AN ALTERNATIVE APPROACH TO DEBT CANCELLATION AND NEW BORROWING FOR AFRICA

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Henry Northover
CAFOD
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Abstract

The World Bank and IMF's debt relief framework, the *Heavily Indebted Poor Country* (HIPC) Initiative is increasingly criticised for not providing sufficient debt relief to enable low-income countries to achieve short term, let alone medium term, debt sustainability. This paper argues that the key weaknesses of the HIPC Initiative stem from its use of an inappropriate analytical criterion when making debt sustainability analyses. The paper, therefore, proposes an alternative approach more suited to countries that are highly vulnerable to economic shocks and beset by widespread and deeply entrenched levels of poverty. This alternative *human development* approach should be used not only for determining appropriate levels of debt service, but also as the basis for a comprehensive financing strategy for low-income countries that encompasses aid and new borrowing. It argues that debt relief in support of domestically-owned poverty reduction strategies is the most efficient and effective form of resource transfer. In the last section, the paper responds to creditors' resistance to going further with debt relief by addressing creditor objections and urging the wider adoption of some existing African proposals as a way forward.

An Alternative Approach To Debt Cancellation And New borrowing For Africa

> "*No country genuinely committed to poverty reduction, good governance and economic reform will be denied the chance to achieve the Millennium Goals through lack of finance.*" **G8 Action Plan for Africa - 2002**

This paper raises a number of key issues to be taken into account in designing official African responses both to current debt relief policies and to some of the new debates over forward financing strategies. It argues that the Millennium Development Goals (MDGs) and domestic Poverty Reduction Strategy Papers (PRSPs) provide a framework for recasting donor and recipient country approaches to debt cancellation, aid and new borrowing. The first section considers the performance of the *Heavily Indebted Poor Country* (HIPC) Initiative against its intended objectives. The second section proposes the use of human development criteria consistent with achieving the MDGs as a way of assessing the sustainability of existing debt burdens and as part of the design of new borrowing strategies. It goes on to argue that debt relief as a form of development finance has unique advantages over and above other aid instruments. The final section of the paper includes a brief discussion of creditor objections to going further with debt relief and suggests some official African policy responses[*].

1) The HIPC Initiative – a flawed approach to debt relief

The HIPC Initiative is now seven years old. Despite marginal improvements to the policy framework that followed the 1999 Cologne G8 Summit, it is proving a weak instrument in meeting its objective of providing a "permanent exit" from the burden of unsustainable debts . It is also proving inadequate in meeting the poverty reduction ambitions set out by the G8 heads of government.

The World Bank and IMF's literature on the results of the enhanced HIPC Initiative produce, and reproduce, some spectacular headline figures on debt reduction. Some of the more recent papers talk of debt reduction of up to "$41 billion over time"[1]. But any judgement regarding the financial benefit of the enhanced HIPC Initiative must start by analysing the impact on the HIPCs themselves. And here, the results can best be described as modest.

- Out of 20 HIPCs which have already reached HIPC decision point, 4 countries (Mali, Niger, Sierra Leone and Zambia) will have annual debt service payments due in 2003-2005 which will actually be higher than their annual debt services paid in 1998-2000.
- 5 countries will be paying almost as much in debt service payments as before HIPC (Ethiopia, Guinea-Bissau, Honduras, Nicaragua, Uganda).
- In 6 countries, annual debt service will be reduced by a modest $15 million in the years 2003-2005.

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[*] The proposals discussed in this paper are designed to address the particular financing constraints faced by Low-Income Countries. While some the principles put forward are also applicable to Middle-Income Countries, the main focus is intended to cover the issues facing LICs maily in sub-Saharan Africa.

[1] *Financial Impact of the HIPC Initiative – First 26 Countries* – IMF July 2002

- The medium to longer term projections on debt servicing are also alarming - Senegal's debt service jumps by 61 per cent in 2004; Nicaragua's rises by 60 per cent in 2002; Mauritania's rises by 46 per cent in 2007; and Honduras faces an increase of 93 per cent in 2002.
- Over half of the HIPCs are spending around 15% of their government revenue on debt servicing. [2]

There are well-documented weaknesses of the HIPC Initiative. These have included systematic overoptimism on the part of the World Bank and IMF when it comes to making future projections and estimates of growth, investment rates and financial inflows. Bank and Fund calculations also fail to tie in or compensate for non-participation of other creditors in the scheme.

We argue here that there is one overriding flaw in the HIPC framework that gives rise to its failure to meet its objectives on debt sustainability and poverty reduction. The central weakness of the HIPC Initiative stems from its over-reliance on the export criterion (150% NPV-to-exports) used to make assessments of debt sustainability.

The experience of Uganda, as the first graduate of the HIPC Initiative, is evidence of this difficulty. Uganda currently has debts that take it over 200% of the debts-to-exports ratio. This will be the third time that Uganda has exceeded its 150% debt sustainability threshold after reaching completion points. Uganda's status as a debt sustainability "drop-out" has been reinforced by plunging coffee prices that have dramatically reduced its foreign exchange earnings.

The export criterion is a wholly unreliable predictor of debt sustainability for a group of countries characterised by an extreme vulnerability to shock and steep fluctuations in export earnings. For Africa in 2001, after adjustments for inflation, prices of non-fuel commodities are one half their annual average value for the period 1979-81. The World Bank and IMF estimate that by completion point 8-10 of the HIPC countries most affected by the slump in commodity prices will have debt-to-export ratios higher than the 150% target set by HIPC itself.

While the export criterion benefits from simplicity and clarity, it bears little relation either to the conditional requirement for governments to produce Poverty Reduction Strategies and pro-poor outcomes or countries' future PRS financing requirements. Exports alone do not reflect the resources available to HIPC governments for poverty reduction expenditures. It would be quite possible, under current criteria, for a country's debts to be considered sustainable from the point of view of external viability, while having insufficient resources to meet even the most basic poverty reduction expenditures. Nor do debt sustainability analyses take account of the extent or depth of poverty that must be reduced in order to achieve the MDGs. Measuring "debt sustainability" without some analysis of the balance between the requirement of governments to meet their debt-servicing obligations and the requirement to finance their core humanitarian expenditures is, we would argue, a misuse of the term sustainability.

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[2] *A Joint Submission to the World Bank and IMF Review of HIPC and Debt Sustainability* – CAFOD Christian Aid Oxfam Eurodad (Northover Lemoine Ladd Drapkin and Kline) August 2002

2 Alternative human development approach to debt sustainability

Clearly, debt sustainability analyses require the integration of a wider set of human development indicators. It is important for any country servicing its debts denominated in foreign currencies that that debt sustainability analyses should measure its capacity to earn foreign exchange through its exports. However, for low-income countries' (LICs') challenged by widespread and deep levels of poverty, a crucial part of the analytical framework must be the feasible revenue available to governments and the trade-off between maintaining their debt-servicing obligations and financing their poverty reduction goals such as the MDGs or PRSPs.

Agencies supporting the Jubilee 2000 campaign have long argued that debt reduction frameworks should be integrated with national governments' poverty reduction financing strategies and capacities. If it is accepted that debt sustainability is not an end in itself but the means to achieve poverty reduction and growth objectives[3], then it is clear that growth and poverty reduction objectives must form an indispensable part of debt sustainability analyses. We argue that the fiscal dimension and the financing of the MDGs needs to occupy the central ground in the determination of thresholds of debt sustainability.

The argument runs like this: if human development imperatives and the achievement of the MDGs are accorded the priority they deserve; if, as is the case, LICs do not have the fiscal revenue – principally income from taxes – needed to make the necessary poverty reducing expenditures and investments; and if they cannot count on sufficient foreign aid to fill their revenue gap, then the only available source of finance is further debt reduction.

According to preliminary calculations, many HIPCs will require a total cancellation, and some will require further aid flows on top of this, if their revenues are realistically to be expected to meet the objective of financing the MDGs[4].

We propose that future calculations of debt sustainability must include an assessment of the feasible net revenue[**] available to recipient/debtor governments. Feasible revenue is counted here as the maximum tax income available to a given government given the poverty of the majority of the population and capable of being raised without giving rise to excessive distortions in the macroeconomy. A number of variants of this model have been proposed[5], but the underlying principle is that the calculation used to measure the amount of debt-servicing governments can afford to sustain must give priority to financing poverty reduction expenditures and the MDGs.

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[3] Masood Ahmed (IMF) – keynote address at InWent debt sustainability conference – 19 May 2003
[4] *Real HIPC Progress Report*– Jubilee Research by Romilly Greenhill and Elena Sista Sept 2003
[**] A feasible net revenue approach would also include receipts of donor flows.

[5] *A Human Development Approach to Debt Sustainability Analyses for the World's Poor* – CAFOD Northover, Joyner, Woodward 1998 and 2001 www.cafod.org.uk/policy ; *Forever in your debt? Eight poor nations and the G-8* - Lockwood, Donlan, Joyner, Simms Christian Aid 1998; *Putting Poverty Reduction First* – Eurodad 2001; *The unbreakable link – debt relief and the MDGs* – Greenhill Jubilee Research. 2002.

Such an approach does raise issues regarding the volume of development assistance and other donor resources available to countries that are not debt-stressed but are nevertheless counted as low-income with low human development indices. It would, after all, amount to a perverse incentive to enhance resource transfers in the form of debt relief to countries that are debt-stressed and poor while ignoring LICs that are managing to meet their debt servicing obligations. This paper argues that a comprehensive financing strategy for LICs consistent with achieving the MDGs would need to provide commensurate new aid flows to non-indebted LICs. Before turning to this wider financing strategy debt and non-debt stressed LICs, it is worth setting out the case for debt relief as a form of development finance.

3 Debt relief as development finance

While the HIPC Initiative is clearly failing to deliver the objective of providing a permanent exit from unsustainable debts, preliminary analyses do show that debt relief, where it is additional and not limited to clearing built up arrears, is an efficient and effective form of delivering development finance.

Analysis of the HIPC Initiative's achievements shows that in some eligible countries debt relief has resulted in demonstrable social and economic gains. For 2001-2003, the HIPC Initiative reduces the average debt service paid by HIPC graduates by about one third. Among these countries, social expenditures are expected to increase in 2000-2003 from the levels in 1998-1999[6]. Where countries have had resources freed up from debt servicing, the proceeds have resulted in some new development programmes and economic progress:

- Mozambique has introduced a free immunisation programme for children;
- User fees for primary education have been abolished in Uganda, Malawi and Tanzania, as have user fees in rural areas of Benin;
- Mali, Mozambique and Senegal are due to increase spending on HIV/AIDS prevention;
- Uganda and Mozambique, among the early beneficiaries of debt relief and enhanced aid flows, have consistently sustained annual growth rates over 5%.
- The requirement to engage in a consultation with civil society in designing Poverty Reduction Strategies has helped to increase the potential for poor people to influence national resource allocation processes.[7]

But the advantages of debt relief go beyond the additional finance it provides to thinly resourced low-income country governments. Debt relief acting as *de facto* budget support is an efficient and effective form of financial transfer with many indirect benefits for the macro economy, growth prospects, the prudential management of public resources, and development policy as a whole.

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[6] "Sustainable Debt: What has HIPC Delivered?" Lucia Hanmer and Ruth Shelton August 2001
[7] *A Joint Submission to the World Bank and IMF Review of HIPC and Debt Sustainability* – CAFOD Christian Aid Oxfam Eurodad August 2002 www.cafod.org.uk/policy

- Debt relief minimises the **unpredictability of aid flows**. Many bilateral aid programmes are still bedeviled by problems of **low stability and low predictability** and **high pro-cyclicality.** Moreover the granting or withholding of aid tends to aggravate economic cycles. Empirical analyses by the IMF[8] show that aid flows tend to be more volatile than fiscal revenue or output, and highly unpredictable. In one in five African countries there is a divergence of at least 30% between budgeted and actual spending – and this is exacerbated by fickle aid flows. Debt relief on the other hand is highly predictable, stable and, therefore, can act as a counter-cyclical source of finance. As a result, debt relief helps low-income governments to strike a balance between meeting poverty reduction expenditure commitments, while striving to maintain fiscal stability.
- Debt relief is **anti-inflationary**. A recent IMF paper[9] points to a strong correlation between higher levels of indebtedness and increased inflationary pressures.
- Debt relief spurs **economic growth**. There is a positive correlation between debt relief and domestic private savings and investment, as well as FDI[10]. Some African finance ministries and regional analysts suggest that high levels of indebtedness lead to HIPC governments increasing their borrowing from domestic credit sources resulting in higher interest rates and the crowding out of local investors from access to affordable credit. Debt write-offs can relieve the pressure on domestic borrowing, increasing the availability, and reducing the cost, of domestic credit thereby acting as a spur to economic growth. On the other hand, there is little if any evidence of a positive interaction between aid flows and domestic investment and savings.[11]
- Debt relief acts as *de facto* **budget support**. By enhancing central government spending capacity, debt relief supports the development of locally owned government expenditure priorities and monitoring systems. In line with donors' emphasis on Medium Term Expenditure Frameworks, debt relief acts as an important boost for (some) donors' efforts to increase the predictability of flows and enhance coordination and common pool approaches. Where debt relief results in increases in national budgets, it facilitates a closer integration of budget management systems and an improved coordination between capital and recurrent expenditures. Aid, however, can distort the relationship between recurrent and capital spending. Some donors prefer to spend on tangible capital projects as opposed to meeting recurrent budgetary costs. Aid, unlike debt relief, can leave recipient governments cash poor and project rich.
- Debt relief cuts down on **transaction costs**. Aid can tie up recipient governments' meagre administrative staff in endless negotiations, report

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[8] *Aid, Public Sector Fiscal Behaviour, and Developing Country Debt*, S. Feeny and M. McGillivray; *The instability of Debt Service Payments and Economic Growth: Is there a Case for Debt Relief*, G. Dijkstra and N. Hermes; *How Volatile and Unpredictable are aid flows And What Are The Policy Implications* Ales Bullit and Javier Hamann IMF 2001

[9] Africa: The Role of Price Stability and Currency Instability - Carmen M. Reinhart International Monetary Fund Kenneth S. Rogoff *International Monetary Fund*

[10] *Private Capital Flows to Tanzania in 1999-2000*, Govt of Tanzania 2002 and *Private Capital Flows to Uganda in 1999-2000*, Govt of Uganda 2002

[11] *Financing Africa's Development: Towards a Business Plan?* paper for AERC Policy Seminar Elbadawi, Ibrahim and Gelb, Alan (2002)

writing and separate auditing procedures with an array of official donors. Some estimates suggest that officials can spend as much as half their time on donor-related activities rather than on improving the delivery of public sector services and administration[12].

- Debt relief improves **local accountability** and good **governance**. Debt relief within the context of locally developed and owned Poverty Reduction Strategies has the added benefit of increasing, and sometimes even kick-starting, political participation in decision-making over the management and distribution of public resources. Many civil society organisations in recipient countries often express their frustration with national governments, and particularly with the official donor community, regarding their unwillingness to take seriously the inputs of a wider group of stakeholders in the design and implementation of national Poverty Reduction Strategies. Nevertheless, some have reported improved access to key decision-making processes and a rise in public accountability over the management of public finances.

To sum up, the donor-recipient country relationship is characterised by continued reliance on ear-marking finance for projects and programmes, detailed conditionality and institutional controls undermining the accountability of recipient governments to their own public and civil society agents. Conditional aid weakens incentives of recipient governments to be transparent and accountable to their own citizens and undermines their capacity to improve public resource allocation for the intended beneficiaries – poor people. Debt relief by contrast can enhance ownership and accountability, it can improve the prudential management of public resources, increase macroeconomic stability and economic growth. The challenge is to transpose some of these pro-development outcomes and principles on to new forward financing or borrowing strategies.

4) Forward financing strategies

The World Bank and IMF, the designers of the original HIPC framework, are now in the process of reappraising their approach to debt sustainability in the context of forward financing or future borrowing strategies for low-income countries. There are two reasons that have prompted this change of approach to debt sustainability.

First, the HIPC Initiative is proving to be a constraint on the ability of some LICs to finance their PRSPs and therefore limits their prospects of achieving the MDGs. Niger, Rwanda and Ethiopia have debt stocks at the edges of their HIPC debt sustainability thresholds. The only new sources of finance available to them are in the form of concessional loans. With current policies, these countries are facing the prospect of either missing out on achieving the MDGs or, even with concessional lending, moving beyond HIPC's sustainability thresholds.

Second, there is a growing recognition that, while the HIPC Initiative's debt sustainability export criterion provided simplicity and transparency, it has been fundamentally deficient as a predictor of medium term debt sustainability.

[12] *Can Africa Claim the 21st Century?* – World Bank 2000, p45

Initial papers produced by the Fund[13], propose a more complex set of standards to determine the burden of debt and its "repayability". The Fund papers discuss different sets of measures of debt to determine the stresses placed on low-income country economies. It assesses the relative merits of measuring debts in terms of stocks and flows, nominal as against net present values. It goes on to suggest complex sets of variables that are informed by country-specific circumstances and risks. This broader analytical dimension includes a wider set of variables – foreign exchange constraints, fiscal capacity, foreign aid flows and rollover constraints. The IMF proposes analyses of vulnerability to shock with a series of stress tests. In essence, the new sustainability criteria are a shift away from a single transnational debt sustainability threshold towards deeper country-specific analyses.

Clearly the introduction of fiscal constraints in debt sustainability analyses is to be welcomed. Once measures of debt sustainability include a debtor government's fiscal capacity, it becomes possible to examine the trade-off between meeting debt-servicing obligations and meeting expenditures on poverty reduction programmes.

However, the Fund papers give only a fleeting mention to this competition between debt-servicing obligations and poverty reduction expenditures. It is mentioned in passing but not fully addressed by the IMF.

This paper does not attempt to define the detail of debt sustainability measures in terms of future borrowing. However, there are a number of key human development principles that should form the basis of new forward financing strategies.

Principles for forward financing strategies

1) There is the broad question of the analytical and decision-making framework that would determine country-specific debt sustainability thresholds. Who is making these analyses? To whom are they accountable? Whose interests do they represent? How are the results of their analyses to be monitored and assessed?

There is a *prima facie* conflict of interests when major creditors such as the IMF and World Bank retain their monopoly of analytical functions in assessing country-specific debt sustainability thresholds. We would argue that in the interests of equity and transparency, a more independent institutional arrangement is required. Such a structural arrangement should clearly separate the analytical and creditor functions currently held by the international financial institutions. If such a division of functions is not possible, there should at least be an institutionally independent auditing or peer review mechanism housed outside the Bank and Fund or other bilateral creditors. We would argue that recipient countries should ultimately hold responsibility for their debt management policies and systems and for the their own criteria for determining sustainable levels of new borrowing.

2) Currently the IMF separates the HIPC initiative's debt sustainability criterion, seen as a mechanism for clearing unsustainable debts acquired in the past, from new sustainability analyses that deal with forward financing strategies, that is, future borrowing and aid flows. We argue that this is an artificial distinction. The IMF and

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[13] *Debt Sustainability in Low-Income Countries – Towards a Forward-Looking Strategy* IMF May 23 2003

World Bank should be developing new sustainability criteria for determining flows of new borrowing based on the recognition that current debt stocks have an impact on future external financing requirements. The financing constraints on low-income countries will be loosened and their future borrowing needs lightened if they are carrying over reduced levels of debt stocks from HIPC Initiative-type operations. In the interests of maximising the prospects of LICs achieving the MDGs, the levels of debt carried forward should be minimised as an integral part of an MDG-forward financing strategy.

3) The over-arching objective of debt relief and new financing must be support for the global effort to mobilise the finances needed to achieve the MDGs by means of costed poverty reduction strategies. However, the use of debt relief as an explicit form of transferring development finance to recipient countries raises issues regarding the volume of resource transfers for countries that are not debt-stressed but are nevertheless counted as low-income with low human development indicators. It would, after all, amount to a perverse incentive to enhance resource transfers in the form of debt relief to countries that are debt-stressed and poor while ignoring LICs that are managing their debt servicing outflows are but are also subject to MDG financing deficits. In response to this objection, we assert the principle that all poverty reduction strategies to achieve the MDGs must be financed, in HIPCs and non-HIPC low-income countries. All countries, including all donor countries, have endorsed the Millennium Declaration that launched the MDGs. As a result, commensurate new aid flows must be offered to non-indebted LICs.

An MDG financing strategy should look first at where the need in terms of the achieving the MDGs are greatest and, with a preference for meeting financing gap with the most efficient forms of development assistance, resource deficits are first met with debt relief and then aid[14].

4) The full cancellation of debts in order to mobilise the finance necessary to meet the internationally agreed development goals raises questions about the levels of future borrowing. If the MDG/PRSP-compliant debt sustainability approach prompts a total cancellation of debts, what is the status of new borrowing? Where there is an outstanding financing gap after aid and full debt relief, does the model preclude any new borrowing, even at the most concessional rates, as unsustainable?

In reality this is the same issue facing the HIPC initiative and its imposed financing constraints on Ethiopia, Niger and Rwanda. A first step in any MDG or PRSP forward financing package must view a 100 percent debt cancellation as part of a one-off investment in achieving the poverty targets. It is envisaged as a policy action tied to "sunset clause", as originally envisaged in the HIPC Initiative, with the purpose of reducing borrowing requirements in forward financing strategies.

Clearly some indepth country-specific research is needed to determine the impact of future borrowing on debt service-to-revenue ratios and whether new borrowing now may serve to undermine countries' capacity to meet the MDGs over the long term.

[14] *Debt and the Millennium Development Goals:A new deal for low-income countries: financing development through debt cancellation and aid* September 2003 CAFOD Christian Aid Eurodad Oxfam GB (Northover Ladd Lemoine and Greenhill) www.cafod.org.uk/policy

5) The over-arching objective of achieving the MDGs through costed poverty reduction programmes needs to be integrated into the assessments of levels of concessionality in new financing flows.

Lower income countries are likely to be characterised by deeper MDG financing gaps. The donors should aim to give higher volumes of aid in grant form where per capita GDP is lower. In other words, the degree of concessionality in new flows for LICs, dependent on the mix of concessional loans and grant aid, should be adjusted according to the depth of financing needs in LICs.

But as well as calibrating the incidence and depth of poverty in determining the levels of concessionality available to LICs, the judgement on levels of concessionality must include the balance between repayment obligations and maximising the prospects of achieving the MDGs by the year 2015. The determination of the optimal levels of new borrowing for recipient countries should include assessments of the levels of additional finance necessary to stimulate the rate of growth required to achieve the objective of halving the numbers of people living in absolute poverty. An optimal level of debt sustainability will need to balance the benefits accruing from increased investments and medium to longer-term economic growth with affordable levels of future debt servicing[15].

6) In the last decade a framework of best practice has developed to guide the engagement of donors and recipients in relation to development assistance. This has been informed by studies into the effectiveness of aid, and is captured, for example, in the OECD guidelines on development assistance, as well as in the Monterrey Consensus.

Donors must recast their aid instruments to be consistent with these best practices in aid. This means including programme designs that are poverty focussed, that encourage local ownership and flexibility and reduce transaction costs. And to enhance recipient country planning processes, such aid flows should be predictable.[16]

7) An important safeguard against moving into unsustainable debt is the creation of in-country institutions with the powers to analyse debt sustainability positions and to rule on the contraction of new loans. Few HIPC countries have created transparent and accountable oversight mechanisms that provide the checks and balances needed for effective debt management systems. Some civil society organisations[17] have

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[15] *External Debt and Growth* by Catherine Pattillo, Helene Poirson, and Luca Ricci IMF working paper April 2002. This paper proposed a wider set of considerations in determining optimal levels of debt-servicing, including stress testing external, fiscal and financial sector linkages. It is clear from this research that optimal levels of debt servicing are significantly lower than those defined by the enhanced HIPC Initiative's definition of debt sustainability thresholds.

[16] Some of these principles have been discussed in more detailed in *Debt and the Millennium Development Goals:A new deal for low-income countries: financing development through debt cancellation and aid* September 2003 CAFOD Christian Aid Eurodad Oxfam GB

[17] Jubilee Zambia is one CSO that has called for the loan contraction process to be subject to constitutional oversight mechanisms that would include a broad set of civil society, private sector, government and parliamentary representatives.

proposed mechanisms that would include governments working with in-country stakeholders to monitor the accumulation of new debts.

5) The Political Context

This paper has argued that, in order to maximise the prospects of low-income countries achieving the Millennium Development Goals or fulfilling the strategies set out in their PRSPs, further debt reductions need to be made. While additional debt relief is not a sufficient condition for meeting the development targets, without additional flows over and above the pledged increases set out in the run up to the *Monterrey Consensus*, further cancellations of debt-servicing are necessary.

The creditor community has nevertheless set itself against further debt reductions. In developing a set of African intergovernmental proposals for a new debt framework, it is important to address some of the objections put forward by bilateral and multilateral creditors and to suggest some possible responses.

1) *Creditors argue that debt relief is financed with development resources and can therefore jeopardise financing facilities that are dependent on reflows in the form of debt repayments. In particular, the concern focuses on the debts owed to the major creditors for low-income countries: the World Bank's IDA facility and the IMF's PRGF. If these sources of finance are run down to provide further debt cancellation, then non-debt stressed LICs would be penalised by having restrictions placed on their access to highly concessional external assistance.*

Recent research by the UK based think tank *Jubilee Research*[18] suggests that the Bank's IBRD facility and the Fund's PRGF capital base derive significant benefits from the explicit guarantees provided by donor countries which allows them to access credit sources on preferential market terms. This suggests that both the IMF and IBRD are overcapitalised and, according to the *Jubilee Research* analysis, have sufficient resources to afford 100% HIPC debt cancellation without jeopardising their reflows to non-debt stressed countries. It is worth noting here that many bilateral creditors have provided 100 percent debt cancellation.

2) Creditors argue that once HIPC debt relief has been delivered, any remaining financing deficits for poverty reduction programmes should be met by increasing flows of aid.

The literature on MDG financing acknowledges that outstanding aid shortages persist even after taking into account the aid increases promised at the UN's Monterrey Financing for Development Conference. Without a near doubling of aid, most low-income countries, and hence most of Africa, are unlikely to achieve the MDGs.[19]

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[18] *Can the World Bank and IMF Cancel 100% of poor country debts?* – draft paper by Jubilee Research October 2003

[19] *The Enhanced HIPC Initiative and the Achievement of Long-Term External Debt Sustainability* – World Bank, April 15 2002

Notwithstanding the tabling of initiatives that would leverage increased aid from donors[20], most of the larger bilateral donors appear reluctant to agree to the increases in aid – that is a doubling of annual aid flows to at least $100 billion a year – that are now generally agreed as the minimum needed to ensure the achievement of the MDGs across the world. In this context, it is worth addressing the question of how to maximise the financial transfers to LICs from within the existing volume of aid flows.

While 30 percent of grant aid is taken up in the form of technical assistance and 10 percent[21] is usually held back in donor administrative costs, cuts to actual debt servicing levels are dollar for dollar financial support to debtor government expenditures. It acts as *de facto* budget support with a low transfer cost and a relatively higher impact on budgets.

3) *Some donors argue that recipient countries do not have the capacity to utilise enhanced aid flows for effective poverty reduction programmes.*

On the whole, the literature suggests that aid absorption is not the major constraint to achieving the MDGs[22]. However, research shows that there are deeper and more sustainable reductions in poverty for countries with good policy environments[23].

4) Many official creditors and African civil society organisations are concerned that the additional resources derived from reductions in debt-servicing may not be used for poverty reduction purposes. Critiques of debt relief point to country case examples where there has been policy slippage, eruption of civil conflict or corrupt use of public assets. Northern donors highlight the fiduciary responsibility they have to their taxpayers to ensure that public aid resources are effectively used for the purposes that are intended. While aid programmes can be, and are all too frequently, suspended, debt cancellation is non-reversible. How should African governments respond to these points?

We would argue that there are a number of African initiatives that have the potential to allay or at least challenge donor concerns.

Uganda has developed a transparent and publicly accountable *Poverty Action Fund* (PAF) to oversee the public use of debt relieved resources and to monitor new borrowing. The PAF is made up of a broad group of stakeholders with the powers to suspend debt relief resources from being channelled to central government's budget.

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[20] The UK Treasury has proposed an International Financing Facility that is intended to bring forward aid increases in an effort to meet the MDGs. Other schemes include proposals for international taxation of currency speculation, carbon taxes or taxes on air travel.
[21] Comment made by World Bank official at the IMF workshop on Foward Finance Strategies in Washington DC Sept 2003
[22] *Supporting Sound Policies with Adequate and Appropriate Financing* – World Bank September 2003 – the paper suggests that some countries measured as good performers are able to absorb more than a doubling of aid flows and that LICs under stress can accelerate their prospects of realising the MDGs with enhanced flows.
[23] Research by Paul Collier and David Dollar – quoted in *The Case for Aid for the Poorest Countries –* HM Treasury March 2002

The NEPAD initiative has developed a unique African Peer Review Mechanism. This APRM goes far beyond any other counterpart peer review schemes by opening performance in political as well as economic governance for scrutiny.

The principles that underpin these instruments and the PRSPs have the potential to address donor concerns. Where PRSP planning processes are developed from genuinely broad-based participatory processes, where the representatives of impoverished communities have an influence over the policy design process, and where PRSPs are embedded in national, sectoral and provincial actions, there is an added incentive for donors to mobilise additional financial support.

It is the further development and strengthening of such credible checks and balances that help to ensure the prudential management of public resources in support of internationally agreed povety reduction goals that will act as a sound basis for negotiating a new African debt and development financing initiative.

Summary

This paper started out by quoting the commitment set out in 2002 by the G8 heads of government in the Africa Action Plan that: *No country genuinely committed to poverty reduction, good governance and economic reform will be denied the chance to achieve the Millennium Goals through lack of finance.*

Few African countries have plotted their PRSPs against the policy and financial trajectories that are needed to meet the MDGs. We argue here that once PRSP costings and policy paths are integrated with MDG targets and costings, the onus will fall on donors to bridge the funding gaps – a commitment that they made public in their Kananaskis 2002 G8 Summit communiqué.

In this overview of issues on debt sustainability, we have argued that there is a compelling case for a closer integration of debt sustainability analyses, sustainability thresholds and forward financing strategies with the overarching objectives agreed and shared by the international community to achieve the Millennium Development Goals by the year 2015. To meet the challanges set out in the Millennium Development Compact and signed up to by all the world's heads of government, a new partnership between creditors and debtors is required. It is a partnership that can work with shared and reciprocal undertakings by both donor and recipient countries.

Henry Northover – CAFOD

Many of the principles outlined in this paper are based on two previous joint agency papers from CAFOD, Christian Aid, Eurodad, Jubilee Research and Oxfam GB (see footnotes 2 and 15 – Northover, Ladd, Lemoine, Greenhill, Kline and Drapkin). The author thanks Romilly Greenhill and Paul Ladd for their valuable comments.