point, the communiqué expresses a commitment towards using grant financing to *ensure that countries do not immediately re-accumulate unsustainable external debts, and are eased into new borrowing*. Comparable commitments have been made before and conditions regarding the concessionality of future external financing are routine in IMF agreements under the Poverty Reduction Growth Facility (PRGF). However, in a number of instances, these stipulations have not prevented countries from covering balance-of-payment gaps with resources outside of their IMF arrangements. If grant financing is provided in line with the DSF it will moreover imply a 20% overall volume reduction to compensate for the higher degree of concessionality for countries that are to receive grants-only and half of that rate for "yellow-light" countries (which receive a mix of grants/loans). This may partly be offset by new resources provided bilaterally – however, if not, governments may feel forced to seek loans, even at less-than-ODA conditions.
- The special paragraph in the communiqué on Nigeria's treatment in the Paris Club – while certainly due to President Obasanjo's scheduled appearance in Gleneagles - does reveal the Ministers' awareness that there is a world beyond the HIPCs. Soon after the summit, the Paris Club has indeed broken with its long-standing negligence on Nigeria and provided an exceptional treatment under Naples terms, which all in all will provide relief to the tune of some 50% of the country's debt.[20] It remains to be seen, however, if this commitment will take effect beyond the Nigerian case to an acknowledgment of the broader and structural debt problem of a broader series of countries and which demands more than one-off sweeping action. Some other relevant cases are already under discussion in one way or another:
    - Kenya, originally a HIPC, which was then declared sustainable with traditional debt relief by the IFIs, has only received a concessional rescheduling under Houston Terms from the Paris Club, and now rightfully complains the huge discrepancy between its own fate and that of its neighbours, which may have undertaken less of an effort to pay up, and have now been rewarded with additional relief.
    - Russia's President Vladimir Putin, who happens to be the host of the next G8 summit, has already made clear that he wants the debt of some CIS countries on the agenda. Central Asian and East European countries have been largely ignored by "Western" debt relief initiatives, although some of them show alarming debt indicators. German government officials have as well identified Tajikistan,

[20] Paris Club Press Release June 29th. For a critical assessment of the deal see: ANEEJ: *The missing llink in Paris Club Debt Relief for Nigeria.* Press Statement July 2nd; and: Kaiser, J.: Nigeria's forthcoming debt relief agreement with the Paris Club in the light of a recent MDG-based sustainability analysis by the World Bank and the IMF; July 7th 2005

Kyrgyz Republic and Armenia, besides Haiti as low income countries in need of additional relief efforts from their creditors.

- The UK itself has pointed to the need for relief for additional countries through its bilateral debt relief program. Through this program Britain refinanced the current debt service of highly indebted low income countries to the World Bank and the AfDB. Mongolia has been one of the few countries, which are spared from paying the Washington Institution. Though amounts are limited (1.9m US-$ annually at present), the programme sets an encouraging precedent.
- African Governors at the IMF, interestingly enough, have pointed to the need to also take action for some middle income countries, *many of which exhibit similar Characteristics as LICs, particularly on social indicators and unsustainable levels of external debt.*[21]
- Finally, the four European ED's which have suggested a more phased approach of IMF debt relief instead of the one-off cancellation in the G8 proposal, have also explicitly mentioned the need to broaden up relief to a broader group of countries under the imperative of uniformity of treatment by the IMF.[22]

- The "interim period" between the announcement of the deal mid-June in London and its eventual application after the annual meetings, constitutes a very special form of moral hazard: As the deal is meant to cover all outstanding claims by the three institutions including arrears, there is not much of an incentive for any HIPC finance minister to keep paying up. This is less of a problem with the 18 countries of the first wave. However, interim and pre-decision-point countries a situation, where any dollar paid is a dollar less in relief, may carry on for some time. The IMF board in a somewhat obstinate statement on August 3rd have declared that *the Fund will continue to operate under existing policies and procedures until decisions to change or modify these policies are taken by the required majorities.*[23] If Finance Ministers of cash-strapped HIPCs are prepared to buy into that view and pay up, remains to be seen. The most likely outcome is a continuous process of pressure from the IMF, possibly with a considerable degree of defensive lending, in order to keep countries formally on-track. In view of this practical dilemma the Belgian ED has come up with a proposal to provide countries with a three-year interim period, in which no buy-back obligations would become effective but only interest due have to be paid.[24] If the Fund will be able to provide carrots and sticks to a sufficient degree, such a strategy, may eventually be successful. First and foremost it reflects the strange idea that countries, which otherwise would

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[21] Communiqué by the African Governors at the IMF; Press Release No. 05/88; April 15th 2005.

[22] Office Memorandum June 30th 2005 to the IMF Managing Director from EDs Kiekens, Kremers, Solheim and Zurbrügg; pt.2

[23] Statement by the IMF managing director following executive board discussion on the G-8 proposal for further debt relief; IMF Press Release No. 05/183; August 3rd 2005

[24] Statement by Mr. Willy Kiekens (Belgium) on G8 debt cancellation proposal; Executive Board Meeting 05/55; June 22nd 2005

be freed from their payment obligations, will start to make payments, once they fail to comply with Fund conditions or have deteriorating governance records. Fund staff, who will have to drag money out of countries in such circumstances are certainly not to be envied!

5. Open questions: additional conditionalities and the danger of Dutch disease

Creditors have been concerned that relieving countries from a substantial part of their external debt may lead to a lack of enthusiasm for policy reforms in debtor countries. As "reform agenda" in creditors' views equals implementation of an IMF programme, the grip, which the Fund will have or have not on countries, has become the central issue of this discussion. Some countries outside the HIPC world, such as Indonesia, have in the last years successfully abandoned lending from the IMF, in order to avoid submitting themselves to the Fund's policy conditionalities. On a conceptual level creditors have reacted to this tendency by suggesting a more formalized surveillance role of the Fund towards countries, which are not indebted to the Fund (any more). More specifically in the context of the present debt relief proposal for HIPCs the Belgian Fund Executive Director Willy Kiekens has suggested to alter the scheme's procedures by transforming the one-off-cancellation into a continuous refinancing of current debt service by rich countries towards their poor debtors[25]. This proposal would bring the scheme closer to the original British proposal, although without the much-criticised flaw that a time-limited refinancing scheme would not cover the full amount of outstanding claims. As Kiekens refers only to the IMF portion of the debt, which is firmly within the 10-year repayment horizon, all claims would be covered, provided the scheme would work smoothly. The proposal's major thrust, however, was first and foremost to provide creditors with an opportunity to withhold debt relief, if at some moment in the process they become unhappy with the debtor's track record in terms of economic policy and IMF programme compliance. Kiekens' initiative has quickly received support from other powerful members of the IMF board, when EDs from Norway, Switzerland and the Netherlands issued a follow-up statement together with Kiekens[26], while African EDs have been equally quick in rejecting it, in order to avoid opening doors to any additional conditionalities[27]. As it revisits a conceptual controversy, which has been difficult to overcome at the Gleneagles summit – and moreover rings the bell of discontent of smaller creditors/donors with the G8's role as masterminds of IMF/World Bank policies, it may still carry some potential for derailing what Gordon Brown and Tony Blair may wish to see as a done deal.

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[25] ibid.

[26] Office Memorandum June 30th 2005 to the IMF Managing Director from EDs Kiekens, Kremers, Solheim and Zurbrügg; Together these EDs represent 38 countries from North and South, holding a combindes 16% of the votes.

[27] Office Memorandum July 5th to the IMF Managing Director from EDs Ondo Mañe, Gakunu and Mirakhor. Together these EDs represent 52 countries from Africa and the Middle East, which hold 6.9% of the votes.

Debt campaigners, in turn, have expressed the hope that a far reaching debt cancellation will give countries more freedom to develop economic policies in line with their own priorities,[28] because the International Financial Institutions would not be in a position any more to threaten countries with withholding relief, if they do not comply with IFI programs.

The jury in person of the IMF staff, which has been asked by both, the European as well as the African EDs, to assess the formal side of the "additional conditionality" issue, is still out. Before the board meets to discuss the debt relief proposal again in preparation of decision making at the annual meetings, staff will present expertise on the question whether formally disbursing resources to countries on the basis of their status as post-completion-point HIPCs conflicts with the need for equal treatment of members, as claimed by Kiekens and contested by the Africans.

In terms of effective policy conditionality, however, neither the concern of the creditors nor the hope of debt campaigners and beneficiary countries' representatives seem to be particularly well founded:

- Notwithstanding the more fundamental question whether conditionalities, which have been actually imposed upon HIPCs by the IMF as a pre-condition for debt relief have in sum been beneficial or detrimental to countries' sustainability, it is now largely consensus, that programmes need to be home-grown and "owned" by those that actually have to implement them. In practice, those programmes with IMF involvement, which have received praise, have in general been those, which could build on genuine home-grown reform agendas. Cases in point are Uganda or Tanzania. Therefore moving the IMF into a position, where it serves as a subordinated policy adviser rather than as an ultimate decision maker with the power to provide or withhold urgently needed debt relief, could only be beneficial to all parties involved.
- The foreseeable post-Gleneagles set-up would not even go as far. As we have seen, none of the countries, we have looked at will become independent from foreign financing through the G-8 deal. The Fund will certainly continue to be among the most important providers of such financing – even if support from Multilateral Development Banks will rather come in the form of grants. And even these grants will certainly not be provided without any conditions attached. The hopes expressed by debt campaigners towards enhancing independence of Southern sovereigns through debt relief, is a therefore futile one, as long countries have to cover substantial balance of payment gaps through foreign, and largely multilateral, lending.

Warnings have been raised by the IMF against two dangers of this year's drive towards substantial more aid – including through debt relief – for the South: First the Fund has warned against the dangers of Dutch disease, i.e. pressure towards currency appreciation

[28] JubileeUSA: First Step on a long journey: Putting the G-8 deal on debt into perspective; June 2005; p.7

and its damaging consequences for exports, caused by relatively large inflows of cash. Secondly the Fund has insisted that available funds be used for reserve build-up, down payment of foreign and domestic debt or for investment, often in real estate. It has urged countries to refrain from "consuming" funds released by debt relief through enhanced payrolls for public service, such as administration, education, health or security. This has in some instances led to some strange spending patterns, like schools and health posts being built, while governments were unable to staff them adequately. Some observers generally consider the fear of Dutch disease in HIPCs as exaggerated. And although nobody would deny the real danger of freed-up resources being squandered via inappropriate public service payrolls, due to generally weak governance structures, a broader and more long-term understanding of what "investment" means in a HIPC context, seems appropriate. Given the limited amounts, which have been made available by the new debt relief scheme, "Dutch disease" would only become a problem, if no supply-side effect would be attained via public spending.

6. **Who has to care about the financing of debt relief?**

Among creditors the most controversial issue between the summit and its results' suggested implementation in Washington next September is the question of financing relief. Even ahead of the summit, debates have been waged on where the compensation for the IFIs was to come from, once they have to waive payments from the poorest countries. Soon after the signing of the Gleneagles final communiqué concerns have been raised from some creditors that they might eventually not have the resources to finance the relief, which Gleneagles foresees. The World Bank has been particularly outspoken, while expressing its fears that Gleneagles might lead to a situation where the multilateral institution might not be able any more to provide countries with the resources they need.[29] Interestingly enough, even the Bank administration could not point to any immediate need, but rather expressed fear that *they will have to come back 'cap in hand' in three years time.* Given the generally short-term character of international aid commitments, the huge quantitative and time-related discrepancies between commitments and disbursements (for the better of for worse) and finally the high level of fungibility of funds at all stages of the aid-assignment process, the Bank's initiative comes as a particularly brazen attempt to secure additional funding for itself on the back of a debt relief initiative.

However, this attempt raises important questions about the general set-up and the justification of compensation of multilateral lenders, once they have to write-off unrecoverable loans. Although from an accountant's perspective there is some point in demanding compensation, it foremost points to a crucial flaw in the mutilateral lending system: The sweeping solution which the G8 have undertaken, is first of all an acknowledgement that the loans which are now to be wiped out, along with their interest and late interest payments, should never have been made been made in the first place. This

[29] The Observer (UK); August 7th 2005

is a conclusion and a somewhat painful acknowledgement, which private sector lenders have to make every day, wherever credit markets function. Only in the context of sovereign multilateral debt management is the question, whether the creditor can actually "afford" to wipe out an unrecoverable claim, raised at all. Ever since the outbreak of the modern sovereign debt crisis, the alleged inability of creditors to "finance" debt relief has led to long cycles of defensive lending. The detrimental effect of this practice, which reflects a market imperfection, has only recently been acknowledged by independent observers[30] as well as by the IMF itself[31] in the case of Argentina. Once the need for multilateral debt relief towards HIPCs had been acknowledged by the IFIs and their powerful members in 1996, nothing contributed as much to the initiative's failure, as the IFIs' firm intention to confine losses as much as possible. In a painful mission creep, HIPC became HIPC-II, HIPC-II was supplemented by bilateral additional relief, original relief was topped-up, and finally all was brushed aside by the "100%" cancellation scheme, which we now see forthcoming. Had the international community been able to independently assess HIPCs' need for relief in the light of those countries' vulnerabilities regardless of "costs" in terms of foregone income, relief would have come much more timely, and most probably at lower overall costs.

So, the best way for debtor governments to seize the opportunity is to simply ignore the question, where IFIs will get compensation from and to what extent. From their end they should implement, what HIPC Finance Ministers have repeatedly demanded, namely an independent assessment of debt sustainability and the resulting need for relief, and then develop their policies accordingly. This can and will not come out of Washington. It requires debtor countries' own initiatives. Given the huge attention which financing for development has received around the G8 summit this year, the chances of winning broad support for this are better then they have ever been since the "Jubilee" year 2000.

Jürgen Kaiser, August 24th 2005

Author contact:

Jürgen Kaiser
Finance, Capital Flows and Debt Relief Advisor
Poverty Reduction Group BDP
UNDP
304 E 45th Street, Room 1192
New York,NY 10017
USA
Tel.: +1-212-906-5047
Fax: +1-212-906-5313
Mob: +49-173-2919374
E-Mail: jurgen.kaiser@undp.org

[30] Blustein,P.: And the money kept rolling in (and out); Perseus 2005

[31] IMF (PDR): Lessons from the crisis in Argentina; Oct. 8th 2003