

DEBT

The economic development of many African countries was for decades inhibited by enormous debt burdens. For the most part, these loans were not extended for development objectives, but rather were given during the Cold War for political reasons or to reduce excess liquidity in Western countries. Years later, when the rulers who signed up for the debts had been replaced by new leadership, these debts remained a very real relic of the mistakes of the past, an impediment to those who wanted to focus on the future prospects of their countries.

Many African countries often paid the majority of their export earnings and a substantial part of their GDP to service their debts. Even when they were able to pay this burdensome debt service, it was not enough to reduce the debt stock in a meaningful way. The loans were therefore rescheduled over and over again or paid back by taking out new loans.

The international community has recognised the magnitude of the crisis and has responded with initiatives that have committed rich countries to cancelling the majority of debts owed by those countries that were most burdened. Of the 41 countries identified for the Heavily Indebted Poor Countries (HIPC) Initiative, 33 are in Africa. For the 33 countries (27 in Africa) that have received debt relief thus far, it has proved to be immensely effective in assisting development objectives:

- Debt relief is estimated to have reduced the debt stock of African Post-Decision Point countries by \$86.7 billion, \$70 billion of this for African Completion Point countries (see box 'The Life of an HIPC').¹
- HIPC and the Multilateral Debt Relief Initiative (MDRI) freed up approximately \$2.3 billion in debt service savings in 2007 – funds that can now be used to finance development.²
- African countries have used the funds that they no longer spend on debt service to reduce poverty. Partly because of debt cancellation, Post-Decision Point countries increased the share of their government revenues directed to poverty reduction from 37.8% in 2000 to 55.1% in 2007.³ In absolute terms, this means an increase in poverty-reducing expenditure from \$5.8 billion (6.8% of GDP) in 2000 to \$20 billion (9.4% of GDP) in 2007 – an increase of \$14 billion.⁴

WHAT DID THE G8 PROMISE?

100%

MULTILATERAL DEBT CANCELLATION

PARAGRAPH 29

'The G8 has agreed a proposal to cancel 100% of outstanding debts of eligible Heavily Indebted Poor Countries to the International Monetary Fund (IMF), International Development Association (IDA) and African Development Fund, and to provide additional resources to ensure that the financing capacity of the International Financial Institutions (IFIs) is not reduced. We welcome the agreement in principle by the Paris Club aimed at achieving a sustainable exit for Nigeria from its debt problems.'

UPDATING THE COMMITMENT

No new agreements were made on debt at Heiligendamm, but the Summit invited all development partners to 'take account of the debt sustainability issues in all of their lending practices' (see 'Moving Forward' box at the end of this chapter).

INTERPRETING THE COMMITMENT

The commitment made at Gleneagles on debt was to expand the pre-existing Heavily Indebted Poor Countries (HIPC) Initiative to eliminate multilateral debt for qualified countries, in what became known as the Multilateral Debt Relief Initiative (MDRI). Because the multilateral commitment was built on the platform of the existing HIPC process, this chapter considers both mechanisms. It evaluates progress by considering the implementation of HIPC and MDRI in general as the vehicles for delivering the promised debt cancellation, as well as measuring the extent to which financial resources have been made available to deliver this. Development partners

committed at Gleneagles that the multilateral debt cancellation deal would be additional to aggregate resources for development from the international financial institutions (IFIs), as opposed to being fully additional for each individual country.⁵

Eligible countries would receive 100% cancellation of debt stock, and this would be accompanied by a corresponding dollar-for-dollar reduction in gross assistance flows from multilateral institutions such as the International Development Association (IDA), the World Bank's concessionary lending arm. Bilateral development partners committed to reimburse the multilateral institutions in order to compensate for any losses resulting from relieving 100% of the debt. Available sums would then be redistributed across all borrowers of the multilateral institution concerned, rather than just to HIPC countries. In the case of IDA, the redistribution would be done in accordance with the Performance-Based Allocation systems, which rewards good performers.

For example: if country A currently pays \$100 million in debt service per year to the International Development Association (IDA), after the MDRI it will be freed of this burden. In return, IDA allocations to country A will decrease by the same \$100 million and, in turn, bilateral development partners will pay this \$100 million into IDA as a whole. These resources will then be redistributed across all those 66 low-income countries that qualify for World Bank lending only through the concessionary arm of IDA. The amount of funding is determined on the basis of policy performance, as determined by the World Bank's 'Country Policy and Institutional Assessment' (CPIA). Better performers may receive a significant share of the \$100 million back as additional resources, whereas worse performers can expect to receive a smaller proportion.

The Nigerian debt deal, which was also part of the commitment, has been implemented. While it is not monitored in this year's report, it is still worth noting as a commitment that the G8 were party to fulfilling along with other creditor nations. The Nigerian debt deal is already resulting in approximately \$1 billion in savings for the Nigerian people every year. Nigeria is directing these funds towards education, health and infrastructure.⁶

This year's report attempts to step back from the specific commitment to consider how this effective tool can be

enhanced in the effort to fight poverty. We acknowledge the extent to which members of the G8 are largely on track to fulfil existing commitments but, because debt cancellation has proved to be effective, note some areas where potential new commitments could also be beneficial.

THE LIFE OF AN HIPC

Debt relief has been extended to African countries through two vehicles: the Heavily Indebted Poor Countries (HIPC) Initiative and the Multilateral Debt Relief Initiative (MDRI). The HIPC Initiative cancels 90% of bilateral pre-cut-off-date debt to Paris Club members and some multilateral debt after countries adopt economic and governance reform programmes and implement poverty reduction plans.⁷ Most Paris Club members, among them all G8 countries, increased the percentage for bilateral debt cancellation to 100%. The MDRI, which was introduced in 2005, cancels 100% of multilateral debt owed to the World Bank, the IMF and the African Development Bank for those countries that complete the agreed-upon steps in the HIPC process.⁸ The HIPC process is divided into three phases:

PRE-DECISION POINT

In order to be eligible for the HIPC Initiative, a country must have an 'unsustainable' debt burden, defined in most cases as a debt-to-export ratio of above 150 percent.⁹ Another condition was that the candidates were 'poor', as defined by a GNI per capita level that qualified the country for highly concessional lending by the World Bank and IMF. With the addition of Afghanistan, the current number of HIPCs is 41. From 2007, no further countries will be included in the HIPC Initiative.¹⁰

DECISION POINT

In order to reach the 'Decision Point' which ultimately triggers HIPC benefits, countries must establish a track record of macroeconomic stability and must have a national poverty reduction plan. At Decision Point,

a country receives interim debt relief, reducing its debt service to levels close to where they would be at Completion Point. On average, the African countries that are currently at Decision Point have been waiting for over four years to reach Completion Point.¹¹

COMPLETION POINT

In order to reach Completion Point a country must maintain macroeconomic stability, carry out structural reforms and implement a Poverty Reduction Strategy satisfactorily for one year (see paragraph on conditionalities under 'What do the G8 need to do?' below). At Completion Point, qualified debts under both HIPC and MDRI are irrevocably cancelled and the country is no longer responsible for their payment.

HOW AMBITIOUS WAS THE G8 PROMISE?

The 2005 G8 promise was a significant step forward in that it expanded on the HIPC Initiative by providing 100% cancellation of multilateral debts owed to the IMF, the World Bank and the African Development Bank up to the end of 2004 to some of Africa's poorest countries.¹²

However, the Gleneagles debt commitment did not revisit the HIPC process. It added additional benefits to the existing process, but ignored problems with the HIPC process on which it was based, and those problems continue to hinder the benefits of debt relief in reaching those for whom it is intended.

DELIVERING THE PROMISE

As of May 2008, 23 countries (19 of them in Africa) have received the full benefits of debt cancellation. The Gambia reached Completion Point in December 2007. In total, African Completion Point countries have received \$70 billion in debt cancellation.¹³

In addition, 10 countries (eight of them in Africa) have reached the Decision Point and are working towards Completion Point. The Central African Republic reached Decision Point in September 2007 and Liberia in March 2008. These ten countries have received \$18 billion in debt service relief.

Ensuring that Liberia reached Decision Point this year is an especially noteworthy achievement for the international community. Liberia was originally named as HIPC-eligible but, due to its 14-year civil war, progress was limited. Under the leadership of President Ellen Johnson-Sirleaf, Liberia worked with major creditors to clear past arrears on debts, and at the same time creditors built in flexibility for Liberia in allowing a Staff-Monitored Programme of the IMF to count towards the requirement that countries demonstrate a track record of working with the international financial institutions.

DEBT CANCELLATION STATUS OF AFRICAN COUNTRIES

PRE-DECISION POINT (6 COUNTRIES)

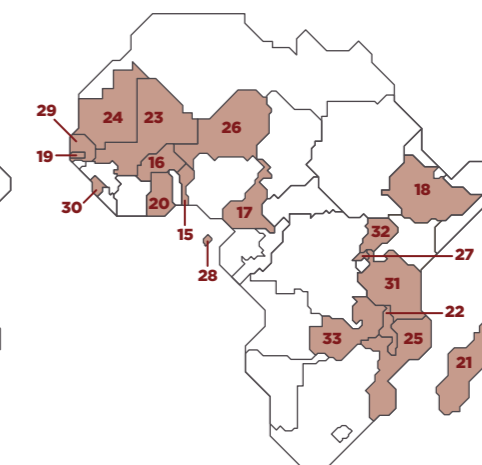
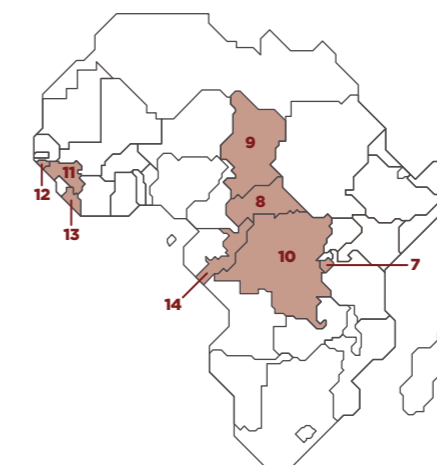
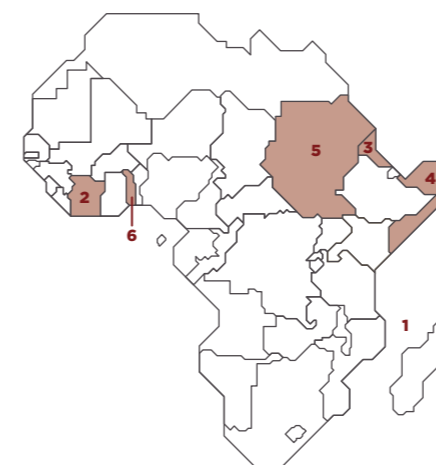
- 1 Comoros
- 2 Côte d'Ivoire
- 3 Eritrea
- 4 Somalia
- 5 Sudan
- 6 Togo

DECISION POINT (8 COUNTRIES)

- 7 Burundi
- 8 Central African Republic
- 9 Chad
- 10 Democratic Republic of Congo
- 11 Guinea
- 12 Guinea-Bissau
- 13 Liberia
- 14 Republic of Congo

COMPLETION POINT (19 COUNTRIES)

- 15 Benin
- 16 Burkina Faso
- 17 Cameroon
- 18 Ethiopia
- 19 The Gambia
- 20 Ghana
- 21 Madagascar
- 22 Malawi
- 23 Mali
- 24 Mauritania
- 25 Mozambique
- 26 Niger
- 27 Rwanda
- 28 São Tomé & Príncipe
- 29 Senegal
- 30 Sierra Leone
- 31 Tanzania
- 32 Uganda
- 33 Zambia



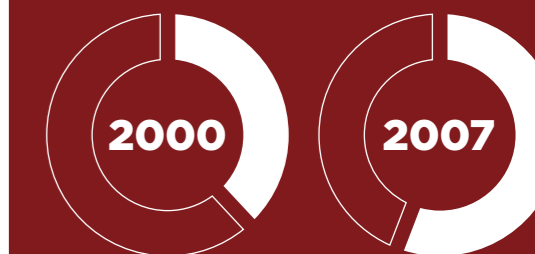
IMPACT OF DEBT RELIEF

\$86.7bn

Debt stock reduction of African Post-Decision-Point countries by debt relief.

\$2.3bn

Approximate debt-service savings freed by HIPC and MDRI in 2007 – funds that can now be used to finance those countries' development.



Post-Decision-Point countries increased the share of their government revenues directed to poverty reduction from 37.8% in 2000 to 55.1% in 2007.

CHALLENGES AHEAD

Lesotho transferred **\$47 million** in 2006 to its creditors. This amount is equal to **two thirds** of its annual development assistance inflows.



10 of the 19 African Completion Point countries have moderate to high risks of future unsustainable debts – the debt sustainability issue must thus be addressed at a systemic level.

A specific challenge to the benefits of debt relief that urgently requires a political response by the G8 are the activities of vulture funds.

DEBT CANCELLATION ELIGIBILITY FOR OTHER COUNTRIES

Poor countries such as Kenya and Lesotho, who spend a significant portion of their domestic resources on servicing debt, were excluded from the original HIPC deal because their debt ratios were below the HIPC threshold. In such cases, the eligibility requirements ended up excluding countries from the benefits of debt cancellation because they had done a relatively good job in managing their debts. Lesotho, for example, has a debt stock to GNP ratio of 38% and in 2006 transferred \$47 million to its creditors. This is two-thirds of its annual development assistance inflows.¹⁴ The Government of Lesotho is committed to achieving the Millennium Development Goals (MDGs) within the context of the National Vision and the Poverty Reduction Strategy processes. However, its fiscal policy space has been very limited, which in consequence has led to slow progress on most MDG indicators.

WHAT DO THE G8 NEED TO DO?

The G8 development partners largely took the steps necessary to fulfil their Gleneagles commitments, alongside other creditor nations, in 2005 by agreeing to the MDRI. It is now incumbent on them to ensure that the financial resources necessary are available each year to implement this commitment and that, as per their commitment, the overall resources available for debt cancellation are additional to other development assistance.

However, the extent to which debt cancellation is successful is inextricably linked to the success of the HIPC process to return debt burdens to sustainable levels. Though HIPC has successfully provided much-needed assistance for Completion Point countries, many countries struggle between Decision Point and Completion Point and face delays in completing the process. Often countries point to the 'conditionalities' or the policy requirements set by the World Bank and the IMF for receiving full debt cancellation as an impediment. A recent analysis from the IMF shows that

conditionalities neither instigate sustainable policy change nor do they help countries to meet the poverty reduction goals agreed to with the IMF.¹⁵

The G8 Communiqué refers to letting Africa drive the development process, noting that democratically elected, transparent and accountable African governments should be given the policy space to plan and sequence their own trade and development strategies.

Development partners should ensure that each country's agreed-upon 'triggers' for reaching Completion Point are sensibly tailored to the country's needs and plans. In addition, top-down structural conditionalities that are hindering Decision Point countries from reaching Completion Point need to be streamlined. Not all conditions are necessarily bad: debt cancellation should be incumbent more on 'bottom-up conditionalities', which are demands derived from the people on the ground. Such conditions allow African governments to take the lead on development and force them to answer to their own citizens rather than to donors.

ARE THE G8 ON TRACK?

HIPC AND MDRI IMPLEMENTATION FOR COUNTRIES IN SUB-SAHARAN AFRICA

As stated above, the G8 are on track in supporting the progression of countries through the HIPC process. In showing flexibility and supporting Liberia to reach Decision Point, development partners demonstrated commitment to delivering debt cancellation to countries in need.

ENSURING COMPENSATORY FINANCE FOR DEBT CANCELLATION

At Gleneagles, development partners committed that debt cancellation resources would be additional to other sources of development financing – not to each individual country but to developing countries collectively.

From 2006 through to 2016, IDA and the African Development Fund of the AfDB have estimated a need of approximately \$10 billion to cover lost reflows from the MDRI. Each country has a different approach to ensuring the long-term security of funding, using a combination of unqualified commitments (i.e. commitments which are not subject to additional legislation or procedural requirements before they can be delivered) and 'qualified commitments' (which do require additional legislation).

The following are the qualified and unqualified commitments to IDA by each of the G8 development partners:

CANADA

Canada made an unqualified pledge of \$29.36 million to IDA for 2007–08, and a qualified pledge of \$83.62 million for 2009–16. No pledges have been made for 2017–44.

FRANCE

France made unqualified pledges of \$45.7 million for 2007–08 and \$471.5 million for 2009–16, and a qualified pledge of \$1.95 billion for 2017–44.

GERMANY

Germany made unqualified pledges of \$68.7 million for 2007–08 and \$712.4 million for 2009–16, and a qualified pledge of \$2.95 billion for 2017–44.

ITALY

Italy made unqualified pledges of \$29.2 million for 2007–08, and qualified pledges of \$302.6 million for 2009–16 and \$1.25 billion for 2017–44.

JAPAN

Japan has made unqualified pledges of \$105.8 million only for 2007–08.

RUSSIA

Russia made unqualified pledges of \$710,000 for 2007–08, \$6.36 million for 2009–16 and \$26 million for 2017–44.

UK

The UK made unqualified pledges of \$113.86 million for 2007–08 and \$1.06 billion for 2009–16, and a qualified pledge of \$4.38 billion for 2017–44.

US

The US made overall pledges of \$232.5 million (\$132.2 million qualified and \$99.6 million unqualified) for 2007–08, and qualified pledges of \$1.4 billion for 2009–16 and \$5.8 billion for 2017–44.

For the purposes of evaluating progress on delivering financial commitments, DATA relies upon the cost estimate made by IDA and the corresponding burden sharing.¹⁶ According to IDA reports, the G8 collectively are on track through 2008 with firm, unqualified pledges. For the period 2009–16 they are almost on track. However, an additional \$2 billion will be necessary, much of which can be mobilised by turning qualified pledges into unqualified pledges.¹⁷ For the period 2017–44, \$34.6 billion will be needed and \$27 billion in qualified pledges has been received so far. This means most G8 countries have taken sufficient provisional measures to ensure long-term funding. The exceptions are Canada and Japan, with observed shortfalls of \$1.354 billion (of a total \$1.467 billion required) and \$4.842 billion (of a total \$4.947 billion required) respectively for the period through to 2044.¹⁸

For two reasons, the efforts of all G8 countries need to be continuously monitored. First, those pledges that are qualified will require that bilateral development partners ensure they contribute the full amount in firm, unqualified commitments. Second, compensation of the IFIs for their loss of revenue through debt relief will require the long-term commitment of the G8 through 2044. Monitoring can ensure that the efforts for compensation will not gradually decline over the years.

A test of the international community's collective commitment to financing the HIPC effort came with Liberia's accession to Decision Point. Liberia was one of three countries for which the development partners did not set aside financing in 1999, pledging to do so when and if such countries reached Decision Point. Despite initial costly delays, the fact that the development partners eventually mobilised the necessary resources to ensure that Liberia's debt cancellation was financed was an important moment of credibility for the process as a whole.

In addition, two recent replenishment conferences have demonstrated goodwill towards ensuring that the collective act of cancelling debt is in fact additional to ongoing assistance flows:

- In December 2007, when the bilateral development partners replenished funds for IDA they also committed to additional compensatory finance for MDRI specifically. Altogether, donor pledges for IDA from July 2008 to June 2011 ('IDA15') amounted to \$25.1 billion and were complemented by \$16.5 billion in internal financing from the World Bank Group and prior donor pledges for financing debt forgiveness. IDA15 will thus operate with an additional \$9.5 billion as compared with the previous funding period from July 2005 to June 2008 ('IDA14'); a 30% increase.¹⁹
- In the same month, the African Development Fund of the AfDB was replenished with \$5.6 billion in new donor resources. When combined with internal resources of \$3.3 billion, this increase results in an overall funding level of \$8.9 billion for the three-year period 2008–10. This is an increase of \$3 billion as compared with the previous financing period (a 52% increase).²⁰

OVERALL ASSESSMENT

The G8 are currently on track with both elements of their Gleneagles commitment on debt. To stay on track, the development partners must address delays in the HIPC process by ensuring that the conditionalities support rather than inhibit progress towards Completion Point, while doing more to promote democratic accountability within African nations.

As a long-term challenge, G8 development partners must ensure that in future appropriation rounds, they continue to adequately compensate the World Bank and the AfDB (African Development Bank) for the cost of debt cancellation under MDRI. There must also be serious consideration of new critical issues as detailed in the box to the right.

MOVING FORWARD DEBT SUSTAINABILITY AND OTHER EMERGING CHALLENGES

In order to have a realistic chance of achieving the MDGs, poor countries need access to new grants and low-interest loans. But this type of financing is limited, and in its absence, many countries might increasingly resort to more expensive loans, and turn to new lenders such as China, India and Arab countries. The World Bank has assessed ten of the 19 African Completion Point countries as having moderate to high risks of future unsustainable debts.

This threat should not be attributed too easily to new lenders. Since their engagement is relatively new, it is difficult to know the extent of the threat to debt burdens. However, there is evidence that China is increasingly adapting lending practices that take the existing debt burden into account. All Chinese loans to Completion Point Countries have been concessional. In addition, to date China has provided debt relief to 31 African countries to the amount of RMB10.9 billion (approximately \$1.38 billion) and has made further pledges on debt relief.²¹ More than anything, the emerging role of new lenders highlights a two-fold need: the need to ensure adequate access to development financing and the need to ensure debt sustainability at a systemic level.

The Debt Sustainability Framework has been designed by the World Bank to analyse the debt risk of HIPC countries and to avoid Completion Point countries sliding back into unsustainable debt. However, this framework does not suffice to address the two-fold need mentioned above. Rather than dealing with debt sustainability at a systemic level, it discourages non-concessional borrowing by curtailing the Bank's low-interest financing to any country that borrows at non-concessional terms.²² In doing so, however, the policy punishes those countries that need resources for development and, having expended options for grants or concessional financing, have turned to other options in an effort to invest in their people.

The 30% increase in IDA's available funds for IDA15 is welcome, but it is expected to be delivered increasingly

through loans rather than grants.²³ In order to preserve the gains made through HIPC and MDRI, the increased contributions to IDA should be used to scale up grants, so that countries do not once again build up unsustainable debt burdens when accessing increased development financing.

In addition, the G8 should develop a charter for responsible lending in order to address debt sustainability at a systemic level. The OECD has already done this – albeit in a voluntary form – for use by export credit agencies.²⁴ Such a charter should take the form of a binding legal framework that sets out internationally recognised legal standards for responsible financing. In addition, it should make provisions for cases of irresponsible lending – referring to both quantity and quality – by fairly allocating the burden between creditors and debtors.²⁵ In a second step, a fair and transparent arbitration panel should be established in order to allow impartial monitoring of compliance of the legal framework for responsible lending.

Another specific challenge to the benefits of debt relief that urgently requires a political response by the G8 is the activities of vulture funds. When an impoverished country has outstanding debt owed to a government or a commercial creditor that has not been cancelled according to HIPC or MDRI terms, there is a chance that a private financial organisation (a vulture fund) will attempt to buy that debt at a steep discount and take legal action to seek repayment of the original amount and more. The number of lawsuits by vulture funds against HIPC countries has increased in the past three years with the provision of debt cancellation, as vulture funds seize on the opportunity presented by resources newly freed or about to be released by debt relief. As most vulture funds sue in US, UK and French courts, legal provisions in G8 countries requiring increased transparency and timely disclosure of their activities would be a significant step towards curtailing such activity. G8 leaders should also expand on the Paris Club commitment not to sell claims on poor countries on the secondary market by urging other creditors to agree as well.²⁶