

DEBT

WHY IS DEBT CANCELLATION IMPORTANT?

For decades, debt has been a major obstacle to development in sub-Saharan Africa, with many countries forced to spend more on servicing their debts than on investing in the health and education of their people.

Many debts are illegitimate. During the Cold War, donors often provided assistance to unaccountable dictators in exchange for their political allegiance. Money was granted or loaned for strategic interests rather than to reduce poverty. Neither donors nor recipients were held accountable for outcomes and much of this funding was wasted or stolen. These regimes are now long gone, but poor countries are still repaying their debts, which have multiplied over and over again due to skyrocketing interest rates.

Debt cancellation has proven to be an effective means of delivering poverty reduction.

- To date, debt cancellation has freed approximately \$2 billion in annual savings for qualified countries, most of them in Africa. For every dollar freed up from debt service, African governments have increased social spending by twice as much.¹
- The Multilateral Debt Relief Initiative (MDRI), launched by the G8 in Gleneagles in 2005, generated approximately \$490 million in debt service savings for 17 African countries in 2006.²
- Overall expenditures on poverty reduction in all HIPC countries increased from \$14.8 billion (9.3% of GDP) in 2005 to \$16.7 billion in 2006 (10.2% of GDP).³
- In Nigeria in 2006, \$750 million that would have been paid to creditors was directed to education, health and infrastructure projects.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 IMF, IDA and African Development Fund, and to provide additional resources to ensure that the financing capacity of the 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 overall agreements were made on debt at St. Petersburg, but the Summit's Update on Africa did provide a progress report on implementation of the 2005 G8 commitments.

INTERPRETING THE COMMITMENT

The commitment made at Gleneagles on debt was to expand the pre-existing Heavily Indebted Poor Country (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 against three benchmarks:

- Implementation of the HIPC initiative, taking stock of the countries moving through the process and the extent to which donors are fulfilling their financial commitments;
- Implementation of the multilateral debt cancellation agreement made in Gleneagles and the provision of financial resources;
- Implementation of the Nigerian debt deal.

THE LIFE OF A HIPC

Debt relief has been extended to African countries through two vehicles: the Heavily Indebted Poor Country (HIPC) Initiative and the Multilateral Debt Relief Initiative (MDRI). The HIPC Initiative cancels most bilateral debt and some multilateral debt after countries adopt economic and governance reform programs and implement poverty reduction plans. MDRI cancels 100% of multilateral debts and is linked to the HIPC reform process. The HIPC process is divided into three phases.

PRE-DECISION POINT

To begin the HIPC process, a country's debt level must be unsustainable; it must be eligible for World Bank and IMF concessional lending programs; it must establish a track

record of macroeconomic stability, and it must have a national poverty reduction plan. Once these conditions are satisfied, it reaches 'Decision Point' and officially begins the HIPC process.

DECISION POINT

At Decision Point, a country can receive interim debt relief, reducing its debt service to sustainable levels. In order to reach Completion Point a country must maintain macroeconomic stability, carry out structural and social reforms and implement a Poverty Reduction Strategy Paper satisfactorily for one year.

COMPLETION POINT

At Completion Point, a country receives the full amount of HIPC debt relief, as well as 100% multilateral debt relief (MDRI) from the World Bank, IMF and the African Development Fund.

STATUS OF HIPC ELIGIBLE AFRICAN COUNTRIES

PRE-DECISION POINT 8 COUNTRIES

- 1 Central African Republic
- 2 Comoros 3 Côte d'Ivoire
- 4 Eritrea 5 Liberia 6 Somalia
- 7 Sudan 8 Togo



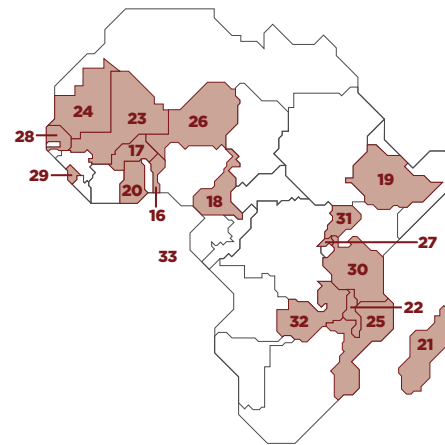
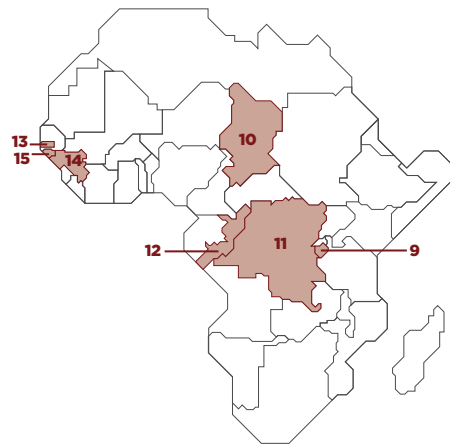
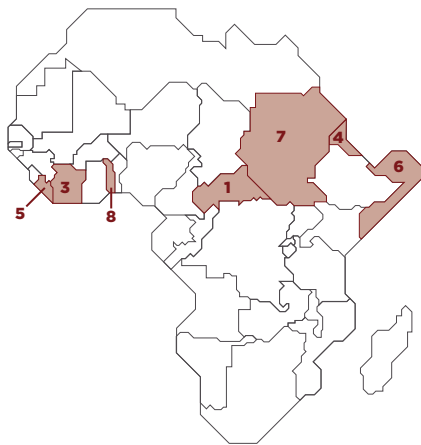
DECISION POINT 7 COUNTRIES

- 9 Burundi 10 Chad
- 11 Democratic Republic of Congo
- 12 Republic of Congo
- 13 The Gambia 14 Guinea
- 15 Guinea-Bissau



COMPLETION POINT 18 COUNTRIES

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



THE GOOD NEWS

\$70bn

The amount that HIPC and MDRI are providing in debt relief to African countries, saving them an average of \$2bn a year.

\$490m

Savings made by 17 African countries during 2006 as a result of HIPC and MDRI debt cancellation.

\$750m

The amount that Nigeria would have paid creditors in 2006, that was instead directed to education, health and infrastructure projects.

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 (ADB) up to the end of 2003/04 to some of Africa's poorest countries. Debt cancellation, including that delivered under the MDRI, is making a real difference in redirecting resources from debt servicing into poverty reduction. By wiping out the multilateral debt stock of qualified countries, the initiative has the additional benefit of improving the countries' creditworthiness.

The Gleneagles debt promise was criticised at the time – and continues to be criticised – for two main reasons. First, delivery of multilateral debt cancellation is contingent upon completion of the HIPC process, meaning that the MDRI is subject to the same strict qualifying criteria and conditionalities as the HIPC initiative. Thus, delays within HIPC result in delays in obtaining multilateral debt cancellation.

Secondly, because donors have interpreted the commitment to mean that the debt cancellation would be fully 'additional' to existing resources, the full benefits are not accruing to each individual recipient country as some thought they would (see box on additionality).

DELIVERING THE PROMISE

The G8 pledged to work with the Boards of the IMF, the World Bank and the African Development Bank to implement the MDRI by wiping out the remaining multilateral debt stocks of countries as they reached their HIPC Completion Point.

Following agreement on the MDRI at the Gleneagles Summit, G8 leaders worked with the boards of the relevant international institutions to approve and implement the initiative. The MDRI was made effective by the IMF and ADB from January 2006, and by the World Bank from July 2006. To date, 22 qualified HIPC countries have received debt cancellation through the MDRI, 18 of them in Africa.

For the latter, the MDRI will result in a nominal cancellation of about \$34 billion over the life of the loans. This is in

addition to \$36 billion in HIPC relief. Combined, the two initiatives are thus currently providing approximately \$70 billion in debt relief to African countries, saving them an average of almost \$2 billion a year.⁵

WHAT DO THE G8 NEED TO DO?

HIPC AND MDRI IMPLEMENTATION FOR COUNTRIES IN SUB-SAHARAN AFRICA

Overall, countries are taking much longer to reach their HIPC Completion Point than they should be. With the exception of Burundi and the Democratic Republic of Congo, which reached their decision points in August 2005 and March 2006 respectively, the majority of the seven African decision-point countries reached the target about five years ago.

Reaching completion point is expected to take approximately three years, based on the average length of time that previous countries have taken. According to the IMF and the World Bank, most of the delays are attributable to failure to comply or stay on track with mandatory IMF-sponsored economic reform programmes, under the institution's Poverty Reduction and Growth Facility (PRGF). The other eight eligible African pre-decision point countries (Central African Republic, Sudan, Comoros, Liberia, Togo, Côte d'Ivoire, Eritrea and Somalia) all find themselves in political and/or economic situations that in the view of the international finance institutions make it impossible to begin the HIPC process (see box on Liberia).

BOTTOM-UP CONDITIONALITY

PARAGRAPH 31: 'It is up to developing countries themselves and their governments to take the lead on development. They need to decide, plan and sequence their economic policies to fit with their own development strategies for which they should be accountable to all their people.'

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.

This Communiqué language marked an important breakthrough. While the G8 and other donors have rightly made development assistance conditional on satisfactory performance in areas such as human rights, corruption and the rule of law, they have also attached a number of economic conditionalities that have undermined national-level development strategies and democratic accountability in Africa. Recognition of this by the G8 paves the way for a new kind of policy conditionality, a 'bottom-up conditionality', which lets African governments take the lead in charting their development course and forces them to answer to their citizens rather than to donors and creditors.

Increasing the policy space of African governments requires a vibrant civil society and free media to aggressively hold governments to account. Donors can do their part in this area by using development assistance to train journalists, provide financing and training to civil society organisations, and strengthen systems for tracing and managing public expenditure. African governments can adopt policies such as Uganda's Poverty Action Fund or Nigeria's Virtual Poverty Fund, which open the government's poverty-reducing expenditures to public scrutiny by transparently managing proceeds from debt relief and development assistance.

THE CASE OF LIBERIA

The success of the HIPC initiative depends not only on the length of the process but also on the availability of financing. This is currently evident in the case of Liberia, which was designated an HIPC-eligible country at the time of the enhanced HIPC agreement in 1999. However, finances were never set aside by shareholders for Liberia's debt relief as they were for 37 other eligible countries, because at the time Liberia, along with Sudan and Somalia, was designated a special case because it was in 'protracted arrears'. As a result, it was decided that special financial arrangements would have to be made for Liberia, if and when it eventually qualified.

Today, Liberia is a different country. It has emerged from the ruins of a 14-year civil war and has begun the long process of recovery. But despite the new government's track record of success, it faces significant challenges in securing the funding necessary to enter the HIPC process.

Liberia currently owes \$3.7 billion to creditors, most of it accumulated by past regimes that grotesquely mismanaged and wasted resources. Of this debt, \$1.5 billion consists of arrears owed to the multilateral institutions, including the International Monetary Fund (\$795 million), the World Bank (\$530 million) and the African Development Bank (\$250 million). It is widely acknowledged that these debts cannot and should not be paid back in full, but the arrears to these three institutions must be dealt with before Liberia can qualify for debt forgiveness. Bilaterally, Liberia owes the US \$391 million, Germany \$232 million, the UK \$76 million, Italy \$51 million, Japan \$56 million and France \$16 million.

Progress in mobilising the necessary resources for Liberia's debt forgiveness has not been proceeding quickly enough. So far, at the Liberia Partners Forum in February 2007, and in subsequent negotiations, donors have agreed to the following:

BILATERAL DEBTS

The US, the UK and Germany have agreed to forgive 100% of bilateral debt. China also committed to cancel all bilateral debts.

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If the G8 are to remain true to the spirit of their Gleneagles promise on debt, they must fill the financing gap and allow Liberia to join the HIPC/MDRI process
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MULTILATERAL DEBTS

- **WORLD BANK:** The World Bank has indicated that it will finance Liberia's debt forgiveness using internal funds.
- **IMF** The most difficult challenge to securing Liberia's debt forgiveness rests with the IMF, where financing must be in the form of new financial commitments from shareholders. To date, the G7 have agreed to fully return all of their SCA-1 and deferred charges – funds held at the IMF which belong to members – as a contribution toward forgiving Liberia's \$795 million debt to the IMF. These contributions are expected to total roughly \$700 million. To fill the remaining financing gap, the G7 have further agreed to contribute \$100 million in new money. However, none of the G7 has pledged a specific amount. The US pledged \$35 million for Liberia to both the IMF and the ADB, but most of this is likely to go to the ADB.
- **ADB** The ADB will use a combination of internal resources and new money to finance Liberia's debt forgiveness. Discussions are still ongoing, but one likely scenario would have Liberia paying 1% of its arrears, with the remaining amount being split 70-30 between the ADB and donors. If this proposal is accepted, Liberia will need a total of \$59 million in new pledges to the ADB. Of that, the US has pledged \$15 million plus an undetermined share of the \$35 million it pledged to the IMF/ADB. The UK has pledged to pay 10% of the donor funding necessary, which in this scenario would be approximately \$6 million.
- **ESTABLISHING AN HIPC TRACK RECORD** Significantly, the IMF has agreed to count Liberia's Staff Monitored Programme as part of its HIPC track record, which puts Liberia on track to meet its HIPC Decision Point by September/October 2007, provided that the IMF financing gap can be filled.

If the G8 are to remain true to the spirit of their Gleneagles promise on debt, it is essential that they make specific pledges to fill the approximate \$100 million financing gap and allow Liberia to join the HIPC/MDRI process.

PRESERVING THE CAPACITY OF MULTILATERAL INSTITUTIONS TO ASSIST POOR COUNTRIES

The second element of the G8 promise on debt was that the multilateral institutions participating in the MDRI would be financially compensated in order to preserve their capacity to give grants to poor countries in the medium and long terms. The plan agreed to by donors was that the MDRI would be resourced in the following ways:

For the **IMF**, all countries with a per capita income of \$380 a year or less (whether HIPC or not) will receive MDRI debt relief financed by the IMF's own resources through the MDRI-I Trust. HIPC with per capita income above that threshold will receive MDRI relief from bilateral contributions administered by the IMF through the MDRI-II Trust. The MDRI-I Trust draws on resources from the 1999–2000 off-market sales of the Fund's gold (estimated at approximately \$4.5 billion), while the MDRI-II draws on transfers of contributions originally provided to fund concessional lending to low-income countries under the Poverty Reduction and Growth Facility (PRGF).

The **WORLD BANK's** share is being financed through scaled-up contributions to the International Development Association (IDA) through the regular, ongoing financing mechanism and supplemented by certain donors wishing to contribute to filling the gap. At present, total confirmed pledges by donors are \$10 million short of IDA's overall costs of the MDRI for 2007–08, which are estimated at \$830 million. This financing gap widens to \$2 billion for 2009–16 (total cost \$7 billion) and to \$10 billion for 2017–44 (total cost \$30 billion). Overall, pledged resources fall 32% short of the amounts needed to compensate the IDA for the implementation of the MDRI. Moreover, the firm financing commitments that have actually been approved and issued by donors to date (\$4 billion) – the so-called 'unqualified' pledges – account for only some 10% of total MDRI costs to IDA (\$38 billion).⁶

On 19 April 2006, the **AFRICAN DEVELOPMENT BANK** joined the IMF and the IDA by approving total debt relief of \$8.5 billion under the MDRI, between 2006 and 2054. In order to preserve the financing capacity of the African Development Fund (AfDF), the ADB reached agreement with donors on

a compensatory financing mechanism under which donors have pledged to provide full financing of the MDRI. Donors have also provided additional contributions to the regular AfDF replenishments. Still, as with the IDA, costs not covered at present represent 4% of actual needs in 2006–07, 22% in 2008–15 and 27% in 2016–54. Over the whole period 2006–54 this is equivalent to a shortfall of 26%.⁷

A pre-condition of the MDRI's full success is that all IDA donors – and most notably the G8 – guarantee, through sustained replenishments, that the multilateral debt cancellation is fully made up over time. The sums that indebted countries would have paid back in the future must be consistently replaced by rich donors in order for the IDA and the AfDF – the two mechanisms which face large reflow losses in the wake of the MDRI – to maintain their capacity to make new grants and cheap loans to poor countries.

From 2006 through to 2016, the IDA and the AfDF need about \$10 billion to cover lost reflows from the MDRI. So far, the G8 and other rich donors have made firm commitments worth less than half this amount. These outstanding needs must be provided for in predictable payments over the next years, so that multilateral development banks are not compromised in their ability to help poor countries achieve the MDGs. The forthcoming IDA-15 round will be a true test of G8 commitment to Africa and other developing countries. So far, the G8 are broadly on track, but public opinion must remain vigilant to ensure that they maintain this type of engagement.

THE CONCEPT OF ADDITIONALITY

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

While eligible countries will receive 100% debt stock cancellation, this will be accompanied by a corresponding dollar-for-dollar reduction in gross assistance flows from institutions such as the World Bank. Donors will reimburse the multilateral institutions in order to compensate for any losses resulting from relieving 100% of the debt. Available sums will then be redistributed across all IDA-only countries in accordance with the Performance-Based Allocation (PBA) system, rather than just to HIPC countries.

An example: if country A currently pays \$100 million in debt service per year to the IDA (or to the ADB), after the MDRI it will be freed of this burden. In return, IDA (or ADB) allocations to country A will decrease by the same \$100 million and, in turn, donors will pay this \$100 million into the IDA as a whole. These resources will then be redistributed across all 66 IDA-only countries on the basis of performance, as determined by the World Bank's Country Policy and Institutional Assessments (CPIA).

Based on an analysis of 15 African Completion Point countries, DATA has found that the MDRI has reduced overall IDA flows by an average of 4% (with a range from +1% for Ethiopia to -17% for Senegal), with the real additionality being, on average, about 96% of the country's pre-MDRI IDA flow.

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For every dollar freed up from debt service, African governments have increased social spending by twice as much
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NIGERIA'S DEBT DEAL

The final element of the G8's 2005 debt package was the promise of a sustainable exit from debt for Nigeria. In 2005, the country's debt of \$30 billion was removed through a combination of Nigerian payments, creditor cancellation and Nigerian discounted buy-back. Nigeria had to make an upfront payment of more than \$12.5 billion.

The real benefit to Nigeria of the debt deal is in the order of \$1 billion per year in debt service savings, for 15 years, and this is already making a real difference. Nigeria saved \$750 million in debt service in 2006 and is using these funds to train and recruit new teachers.⁸ The real cost to donors is much less than this, and is spread out over many years. Despite this, the Nigerian debt deal is currently being counted in official aid statistics as a two-year development assistance spike of \$5 billion in 2005 and \$11 billion in 2006.

ARE THE G8 ON TRACK?

HIPC AND MDRI IMPLEMENTATION FOR COUNTRIES IN SUB-SAHARAN AFRICA

On implementation of the MDRI, the G8 are on track. Eighteen countries in Africa have so far benefited from full HIPC and MDRI debt cancellation, generating savings of about \$490 million during 2006. An additional seven countries are receiving HIPC interim relief i.e. they are paying greatly reduced amounts. To stay on track, the G8 must address delays within the HIPC process. All donors, and especially the G8, must fulfil their pledges relating to the HIPC Trust Fund and the Debt Reduction Facility for IDA-only countries. It is also vital that the G8 contribute to the resolution of Liberia's arrears crisis so that the country can urgently receive much-needed debt cancellation.

ENSURING COMPENSATORY FINANCE FOR THE MDRI

By June 2006, the G8 had confirmed their commitments to the MDRI and had started their internal processes toward securing the resources to finance them. Each country has a different approach to ensuring the long-term security of funding; therefore, measuring progress differs for each. In all cases, actual appropriation takes place on a yearly basis

through the budget process, although some countries (such as France, Germany and the UK) already have multi-year legislative authorisations in place. In the end, what matters are the formal and firm ('unqualified') financing pledges. The following is the updated situation for the IDA.

CANADA made an unqualified pledge of \$30 million to the IDA for 2007–08, and a qualified one of \$79 million for 2009–16, while nothing has been pledged for 2017–44.

FRANCE made unqualified pledges of \$48 million for 2007–08 and \$450 million for 2009–16, and a qualified one of \$1.87 billion for 2017–44.

GERMANY made unqualified pledges of \$70 million for 2007–08 and \$710 million for 2009–16, and a qualified one of \$2.9 billion for 2017–44.

ITALY made unqualified pledges of \$30 million for 2007–08, and qualified ones of \$290 million for 2009–16 and \$1.2 billion for 2017–44.

JAPAN has made unqualified pledges of \$97 million only for 2007–08.

RUSSIA made unqualified pledges of \$800,000 for 2007–08, \$6 million for 2009–16 and \$26 million for 2017–44.

UK made unqualified pledges of \$124 million for 2007–08 and \$1 billion for 2009–16, and a qualified one of \$4.4 billion for 2017–44.

US made overall pledges of \$233 million (\$146 million qualified and \$87 million unqualified) for 2007–08, and qualified ones of \$1.4 billion for 2009–16 and \$5.8 billion for 2017–44.

On financial compensation to the participating institutions, the G8 are currently broadly on track, although only in the very short term (2007–08, a period which represents just 2% of total debt relief costs). France, Germany, Italy, Russia, the UK and the US have all pledged 100% of their obligations over the whole period using qualified and unqualified pledges, while for

Canada and Japan there are observed shortfalls of \$1.3 billion (of a total \$1.4 billion) and \$4.7 billion (of a total \$4.8 billion) respectively.

In order for the multilateral institutions to maintain operating capacity to assist poor countries in the future, while at the same time providing debt cancellation, many successive rounds of appropriations will be needed from donors for the World Bank and the African Development Fund. In particular, firm financing commitments from donors are needed for the first decade of debt relief costs.

The long-term operational solidity of the multilateral development banks will be kept intact if what they disburse in grants and/or concessional loans is fully compensated by donors. At present, the IDA has received firm compensation commitments for only half the cost of debt relief over the next decade. The G8 must continue to contribute their equitable shares towards these costs. Since there already appears to be a shortfall, it is important to tackle this dangerous outlook without delay.

NIGERIA'S DEBT DEAL

Nigeria's debt deal has been agreed to and implemented – therefore, the G8 are on track.

OVERALL ASSESSMENT

The G8 are currently on track with all three elements of their Gleneagles commitment on debt. To stay on track, donors must urgently address delays in the HIPC process, such as those being experienced by Liberia as it seeks to enter the initiative. Going forward, G8 donors must ensure that in future appropriation rounds, they continue to adequately compensate the World Bank and the ADB for the cost of debt cancellation under the MDRI. In particular, Canada and Japan must align their commitments to cover 100% of their share in this particular replenishment process.

In their provision of bilateral debt relief, four G8 countries offer more generous terms to HIPC countries than those agreed within the Paris Club. The UK, the US, Italy and Canada have all cancelled 100% of their development assistance and commercial (export credit agency) debts, whether they are classified as pre- or post-cut-off date debt. (A country's cut-off

date marks the point at which it first attended the Paris Club to seek re-scheduling or cancellation of its debt). France, Germany, Japan and Russia have not committed as much as their peers, and have not cancelled their post-cut-off date commercial claims.

MOVING FORWARD

The MDRI has provided significant relief for some of Africa's poorest countries, but there are still key concerns relating to the delivery of debt relief.

First, poor countries such as Kenya and Lesotho, which spend a significant portion of their domestic resources on servicing debt, were excluded from the deal because their debt ratios were below the HIPC threshold. In this case, the eligibility requirements ended up excluding these countries from the benefits of debt cancellation because they had done a relatively good job of managing their debts.

Second, a more satisfactory means of arbitrating the origins of debts should be established, so that odious and illegitimate debts are dealt with through a fair and transparent process, recognising creditors' co-responsibility for bad debts.

Finally, it is important to address the issue of new debt. In order to have a realistic chance of achieving the Millennium Development Goals, poor countries need access to new grants and low-interest loans. But this type of financing is limited and, in its absence, many countries are taking on expensive loans from emerging powers such as China. A new policy by the World Bank threatens to exacerbate the problem by curtailing the Bank's low-interest financing to any country that borrows at non-concessional terms.

Countries therefore face a Catch-22 situation: give up hope of achieving the MDGs or reaccumulate debt by borrowing more on unfavourable terms. To avoid this situation, donors need to increase the volume and predictability of their aid, and the World Bank should make more concessional financing available to countries striving to achieve the MDGs.