

A LASTING SOLUTION TO AFRICA'S DEBT PROBLEMS

Issues Paper for the UNECA

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I. EXECUTIVE SUMMARY

II. BACKGROUND

At their Annual Conference in Addis Ababa on 1 June, 2003, African Ministers of Finance, Economic Planning and Development issued a Ministerial Statement calling on the United Nations Economic Commission for Africa to convene an international conference on Africa's debt. Ministers expressed concern that:

- since the 1999 G8 Summit in Cologne, at which the G8 committed themselves to cancel US\$100 billion of debt for 42 (including 34 African) of the world's poorest nations under the Enhanced Heavily Indebted Poor Countries Initiative (henceforth known as HIPC II), only 7 African countries have reached their completion point under HIPC II.
- in the meantime, the economic and debt relief assumptions on which debt relief was based have proven highly optimistic, and many countries, including most of those which were supposed to have sustainable debts as a result of HIPC II, are sinking back into unsustainable debt burdens.
- HIPC II does not address sufficiently the needs of post-conflict countries, issues related to odious debt, and the debt burdens of highly-indebted middle-income African countries.

This issues paper has therefore been prepared as a background paper for the international conference, in order to propose a concrete, workable African plan of action to reduce the African debt burden. Its opinions are based on those expressed by African Ministers and officials in many fora¹ as well as debt reduction strategies designed by 30 African governments in the context of the HIPC Debt Strategy and Analysis Capacity Building Programme.² –

Sustainable reduction of Africa's debt depends on measures which go well beyond external debt relief, in particular include wider debt management issues, the long-term financing of sustainable development, and measures to allow Africa to combat shocks to its economies. As a result, the paper contains four sections:

- 1) A critical evaluation of external debt relief mechanisms and proposals
- 2) Proposals to reinforce overall debt management in Africa.
- 3) Proposals to improve the financing of Africa's sustainable development
- 4) Proposals to allow Africa to mobilise non-debt foreign exchange.

The final section provides key conclusions and recommendations for Ministers.

III. EXTERNAL DEBT RELIEF PROPOSALS

2.1 Heavily Indebted Poor Countries

For the majority of African countries (34)³, which are classified as Heavily Indebted Poor Countries (HIPCs),⁴ access to debt relief depends on the progress of HIPC II. As

¹ In particular, the HIPC Ministerial Network Meetings (see www.dri.org.uk for their conclusions), the meetings of HIPC Commonwealth Ministers, and the meetings of the G24.

² The HIPC DSA CBP is funded by the governments of Austria, Canada, Denmark, Ireland, Sweden, Switzerland and the UK, and is executed by Debt Relief International and its partner institutions – the BEAC/BCEAO Pole-Dette, CEMLA, MEFMI and WAIFEM.

³ Angola, Benin, Burkina Faso, Burundi, Cameroon, Chad, Comoros, Congo DR, Congo R, Cote d'Ivoire, Ethiopia, Gambia, Ghana, Guinea, Guinea-Bissau, Kenya, Liberia, Madagascar, Malawi,

a result, this section concentrates largely on HIPCs. The final sub-section analyses the debt burdens and relief prospects of African non-HIPCs.

HIPC II has marked a major step forward in debt relief to African countries:

- it bases debt relief on targets for the “sustainability” of the debt of the debtor country, rather than rules fixed by creditors
- it in theory includes all types of creditors in provision of relief, including multilateral creditors, which had previously been exempt from relief.
- it links the spending of relief to poverty reduction spending, and the progress of relief to poverty reduction strategies rather than adjustment strategies.

As a result of this flexibility, HIPC II has been able to promise to reduce the “present value” (PV) of HIPCs’ debt by US\$25 billion (and additional pledges of debt relief by creditor governments will provide another US\$5 billion) for the 26 countries which have already reached their decision points. When relief is delivered to all 34 countries which are currently believed to be eligible for the Initiative,⁵ the total amount of PV relief will be US\$36.4 billion, plus US\$8 billion of additional bilateral pledges – or 47% of the pre-HIPC PV. In terms of “liquidity” relief, HIPC has promised around US\$56 billion of relief over 33 years (out of US\$124 billion of scheduled service) – or around 45%, and additional bilateral pledges will add another US\$11 billion.⁶

However, in terms of delivery of actual relief, the HIPC II has fallen well short of its promises. Each of its elements of flexibility have fallen short of expectations.

3.1.1. Debt Sustainability Criteria

There has long been a debate over how judge whether the debt of developing countries is sustainable – ie their capacity to repay their debts. This revolves around:

- The way to measure debt burdens
- The types of debt to include in the measurement
- The way to judge payment capacity
- The thresholds to set to judge debt sustainability

3.1.1.1. Measuring Debt Burdens

Three elements are usually suggested for measuring debt burdens

- Debt stock – the nominal amount of debt owed by a country
- The present value of debt – the future debt service on a debt aggregated based on its cost in today’s money (see Martin, Johnson and Aguilar 2000)
- The debt service – the annual amounts payable on the debt.

Mali, Mauritania, Mozambique, Niger, RCA, Rwanda, Sao Tome e Principe, Senegal, Sierra Leone, Somalia, Sudan, Tanzania, Togo, Uganda and Zambia.

⁴ HIPCs are defined as IDA-only countries with heavy debt burdens. It is important to note the distinction between these countries and those which receive full HIPC Initiative relief, which are defined by whether their debt exceeds the HUPC eligibility criteria after the provision of maximum non-HIPC relief (Naples Terms or 67% debt cancellation by the Paris Club).

⁵ Excluding Liberia, Somalia and Sudan (which are almost certainly eligible for relief if they were to resolve political problems and launch IMF programmes) and Angola, Kenya, Vietnam and Yemen which have conducted DSAs which so far indicate that they are ineligible for the Initiative.

⁶ All of the data on relief in this paragraph are from IMF and World Bank (2002c).

Until the early 1990s, stock and service were the preferred concepts to measure debt burdens. They were easy to understand and to calculate for governments, creditors and foreign and domestic private sector investors. They remain the key concepts private investors and rating agencies use to judge debt burdens. Nevertheless, in the 1990s, the concept of PV debt reduction was introduced to allow Paris Club creditors to show that their different ways of providing debt relief (some cancelling debt up front, other reducing interest rates and therefore providing relief over several decades) were of equal value to a debtor country (even if this was not the debtor's viewpoint).

It is now often suggested (as in the recent IMF Board Paper (IMF 2003) that PV is the most theoretically valid concept. It is true that PV reflects the concessionality of the debt owed by low-income countries. However, it is not an accurate measure of what is known as the "debt overhang" (the burden of debt stock which deters investors and has other pernicious effects), because:

- no private market actors assess debt burdens using PV – they all use the nominal "stock" of debt. While creditors may wish to pretend that reductions of stock and service are equivalent by using PV calculations, the investor community and civil society in the debtor country react very differently to reductions in debt stock and service. In Guyana, where civil society believed the press releases that Guyana would receive US\$636 million of (PV) debt relief under HIPC I, they failed to understand PV and burned down part of the Finance Ministry when the Minister tried to explain that this would be delivered only over 30 years through gradual debt service reduction. *If HIPC is to continue to use PV rather than stock, creditors and investors need to be educated about its meaning and trained to track it – but it would be preferable to abandon it altogether and revert to stock.*
- many also question the validity of how PV is calculated. A recent IMF Board Paper (IMF 2003) discusses the problem at length but produces no a solution. The IMF paper indicates that the PV discount rate should be based on the interest rate which countries could earn by investing the loan disbursements internationally. This would currently be around 2.5%, after a dramatic fall in 2001-03. Yet the actual discount rates used for HIPC II and IMF calculations of the concessionality of new loans, are linked instead to the cost of borrowing export credits from OECD governments (so-called CIRRR rates), which are around 4%. So the PV is actually discounted much more heavily than it should be and therefore seems less of a burden, depriving countries of debt relief. These interest rates also fluctuate. With their rise in 1999-2000, countries reaching decision points in 2000-2001 lost hundreds of millions of dollars of debt relief without any objective justification. As they tumbled after September 11, countries with the worst adjustment "track record" gained hundreds of millions of dollars of debt relief at decision point. *If the international community insists on retaining PV for the overhang measure, it would be far more equitable among countries and over time to freeze discount rates at those applying on investments by developing countries (around 2.5-3%).*

3.1.1.2. Which Debts to Include

The most recent IMF paper (IMF 2003) indicates that external public and publicly-guaranteed debt remains the most reliable indicator. It marks a major step forward in acknowledging that low-income countries' debt problems are similar to those of other countries, by suggesting including domestic and private sector debt in the analysis, but hints that these would not be important for most low-income countries.

Our analysis indicates that these two types of debt, which are excluded from HIPC assessments, are essential to assessing debt sustainability in HIPCs. Fortunately, HIPCs have been analysing them for themselves, reaching the following conclusions:

- domestic debt is a huge burden in most HIPCs (see Johnson 2000). Treasury bills, bonds and stocks are small in many countries, partly because they are only just now beginning to use market-based instruments. However, when less traditional debt – central bank overdrafts, arrears to suppliers and government employees – is taken into account, the burden of domestic debt service is higher than external debt service for more than 20 HIPCs. This is currently being largely ignored, with PRGF programmes assuming optimistic rapid clearance of domestic arrears, or falls in inflation which reduce domestic debt interest rates. It is impossible to ensure adequate resources for poverty reduction spending unless we analyse and resolve the domestic debt problem. The international community insists that this burden cannot be reduced using resources committed for HIPC, but there are many other ways of doing so, using programme aid or privatisation receipts (cp. Cape Verde, Ghana, Tanzania). As a result, HIPC Ministers have insisted that ***all debt sustainability analyses and PRGF documents should examine total (domestic + external) debt burdens, and the international community should give high priority to solving domestic debt problems, which are undermining the private sector, growth prospects and the sustainability of external debt.***
- Another key burden emerging for low-income countries, especially those which have liberalised capital accounts and have received large foreign investment (eg Bolivia, Gambia, Ghana, Guyana, Mozambique, Tanzania, Tchad, Uganda and Zambia) is the rapidly growing ***private sector debt*** to finance foreign investment projects or export/import transactions. The recent IMF Board paper (IMF 2003) indicates that most low-income countries have low private capital flows, but this is not so (Martin 2003). Private sector debt stocks of 50-100% of export earnings are not uncommon in these countries, and there is an ***urgent need to enhance monitoring and analysis of these debts in order to ensure that they will stay sustainable and not produce their own foreign exchange crises in the recipient countries if private sector debtors fail to reimburse the debts or foreign exchange reserves become short for other reasons*** (Baball 2002; Martin 2002b).

HIPC has included all ***publicly guaranteed debt*** in debt sustainability. This includes debt contracted by other public sector institutions (parastatals, federated states, municipalities), as well as debt contracted by the private sector but guaranteed by the government. Recently (IMF 2003) it has been suggested that some of such debt (subject to case-by-case country examination) might be excluded because it is to finance “enclave” projects which earn enough foreign exchange to repay it. However:

- excluding such loans from past IMF programme concessionality ceilings encouraged irresponsible lending of expensive, less high-quality finance by export credit agencies and commercial lenders, often providing continuing “escape funding” to parastatal agencies which therefore failed to restructure.
- high projected foreign exchange earnings often fail to materialise, and the debt service falls on the government or undermines the foreign exchange market.
- this is why all international institutions (ref Debt Compilers Guide) still treat such debt as publicly guaranteed debt.

As a result, countries would rather see all such debt included in analysis - though some of it might need to be treated outside the HIPC framework.

3.1.1.3. Judging Payment Capacity

There remains a huge amount of confusion about how to judge the payment capacity of a country. Theoretically, one could use GDP/GNI, exports or budget revenue, preferably expressed in present value terms if PV is being used as the measure of the debt. But the fundamental issue is who pays the debt service. This means that:

- payment capacity of government external debt or total debt depends on budget revenue (excluding grants). Most African governments have liberalised foreign exchange markets and do not have captive private sector export earnings to pay debt service. In addition, they may be unable (or unwilling given inflationary risks) to buy foreign exchange in the markets to transform private export earnings into government forex to pay external debt service (or local currency to pay domestic debt service). This is particularly true when most export earnings are held in offshore accounts and used to repay private sector debt; or when export-earning projects are given long tax holidays, so that they contribute no tax revenue to government.
- if we are judging total national debt payment capacity, we should use export earnings (because private sector export earnings are available to pay private sector debt). However, it is vital in most African countries to analyse government, parastatal and private sector export earnings (breaking down the private sector where necessary into sub-sectors or mega-companies or projects) and their fungibility to protect against foreign exchange shortage.
- It is very difficult to see what relevance GDP/GNI have to any assessment of payment capacity for low-income countries, as there is no necessary correlation between it and the availability of resources to pay debt.

In addition, the HIPC denominators are highly flawed because they are based on:

- a three-year average, or the most recent year, of export earnings, and the most recent year of budget revenue;⁷ and
- a snapshot of sustainability taken only twice in a 3-4-year period - at decision and completion points, thereby taking no account of the need to respond immediately to “shocks” to the economy between or after these points (see section 3 below).

In assessing payment capacity, budget revenue should be the key denominator for government debt, and export earnings for total national external debt (other denominators can be used as extra checks if required). Both should be calculated using averages tailored to the measured volatility of national budget revenue or export earnings, and calculated on an annual basis from the decision point.

3.1.1.4. Thresholds

The amount of debt relief under HIPC has been determined by eligibility thresholds which (according to public statements by Fund and Bank officials) were based on initial analysis (eg Underwood 1989) modified to suit political compromises among G7 creditors, balancing the need to include strategic G7 allies and the desire to keep costs down. This is above all true of the “Cote d’Ivoire” criterion – the PV/budget revenue threshold of 250%, which was set at a level just low enough to include Cote d’Ivoire, and accompanied by empirically unjustified sub-criteria to keep down costs.

⁷ Though the Board papers defining HIPC methodology left it open for DSAs to use different averages, based on country-specific analysis of export volatility, all have used the 3-year average.

Several studies (eg Cohen 1998; Elbadawi, Ndulu and Ndung'u 1997; Johnson 2000; Martin 1999a; Pattillo 2002; and Vaugeois 1999) have examined the levels of debt which have proven historically or econometrically unsustainable. They have found that the PV/export criterion of 150% in HIPC II is somewhere near sustainable levels. However, the PV/budget revenue criterion is far from sustainable. Vaugeois (1999) and Martin (1999a) indicate that PV/BR should be reduced to 155%. Johnson (2000) finds that PV/BR of total (external plus domestic) debt has proven unsustainable at 150%, implying much lower thresholds for external debt. These studies also indicate that debt service/exports should be set at 12% (as opposed to 15-20% under HIPC).

In addition, and in spite of the fact that all HIPCs regard this as the key indicator of debt burden if the aim is to free resources for poverty reduction spending, HIPC II continues to avoid systematic attention to debt service/budget revenue. It aims only for a ratio which is "low and declining". This leaves a large leeway for subjective viewpoints about the desirability of poverty reduction spending and the need for further budget deficit reduction, and especially for tailoring the profile of relief to creditor preferences, leaving many HIPCs with high ratios in the initial years of HIPC relief. *Independent analysis has found that this ratio should be set at around 13 % – a level near the 10% endorsed by bodies as diverse as Oxfam and the US Congress.*

It is vital to analyse debt sustainability using the broadest possible range of indicators (PV compared to GDP, exports, and budget revenue and debt service compared to exports and revenue), and to tailor analysis and prioritise indicators according to country circumstances. In this context, African and HIPC Ministers welcome the BWIs (IMF/WB 2003a) acknowledgement of this in discussing the long-term debt sustainability of HIPCs, as opposed to the excessive past focus on a single ratio under which a country qualified for HIPC relief. However, *African and HIPC Ministers are clear that the key burden for them is fiscal liquidity (as shown in 3.1.3.1 below) and therefore top priority should be given to reducing debt service/revenue.*

3.1.2. Non-Participation of Creditors

Another factor undermining HIPC is non-participation of various creditors, particularly non-OECD governments and commercial creditors, in relief:

- **Non-Paris Club creditor governments.** At least 32 creditors are refusing to participate. These fall into 5 categories: creditors which are non-members of the BWI or take little notice of their decisions because they are under international sanctions; middle-income Arab or North African countries; Asian countries (largely China and India); former Eastern European countries; and other HIPCs. In the last 18 months some of these creditors (eg India, Libya) have indicated in principle their willingness to participate. However, these statements have not been materialising as actual debt relief for countries (eg India has been relieving only aid debt and not export credits; Libya had not signed a relief agreement yet).
- There is around US\$2 billion in PV terms outstanding from HIPCs to **commercial creditors**. A worrying recent trend has been some non-Paris Club governments and commercial creditors refusing to participate and suing debtors (usually successfully) for full recovery of debt. Even if the original amount of debt is small, judgements in international courts have awarded 3.5-4 times this amount to the creditor, due to the accumulation of interest and legal fees, forcing some

debtors to pay amounts as large as US\$50 million in one year, which can devastate poverty reduction spending plans.⁸

- **The Paris Club** has made major steps forward under HIPC II. It has agreed that, for many HIPCs where Cologne terms will be insufficient, it will cancel up to 100% of pre-cutoff date debt, and most Club members have gone further to cancel post-cutoff date debt where necessary to attain sustainability thresholds. However:
 - a few creditors are charging excessive interest rates, fees or penalty interest in Paris Club bilateral agreements (failing to provide agreed PV reduction).
 - a considerable number of HIPCs (Bolivia, Ethiopia, Gambia, Guyana, Nicaragua, Sao Tome, Uganda and Zambia) have not received relief due under HIPC, because the amounts are small, the period between decision and completion point is short, there is an administrative backlog in the Club, or there are delays in creditor discussions or PRGFs.
- **Multilateral creditors** have generally made the most progress under HIPC, with all major creditors agreeing to participate and some agreeing to provide interim relief between decision and completion points. However,
 - many multilateral institutions are not making the maximum possible contributions to HIPC from their own resources. While they have gone further than before, there remain reserves (including gold), provisions and reflows which could be used, notably by the IMF, World Bank and Inter-American Development Bank, but also by other multilateral and subregional organisations, without damaging their financial credibility or future lending to HIPCs (see DDC Ireland 2003). Instead, bilateral donors are diverting grant funding to support this relief (see 3.4 below).
 - 7 regional and sub-regional institutions (representing only 1.4% of total HIPC debt) have not yet agreed to participate in HIPC.

At a global level non-participation was long seen as insignificant (only 10-15% of total debt), leading the international community to ignore the problem. Yet, for individual HIPCs and at the margin it is a critical factor in debt sustainability. HIPCs themselves estimate at 22 (eight more than the BWIs) the true number of countries which will be unsustainable at completion point if non-participation is taken into account. They also indicate that five of the first seven African countries to reach completion point cannot be sustainable if deadlock with various creditors continues.

In 2001-2003, partly due to dialogue with HIPCs, the international community has realised non-participation is seriously undermining sustainability for many HIPCs. Yet it has made little progress in resolving the problem. HIPCs have urged it to:

- ***Establish as an urgent priority a rapid response legal technical assistance facility to help HIPCs to discourage or deal with creditor litigation***, run by an appropriate independent institution. In spite of the urgency of this issue, there has been no progress. The Bretton Woods Institutions have argued that they cannot run such a facility without appearing to take sides in legal disputes.
- ***Publish the details of creditors that refuse to provide relief***. The international community is now publishing these annually in BWI Board Papers. Similarly,

⁸ Information received from HIPCs via HIPC CBP questionnaires. See also IMF/World Bank 2003 for validation of these hypotheses though some of the amounts quoted there exclude fees.

HIPCs have committed themselves to publishing all such details and to working with international organisations and civil society to change such creditors' minds;

- *Widen the use of the IDA commercial debt reduction facility to cover such creditors.* This is currently being studied, and HIPC Ministers have recently expressed their impatience at the slowness of this process;
- *Create a separate Trust Fund for clearing HIPC debts to other HIPCs (and to other countries which have debt cancellation from the Paris Club).* This could be extended to all African creditor countries of whom 14 have not yet pledged all necessary relief (Algeria, Angola, Burundi, Cameroon, Cape Verde, DR Congo, Namibia, Niger, Nigeria, Rwanda, Senegal, Togo, Zambia and Zimbabwe). Though they account for only US\$241 million of relief in PV terms, it is important to clear this legacy of inter-African debt. Libya also needs to implement its pledge to provide relief, as it accounts for a further US\$224 million.

3.1.3. Delayed Relief

Relief is being provided over excessively long periods under HIPC, for two reasons: the very gradual provision of relief by some creditors, and the delay in overall relief.

3.1.3.1. Failure to Frontload Relief

Apart from the IMF, World Bank and a few small multilaterals, few creditors are "frontloading" relief enough to bring down debt service ratios and kick-start poverty reduction spending, particularly before completion points. Table 1 shows HIPC service ratios in the year after decision point: many face problematic levels. The Paris Club and other creditors are providing relief over 30-40 years through rescheduling and reduced interest rates. *They could provide moratoria on interest and post-cutoff date service (as the Paris Club has done often in the past) to increase service relief.*

| <i>Country</i> | <i>DS/Exports</i> | <i>Debt Service/Revenue</i> |
|---|-------------------|-----------------------------|
| Cameroon | 10.3 | 11.8 |
| Chad | 4.9 | 11.8 |
| DRC | 20.0 | 26.0 |
| The Gambia | 8.7 | 22.3 |
| Ghana | 4.1 | 11.7 |
| Guinea | 8.7 | 19.4 |
| Guinea-Bissau | 6.6 | 11.0 |
| Madagascar | 5.8 | 11.4 |
| Malawi | 10.1 | 13.4 |
| Mauritania | 13.7 | 17.1 |
| Sao Tome | 8.7 | 12.8 |
| Senegal | 8.0 | 11.9 |
| Sierra Leone | 11.6 | 18.2 |
| Uganda | 14.6 | 15.7 |
| Zambia | 14.2 | 28.7 |
| Notes – Ratios marked in bold are those with debt service problems Table restricted to countries having reached decision point | | |

3.1.3.2. Delay in Reaching Decision and Completion Points

There is growing delay in reaching decision and completion points under HIPC. As of September 2003, 23 African countries had reached decision point and 7 had reached completion point. However, almost all this progress occurred in 2000, when 18 countries reached decision point. Since then, it has slowed dramatically. In the most recent year, only 1 (DRC) reached decision point and 2 (Benin and Mali) completion point. Table ? shows the originally expected completion points for HIPCs and those which are currently projected.

| Country | Original CP⁹ | Latest CP | Delay |
|----------------------|--------------------------------|------------------|------------------|
| Benin | Q1 2002 | 3/2003 | 12 months |
| Burkina Faso | Q4 2001 | 4/02 | 7 months |
| Cameroon | 10/2002 | Q2/2004 | 18 months |
| Chad | 5/2003 | Q2/2004 | 12 months |
| Ethiopia | 2002 | Q1 2004 | 24 months |
| The Gambia | 12/2002 | Q2 2004 | 18 months |
| Ghana | 10/02 | Q4 2004 | 24 months |
| Guinea | 12/02 | Q4 2004 | 24 months |
| Guinea-Bissau | 12/02 | Q2 2005 | 30 months |
| Madagascar | 12/02 | Q3 2004 | 21 months |
| Malawi | 12/02 | Q3 2004 | 21 months |
| Mali | Q2 2002 | 3/03 | 9 months |
| Mauritania | Q1 2002 | 6/02 | 6 months |
| Niger | 12/02 | Q4/2003 | 12 months |
| Rwanda | 12/02 | Q4 2003 | 12 months |
| Sao Tome e Principe | 12/02 | Q4 2004 | 24 months |
| Senegal | 6/02 | Q4 2003 | 18 months |
| S. Leone | Q1 2003 | Q2 2004 | 15 months |
| Zambia | 12/02 | Q2/2004 | 18 months |
| AVERAGE DELAY | | | 17 MONTHS |

What is the cause of this delay ?

- The popular perception – caused by the welcome vociferousness of HIPC country civil societies and international NGOs – has been that relief is being delayed by the design and execution of new participatory processes to design poverty reduction strategies – leading to much discussion of the “tradeoff” or “tension” between rapid HIPC and slow PRSPs. PRSPs have generally taken longer than expected to finalise,
- However, recent discussions with and publications by Bretton Woods staff confirm what HIPC Ministers have been saying for two years – that traditional

⁹ Most of the dates quoted were published in BWI Board Papers assessing HIPC progress. Where this is not the case, original CP dates are calculated as two years from DP, which was the assumption used by the BWIs on the basis that it would take 12 months to prepare a final PRSP and this PRSP would need to be implemented for a further 12 months before completion point.

conditionality rather than PRSP processes are causing almost all the delay. Only 4 of the 15 African HIPCs have been able to implement their PRGF macroeconomic and structural conditions on schedule. Five have had PRGF delays of 0-6 months, 3 of 6-12 months, 2 of 12-24 months and 2 of more than 24 months.

- As a result, a maximum of four African HIPCs are having completion points delayed by PRSPs, as opposed to 11 where delay is due to PRGFs.

Delay due to traditional conditionality manifests itself in three ways:

- over-rigid fiscal and macroeconomic frameworks to reach lower inflation targets even in “post-stabilisation” countries with inflation around 5%. This results in overambitious targets for expenditure containment and revenue mobilization, causing expenditure overruns and revenue shortfalls for 11 countries.
- insistence on executing “leftover” structural conditions from past ESAF/PRGFs (regardless of whether these will reduce poverty). Delays in executing such conditions have delayed PRGFs in at least 11 countries; and
- the proliferation of new poverty reduction performance criteria, especially for those countries which reached decision points before the fourth quarter of 2001 when the BWI staff began to reverse such proliferation. As the latest BWI Board paper indicates, such conditions may become problems for progress in future.

There has been some recent progress to reduce conditionality:

- recent PRGFs have streamlined conditionality, limiting conditions more to macro issues – but with some structural conditions moving to World Bank programmes;
- an agreement in March 2002 that the period of execution of a full PRSP could be less than 1 year if this will cause major problems for funding.
- very limited evidence of more flexibility on the macro framework for those countries with inflation below 5%, with more stress being placed on growth and anti-poverty spending than on further reducing inflation and deficits.

However, it is easy to exaggerate the change. Ministers and senior officials of 34 HIPCs indicate that most of them have seen little sign of flexibility either in letting them design their own alternative macroeconomic frameworks or in interpreting their compliance with conditions. Seven measures are essential:

- *continued progress to streamline the number of conditionalities across the programmes of all multilateral and bilateral organisations;*
- *elimination of all structural conditions which have not been analysed to be essential to growth and poverty reduction, and especially of all micro-management of their economies.*
- ***Poverty and Social Impact Analysis of macroeconomic frameworks in all PRGF programmes, with Fund staff asked to demonstrate how, for post-stabilisation countries, they are making the macro framework more flexible;***
- ***explicit presentation in all PRGF documents of alternative macroeconomic scenarios which show the growth and inflation tradeoffs examined.***
- ***flexibility in interpreting compliance with poverty reduction criteria for countries which suffered from excessive proliferation in 1999-2001.***
- ***comprehensive programmes to build the capacity of governments and civil societies in African countries to design and analyse the potential and actual impact of macroeconomic and structural policies on poverty reduction.***

- *a comprehensive annual review of PRSPs, PRGFs and PRSCs, to ensure they are streamlining conditionality and promoting poverty reduction.*

The delay in completion points is of growing concern because it can result in the cancellation or expiry of debt relief. Three countries have already reached their limits for IDA interim relief, three have had IMF interim relief suspended due to falling off track with their Fund programmes, and 5 countries are due to run out of interim relief from the AfDB by the end of 2003. The Paris Club has also been threatening to suspend relief for countries which are off track with Fund programmes. Suspension of relief – combined with suspension of aid - is disastrous for any country, providing an immediate “shock” to the economy, and should be assiduously avoided except in extreme circumstances. *The IMF, IDA, the other MDBs and the Paris Club need by the end of 2003 to design rules for extending interim relief (providing the same percentage of debt service reduction as in previous years) in all circumstances except complete rupture of relations with a country.*

3.1.4. Failure to Fully Finance HIPC Debt Relief

It is true that financing for HIPC relief has mostly been mobilised. The exception is funding for “*additional*” debt relief. HIPC II envisaged only 90% debt cancellation. Any additional cancellation by individual creditor governments was intended to provide a “safety margin” for HIPCs, through an extra US\$5 billion of PV relief, reducing their PV/exports by an average 21%, so that they could be sure that their debt would remain sustainable, even in a context of shocks to exports or budget revenue. However, instead, the additional relief has been counted into HIPC relief in order to allow countries to appear to reach HIPC thresholds. Recently, developing country and like-minded donor representatives have been insisting that this additional relief be reinstated and provide the intended buffer zone.¹⁰ Their argument is that if HIPC relief is not enough to reach HIPC thresholds, all creditors should share the additional burden equally. A BWI Board paper (IMF/World Bank 2003b) stressed the additional costs of such relief (US\$1.2 billion in PV terms) and the unequal distribution of the benefits among African countries for debt relief and poverty reduction spending. Nevertheless, it looks as though progress in this area is possible. Given that at least 7 of 14 countries analysed by the BWIs would have their PV/export ratios reduced by 10% or more, *it is vital that a decision to reinstate and fully fund additional relief be taken before the 2004 Spring meetings of the BWIs.*

Two other elements of HIPC debt relief also need financing:

1) Topping Up of Relief at Completion Point

HIPC II has in theory been adapted to take account of economic shortfalls compared to projections, by allowing relief to be “topped up” at the completion point if ratios change substantially. Recent BWI analysis shows that the 2001-02 downturn in commodity prices rendered 14 unsustainable again and eligible for “topping up”.

Topping up might add US\$1.1 billion to HIPC relief but, for fear of cost to creditors, its implementation has been hedged around with restrictions:

¹⁰ Norway is so exasperated with others taking for granted its additional relief that it has refused to give relief until after completion point, forcing others to provide enough relief to reach HIPC thresholds.

1. it aims only to reach “sustainability” at the moment of the completion point, and not beyond. The one country which has qualified for topping up – Burkina Faso – will have unsustainable debt ratios for 16 years after completion point.
2. it must be due to an external shock which causes fundamental change in country economic circumstances. As a result, Benin and Mauritania did not get topping up though they had unsustainable ratios for several years after completion point.
3. some are now arguing that it should not compensate for fluctuations in CIRRs and exchange rates, which have dramatically increased PV recently. They describe them as “technical factors” which do not impact fundamentally on a country’s economic circumstances, and are trying to exclude “topping up” for Ethiopia and Niger. However, it is obvious that these are exogenous shocks beyond country control, and that having a higher PV (under HIPC which treats PV as the measure of debt overhang) impacts negatively and fundamentally on investment in the economy. In addition, all countries which had relief increased from HIPC I to HIPC II, Burkina Faso at completion point, and countries which reached decision points recently, have been given relief based on current CIRRs and exchange rates. This latest argument is therefore entirely spurious.

Topping up already means little, falling way short of providing long-term debt sustainability to HIPCs. If the latest proposal is accepted, it will reduce topping up benefits to HIPCs to only US\$600 million. *It is vital that this be rejected and topping up be provided to Ethiopia, Niger and other forthcoming countries on the basis of current rates, in order to retain the credibility of the entire topping up process.*

2) Possible Eligibility of Other Countries.

At least three other African HIPCs (Liberia, Somalia and Sudan) are potentially eligible, and could increase costs of the HIPC Initiative by around US\$10.6 billion in NPV terms (see IMF 2003a and b). These extra costs seem to be contributing to anxiety that HIPC costs are escalating out of control. However, they should be seen in perspective. Total HIPC costs are US\$50 billion – but this will be paid out over an average 15-25 years, at an average cost of about US\$2.5 billion a year. This is less than 5% of annual ODA flows. In terms of flows per capita, it represents around 0.3% of the amounts currently being requested to reconstruct Iraq. In addition, these countries are post-conflict (like Iraq) and will desperately need such funding for reconstruction purposes. As Kifi Anna has said, “One ought not to take resources earmarked elsewhere and shift them to Iraq”. *It is essential that the international community finalise how they would fund these extra amounts by the Spring 2004 IMF-World Bank meetings, as the peace agreements in Sudan and Liberia appear to be progressing rapidly.*

3.1.5. Flexibility in Judging and Funding Long-Term Debt Sustainability

A recent IMF/World Bank Board paper has stressed the need to ensure long-term debt sustainability for low-income countries. As discussed above, it has been more flexible in suggesting judging multiple ratios (including domestic and private sector debt as appropriate, and in relation to budget revenue). However, it is not at all clear that the international community is prepared to realise the funding implications of this suggestion. For example, due to the funding needs for reaching the MDGs, Burkina Faso’s debt will be unsustainable for 16 years. In addition, the IMF has been insisting that several countries (Ethiopia, Mali, Niger, Rwanda) cut poverty reducing spending to maintain debt sustainability. This is because the Fund has failed to take a

sufficiently active role in seeing whether additional grants can be mobilised to keep debt sustainable, or advocating a more flexible interpretation of debt sustainability.

The international community therefore needs to take 5 steps to reconcile debt sustainability with reaching the MDGs:

- *Increasing grant flows (partly via the increase in ADF and IDA grants – see section IV below) to allow HIPCs to borrow less to fund the MDGs*
- *Ensuring a more equitable balance of country grant/aid allocations*
- *Increasing grant flows where the country has higher domestic debt burdens.*
- *Allowing countries to borrow more (on concessional terms) if grants cannot be mobilised to fund the MDGs, PV/export ratios can be kept below 200%, and debt service/revenue ratios can be kept below 10%.*
- *Providing adequate grant contingency financing to protect against (or compensatory financing to respond to) shocks, to avoid new borrowing.*

The international community's response as countries reach their completion points in the next few months will be a litmus test of whether it is prepared to abandon the MDGs for theoretical concepts of debt sustainability and "freezing" costs to creditors.

3.2. CONFLICT-AFFECTED COUNTRIES

African conflict-affected countries are a special case which deserve examination because they desperately need maximum financing for reconstruction. They are almost all awaiting progress towards their HIPC decision or completion points. Many countries have had severe internal or regional conflicts (Angola, Burundi, Cote d'Ivoire, DRC, Rep.Congo, Eritrea, Ethiopia, Guinea-Bissau, Liberia, Madagascar, RCA, Rwanda, Sierra Leone, Somalia, Sudan, Uganda). Fortunately, few of the above governments are still in the middle of full conflict.

The international community has introduced more flexibility for countries in the first group, through emergency new financing and more rapid debt relief and economic reform. There have been fundamental changes in the speed and nature of BWI engagement with these countries – the most recent being the LICUS process and the provision of all World Bank emergency post-conflict assistance in the form of grants.

HIPC and debt relief cannot of course be expected to resolve the problems of conflict-affected countries, but should be making a fullest possible contribution. In acknowledgement of this, the requirement for a three-year track record before decision point has also been reduced to 12-18 months for post-conflict countries, such as DRC and Sierra Leone.

Yet the HIPC progress of post-conflict countries has been very slow. This is partly because some countries are still negotiating peace or rebuilding governments (eg Burundi, Cote d'Ivoire, DRC, Liberia, Sudan). Others have shown less interest in fundamental economic reform or poverty reduction strategies. However, in some cases, three clear problems have emerged:

- in several countries, HIPC debt relief has not been frontloaded enough to reduce debt service in the early years, freeing spending for emergency reconstruction.
- several countries have had problems mobilising funding to clear arrears to the multilateral institutions, causing delays to their reconstruction programmes.

- in several countries (Ethiopia, Guinea-Bissau, Rwanda, Sierra Leone), there has been a clear tension between the needs of government spending for reconstruction, and the orthodox recipe of cutting budget deficits in order to reduce inflation. All the above governments argue that, given that external grants and concessional loans are available, they should be allowed to accelerate post-conflict spending because the budget deficit can be financed without provoking inflation.

Three steps could ease the specific difficulties of conflict-affected countries:

- *More focus on reducing debt service/exports and debt service/budget revenue ratios in the early years when designing HIPC debt relief delivery;*
- *Additional resources to assist countries to clear arrears before HIPC;*
- *More flexible conditionalities, especially macro frameworks, to allow increased disbursements and more expenditure for reconstruction.*

Much less attention has been paid to countries which have been affected by conflicts in neighbouring countries (such as Burkina Faso, Guinea, Kenya, Mali and Tanzania). These countries also have a case for enhanced assistance from the international community but have received much less flexibility except through emergency aid. *Costs incurred through refugees, loss of key transport links or other spillovers of conflicts should be specified much more clearly in PRGFs and emergency grant assistance mobilised to cover them immediately.*

3.3. NON-HIPC AFRICAN COUNTRIES

World Bank (GDF 2003) data show non-HIPC debt burdens fall into seven groups:

- Two countries (Angola and Kenya) are “semi-HIPCs”. They have appeared on the HIPC list as candidates for relief, but have not qualified for any yet. This is partly because they do not have track records of IMF programmes, but also because they have not conducted their own independent debt sustainability analyses to assess their burdens. Preliminary estimates by the BWIs and the Angolan government indicate that it will not qualify for HIPC relief, but is eligible for Naples Terms. The position of Kenya is less clear, especially given the recent fall in its tourist revenues and the high level of parastatal debts, and it should be an early priority for a HIPC debt sustainability analysis.
- Two countries (Nigeria and Zimbabwe) which are by income and debt burdens eligible for concessional debt relief from the Paris Club but, because they have not been declared IDA-only or followed IMF programmes cannot receive it. According to GDF numbers, Nigeria is severely-indebted and Zimbabwe is only moderately-indebted but, following the recent collapse in Zimbabwe’s exports, it now has nominal debt/export ratios of 230%. *Both countries are eligible for at least Naples Terms, and should be early candidates for detailed analysis of their burdens to see whether they qualify for HIPC.*
- One country (Gabon) which is middle income and severely indebted but according to current Paris Club rules, could qualify only for rescheduling of its debt. Though severely-indebted lower-middle-income countries, such as Jordan and Yugoslavia, have received large-scale Paris Club debt cancellation, Gabon’s upper-middle income makes debt cancellation difficult to envisage.
- One country (Tunisia) which is middle-income and moderately-indebted but has no intention of asking for debt relief.

- Three countries (Equatorial Guinea, Eritrea and Lesotho) which are less-indebted and low-income and do not intend to ask for debt relief.
- Ten countries which are middle income and less indebted (Algeria, Botswana, Cape Verde, Djibouti, Egypt, Mauritius, Morocco, Seychelles, South Africa, Swaziland) and for which debt cancellation cannot be envisaged, though high service ratios for Algeria and Morocco indicate a case for debt rescheduling.
- Two middle-income countries for which the World Bank does not publish debt data (Libya and Namibia) but which are believed to be less indebted.

Some of the above countries (as well as many HIPCs) might easily qualify for debt relief if relief were to be provided on “odious debts” accrued by odious regimes or for odious purposes such as military conflicts, capital flight etc. However, the principal problem with relieving odious debts is that neither creditor nor debtor governments appear to support such a concept, whatever its moral justification. The only way out of odious debt appears to be enhanced efforts by all sides to avoid creating it in future.

Overall, then, the current debt burden for non-HIPC African countries is rather limited, and initiatives to cancel debts of all African countries are not likely to prove very fruitful at an international level, though *Angola, Kenya, Nigeria, Zimbabwe and possibly Gabon appear good candidates for early analysis and action.*

PART IV)

FINANCING SUSTAINABLE DEVELOPMENT: TIME TO GET SERIOUS ?

Financing debt relief needs to be seen in the context of overall availability of development finance, because debt relief on its own will be woefully insufficient to allow African countries to finance the MDGs. Recent pledges have indicated aid increases, but there is a long road between pledges and disbursements. To assess whether donors are serious about financing the MDGs, we need to look at amounts, and at their composition and quality.

4.1. Amounts of Aid

US\$52 billion of aid (net of debt service) is disbursed to developing countries each year (DAC 2003). This compares with estimated amounts needed to reach MDGs of US\$100 billion (UK; World Bank 2002; Zedillo).¹¹ Current estimates by the BWIs, and African countries remain somewhat sketchy, and *it remains a priority for African countries to improve their capacity to calculate these costs, and for all BWI Board country papers to present starkly to donors the financing amounts needed for countries to reach the MDGs and national development goals, drawing on UN analyses as appropriate, in order to mobilise the right amounts to reach the goals.*

Since the Monterrey summit global prospects for aid have sharply improved:

- Monterrey-related aid pledges total US\$12 billion a year more by 2006. The 2002 G8 Summit agreed that 50% of these funds would be allocated to Africa.
- Since then, the US has announced another US\$15 billion (now apparently reduced to US\$10 billion by Congress) for the global fight against HIV/AIDS.
- The UK proposed an International Financing Facility (IFF), to mobilise US\$50 billion of aid per year by issuing bonds, based on donor commitments to provide future flows to IFF. This has been endorsed in principle by several G7 members.
- There have been significant new developments in global aid funds, such as the Education for All Fast Track Initiative, the Global Fund to Fight AIDS, Tuberculosis and Malaria and replenishment of the Global Environment Facility.
- IDA and ADF have received significant replenishments, with improved effectiveness monitoring, and can provide grants up to 21% of their commitments.

African/HIPC Ministers have endorsed these moves, but have stressed that some pledges are a long way from being commitments, notably those of the US, and the UK IFF which must get more G7 support. They have also underlined that some initiatives are potentially double-counting rather than providing additional funds, and that *the UN system needs to analyse independently whether funds are genuinely additional.*

4.2. Current and Future Composition

Of current amounts (World Bank 2003c), only US\$26 billion is spent on programmes and projects in countries. The rest is: US\$3 billion on bilateral aid administration; US\$13.6 billion on technical assistance, little of which actually enters the recipient

¹¹ The World Bank (2003c) has suggested that US\$32 billion a year might be enough to attain the MDGs. However, the methodology for this calculation is unclear, based on a combination of trying to avoid increasing aid flows to countries which are highly aid dependent, with subjective judgements about the ability of countries to absorb funds, which are not shared by the country authorities.

economy; US\$2.3 billion on debt relief which is actually paid to other creditor agencies; and US\$3.2 billion on emergency assistance.¹² It is also astonishing that programme aid (including budget and sectoral support) remains less than 20% of total aid, even on average in the best performing countries, in spite of all sides being agreed that this is the best way to support country-designed policies.

Taking into account this composition, the IFF proposals, if spent on the MDGs in the developing countries, would QUADRUPLE aid available for such spending.

A large amount of current aid also goes to middle-income countries, including some which could easily reach the MDGs without much aid by reorienting their spending; or to projects which are not reducing poverty. Aid could contribute much more to funding MDGs if moved to the poorest countries and to MDG-oriented projects.¹³

There is therefore huge scope for increasing the impact of aid on the MDGs by:

- reducing administrative costs in bilateral and multilateral agencies; replacing technical assistance with cheaper, untied and more effective/locally-owned capacity-building; untying and improving the efficiency of emergency assistance, switching from project to programme assistance, and devoting aid to low-income countries and to poverty-reduction in all countries.
- all donors should set clear targets to reduce administrative costs, move to capacity-building, untie and thereby reduce spending on emergency assistance, increase budget support sharply, move aid predominantly to low-income countries and focus aid on poverty reduction in all countries.
- they should also making multiyear rising commitments to countries where budget transparency and anti-poverty efforts are high.

4.3. Quality of Financing¹⁴

4.3.1. Concessionalality

Until now the only enforceable criterion in IMF programmes to affect the quality of aid has been its concessionalality. The judgement and calculation of concessionalality (also known as grant element) of loans is a highly inconsistent and subjective process, even more complex than PV (see Johnson 2003). Depending on the discount rates used by different organisations, and the dates on which the grant element is measured, the concessionalality of a loan can vary by as much as 20%. *Lenders and borrowers must agree a genuinely objective means of assessing the concessionalality of new loan.*

The existing system also throws up major anomalies. For example, IMF PRGF loans have a grant element below 35% and therefore, according to the IMF's own criteria, PRGF countries should not be allowed to borrow PRGF loans ! If PRGF loans are to continue to be made by the IMF, then they must be more concessional (IDA terms), or cut to token amounts to avoid compromising debt sustainability. Rwanda recently took only a token amount of PRGF funding, preferring to borrow from IDA. *Other*

¹² These amounts omit multilateral spending on administration and TA, which are large.

¹³ However, this principle should not be taken to extremes. For example, it has recently been suggested to cut UK aid to Bolivia, Guyana and Lesotho, lower-middle income countries with large poor populations and strong commitment to reducing poverty. This should be avoided.

¹⁴ There are many ways in which to judge the quality of financing and its potential to contribute to reducing global poverty (see Martin 2002a, and Johnson and Martin 2003, for more detail).

countries should be encouraged to follow suit. This would allow the Fund to reduce PRGF borrowing levels over time, in tune with IMF recommendations to phase out IMF lending to “mature stabilisers (IMF 2003b), and a shortage of PRGF funding from 2006 (IMF 2003c). No further aid funds should be provided for PRGF.

Many lenders also provide widely varying terms to different borrowers without any standardisation. ***Recipient countries should establish a system for monitoring these terms and exchanging information to encourage donor best practice.***

In addition, there are no clear guidelines for concessionality thresholds below which countries should not borrow. The IMF has in most PRGF programmes insisted on a minimum grant element of 35%: but in some countries it has allowed exceptions; and in others it has pushed for higher grant elements (eg 50% - coincidentally in line with minimum grant element thresholds for UNCTAD Least Developed Countries agreed two decades ago). Some countries have more objectively fixed different levels (Ghana 40%, Mozambique and Tanzania 60%), which have been based on grant elements to keep their debt sustainable. Many important donors for African countries - such as BADEA, IsDB, OPEC Fund – are close to a 35% grant element, so ***it is crucial to set objective guidelines for thresholds based on future debt sustainability and access to funding for the MDGs. African governments should develop this capacity rapidly.***

One major debate on which African governments have had relatively little input has been whether international organisations should be providing loan or grant financing. IDA and ADF have decided to disburse grants largely on based on OECD government and NGO pressure. While African governments approve the idea of receiving grants, they are opposed to the allocation of grants to specific sectors or types of aid (eg HIV/AIDs or emergency assistance), which could contradict national development priorities and distort their spending allocations. They would prefer to see a percentage of each countries’ financing disbursed in grant form depending on its poverty level and its debt sustainability prospects.

4.3.2. Value for Money

More than US\$12 billion of aid (including most TA and much emergency assistance) is tied (or partially tied) to exports from the supplying country, which reduces its value to the recipient country by 25-40%, because its costs are set uncompetitively. Therefore US\$3-5 billion a year of value to MDGs could be generated by untying aid.

No recent aid pledges go further in untying aid, apart from those of additional funds from countries (eg the UK) which have already committed to 100% untying, and those to multilateral facilities. ***Donors should rapidly reach agreements to untie aid, especially technical assistance and emergency aid.***

4.3.3. Commitment and Disbursement Procedures

Turning pledges into rapid disbursements will require fundamental reforms in donor and African procedures via wholehearted partnership (HIPC Ministerial Forum 2003; World Bank 2003a/c). Past disbursements have fallen well short of commitments (Bulir and Hamann 2001), creating the biggest shocks to development. African governments estimate that disbursements have fallen short of projections by 30%.

Many have recommended a huge list of measures to improve procedures, including:

- coordinating aid through PRSPs, and not insisting on additional conditions;
- providing multiyear pledges to assist budgetary planning and ensuring that disbursements are timed in harmony with budget and expenditure cycles
- simplifying and harmonising procedures to expedite disbursements;
- decentralising decision-making and funding to local embassies and resident offices (or to those of other donors who can represent their interests).
- taking greater account of African aid management practices and capacities;
- pooling funds to reduce the negative impact of excessive numbers of donors and fragmented assistance (see World Bank 2003a)
- building into all funds, especially of the IMF, MDBs and EU, contingency finance which can be disbursed to compensate against shocks (see V below).

However, some of the recent global aid initiatives have a high risk of moving in the other direction. This is particularly true of the US initiatives for the Millennium Challenge Account and the AIDS funding, which risk being poorly coordinated with other donors and micro-managed out of Washington (see Radelet 2003).

4.3.4. African Absorptive Capacity

It is extremely common in the donor community to hear that country X (or sector Y within a country) cannot absorb more aid. This is usually based on a static view of country absorptive capacity based on current government and donor procedures. A recent World Bank paper on supporting the MDGs (2003c) has stressed the need for long periods to improve absorptive capacity in many low-income African countries.

Yet there are a growing number of astonishing success stories in increasing absorptive capacity in Africa. In 1998 in Uganda, when President Museveni launched Universal Primary Education, donors doubted that Uganda could absorb more aid for education. Five years later Uganda is absorbing three times as much donor education funding. Various other HIPCs have in recent years successfully implemented programmes such as decentralisation, MTEFs, financial accountability capacity building and procurement reform, which have dramatically increased their absorptive capacity. As a result, African ministers are confident that large expenditure programmes are currently under-funded and could rapidly absorb additional money.

However, it is essential to convince donors and improve African practices, by establishing a programme to exchange research, information and training among African governments on best practices in aid absorption and coordination.

4.3.5. Donor Coordination and Monitoring

At an international level donors have been accelerating their efforts to coordinate and harmonise, notably via the SPA and the Rome High-Level Forum on Harmonisation. However, African governments have not led this coordination and harmonisation. For example, few African experts were involved in SPA reviews of best practices in African countries, or in designing background papers for the Rome meeting.

Similarly, there are many examples of best practices with African governments leading donor coordination (Uganda's Stockholm Principles; Tanzania's Independent Monitoring Group; Ghana's New Financing Strategy), and HIPC African

governments have begun systematically to evaluate donor practices themselves through the HIPC CBP. However, the World Bank (2003) and UNDP have highlighted the fact that donor coordination is too often run by donors rather than African governments. African governments need to establish their own initiatives to exchange best practices on donor coordination with one another, and to intensify high-level discussions on aid quality and policy with the OECD DAC members in order to establish a system of genuinely mutual and transparent evaluation.

This monitoring system should establish quantified and time-bound indicators in PRSPs for donors, of the type listed in ?? above. These indicators could also be included in PRGF and PRSC documents to show that the BWIs are taking an explicit view of the desirable quality of new financing.

4.4. Why Finance Debt Relief ?

Within these global trends, why make the financing of debt relief rather than new aid a priority ? Birdsall and Williamson (2002) provide five reasons, that debt relief

- 1) has more political resonance in OECD countries than new aid;
- 2) therefore will bring more additional resources to developing countries;
- 3) if properly designed, with a longer list of eligible countries, will not redistribute funds away from the best performing to the most-indebted
- 4) is much more efficient than new aid, because it reduces the burden of managing aid and acts like budget support by increasing recipient ownership.
- 5) could also encourage private investment more than new aid, by reducing the debt overhang as well as funding government spending; and
- 6) can improve the quality of all aid by freeing donors from defensive lending to refinance debts and allow them to direct it for poverty reduction.

All of these justifications have strong empirical support from our empirical work with HIPC governments. African countries are seeing additional resources, feeling greater ownership of debt relief, and mobilising more private investment. These positive effects are enhancing their commitment to economic reform and poverty reduction, proving wrong the “moral hazard” idea that debt relief would reduce the incentive for policy change, and reducing their “dependence” on aid.

BWI analysis has also concluded that funding of HIPC relief has been additional (IMF/World Bank 2003c). Even though large amounts of aid are being diverted from bilateral aid budgets to fund relief by multilateral institutions (see Martin 2000c), some debt relief has been funded by additional finance, especially IMF gold sales, and US accounting treatment of debt relief which does not require more funding. Debt relief political resonance has also helped some governments (notably the UK, US and Ireland) to mobilise more aid; it has allowed some institutions (notably the EU) to disburse funds more rapidly and predictably; and it has encouraged some regional multilateral organisations to focus more closely on their poorer and smaller members.

These arguments should not be pushed too far. Debt relief is more efficient and faster disbursing than new aid. Yet if HIPC stalls, it will suspend fast-disbursing programme aid and debt relief. To avoid this, donors need to minimise diversion of programme aid to financing debt relief trust funds which provide relief over a long period, and instead maintain independent programme aid disbursements to support recipient country policies, maximising recipient choice of how to fund poverty reduction. All of

the funding sources discussed in this paper could be better used for programme aid funding unless the reforms in HIPC suggested in sections 2-3 above are implemented.

HIPCs have also received more funds as a result of HIPC (IMF/World Bank 2002c and 2003a/c). Debt relief and increases in anti-poverty spending have encouraged donors to provide more aid – and in more flexible forms such as multiyear coordinated budget support – resulting in higher flows to some HIPCs. However, according to HIPCs, this is not universal or sustainable for the following reasons:

- the growing alignment of donors behind Fund conditionality makes flows highly vulnerable to suspension of Fund assistance. As long as Fund conditionality remains too stringent, this is unacceptable.
- additionality (and higher-quality money) is not related to MDG or anti-poverty performance – but depends on donors and historical relations. For example, Mozambique receives 75% grants and 35% programme aid, but Mali 35% grants and 15% programme aid, when both are regarded as high performers.
- countries which had made huge efforts to mobilise additional funds before HIPC (eg Rwanda) or which had large amounts of arrears which they are now having to repay (eg DRC) have lost money since HIPC arrived.

In addition, even if Monterrey promises produce large increases in aid, increased flows to HIPCs mean a diversion from non-HIPCs.

4.5. Prospects for Funding Debt Relief

Additional debt relief could clearly be funded, from many possible sources:

- the Monterrey pledges and IFF could all be used in whole or part to fund relief.
- the IMF is the only off-budget source of funding available in the development world, due to its capacity to revalue its gold reserves or to create global liquidity through issuing SDRs. It is vital to note that there is no legal reason why its funds from 2 sources could not be transferred to fund relief by other creditors:
 - IMF gold reinvestment or sales. The IMF holds 89 million ounces, worth US\$32.9 billion at current prices (US\$370/oz on 31 August). Selling half of this could more than fund all the additional relief needed for topping up and remaining new HIPCs. Selling two-thirds of it, combined with reprofiling relief by the Paris Club, would allow all HIPCs to have their debt service/revenue ratios reduced below 10% for the foreseeable future.
 - SDR allocations could create additional global reserves for reallocation to debt relief. Voluntary transfer of allocations from OECD countries to developing countries could provide huge additional resources, sufficient to fund contingency reserve financing as well as debt relief.
- multilateral development banks could also find large additional funding for debt relief (Birdsall and Williamson; Chantrey Vellacott; Debt and Development Coalition Ireland) from their reserves, capital and provisions without any damage to their credibility or market creditworthiness.

All of these sources could fund debt relief but, in the current international political climate, and given that international civil society pressure for debt relief has waned, there is more consensus behind increasing aid flows to countries which are performing best in poverty reduction – some of which may not be the most indebted. Therefore the priority for the international community should be to mobilise more aid and argue for using all available additional resources (including IMF gold, SDRs and MDB resources), of which a proportion can be allocated to debt relief.

V) COPING WITH “SHOCKS”

5.1. *Scale and Causes of “Shocks”*

The background paper (Martin and Alami 2001) as well as BWI studies (IMF 2003; WB 2003) show the degree to which African countries were hit by severe, lengthy and frequent shocks in recent years (repeating the analysis of innumerable earlier studies). Even the BWIs have given up suggesting that shocks are not key variables in African development. At least 14 African countries have been hit by severe external shocks during 1999-2002 – excluding of aid shortfalls compared to projections, which are the most important shocks – highlighting the need to combat them.

The causes of “shocks” are clear:

- projections of economic prospects which take too little account of potential shocks to aid, commodity prices and climate. The BWIs often argue that such shocks cannot be foreseen – but shocks of similar magnitudes have happened many times in recent decades, a secular decline in commodity prices is beyond doubt, and climatic shocks are easily predictable because they occur with regular frequency. In this light, BWI programme projections are systematically overoptimistic, so that their shocks are “non-shocks”. Projections should be made realistic, basing balance of payments and budget “financing gaps”, future borrowing and the debt burden on recent trends and volatility/probability analysis (see also Serieux 2002).
- insufficient analysis of other shocks to growth and budget revenue. BWI papers (eg 2002c) show that GDP growth has been 1% below target and way below the rates needed to halve poverty in most countries. It also mentions shortfalls of budget revenue (a persistent problem in Africa in the past) but does not take into account the effects of these shortfalls on poverty reduction spending.
- largely ignoring another key “non-shocks” – for example the potential impact of the HIV-AIDs pandemic on growth and debt sustainability. UNAIDs and World Bank indicate growth could be reduced by 2.5% a year in the worst-affected countries – and this will sharply reduce budget revenue and exports by cutting skilled labour forces. Yet only 3 HIPC analyses have taken this into account.

5.2. *Solutions to Shocks*

The background paper reiterates the many potential solutions to these shocks. Yet, until recently, the measures planned to overcome shocks were woefully inadequate. Most of the measures introduced by the international community have focussed on emerging market and other large economies – so that until recently there has existed no well-structured mechanism for preempting or responding to shocks to low-income or most African economies.

The responses have consisted of:

- (predominantly) asking countries to adjust their economic programmes and projections downwards to match the shocks
- (secondarily) providing additional disbursements of multilateral and bilateral programme loans and grants (usually too little and too late) to compensate for part of the shocks and fill financing gaps remaining after additional “adjustment”.
- (virtually not at all) accessing international contingency and compensatory facilities such as those of the IMF (which are too expensive for low-income countries), and EU STABEX (which was notorious for virtually never disbursing).

- Distinguishing between permanent shocks, to which a country should be expected largely to adjust, and temporary shocks, which could require external financing.

However, this system of responding to shocks cannot work in the context of the MDGs. Every dollar of “adjustment” by an African country due to inadequate or inaccessible financing, or decisions that shocks are “permanent”, is a dollar less spending (some of which will need to be cut from spending to reach the MDGs). In addition, this attitude is completely inconsistent with that of the HIPC Initiative, in which permanent shocks are compensated which temporary shocks are not !

Recent BWI papers have suggested that shocks can be dealt with by reducing the “overoptimism” of BWI macroeconomic projections and conducting “stress tests” or “sensitivity analysis” in programmes. They have also suggested several piecemeal measures to protect African governments against shocks, such as lending in local currency, or measures to hedge against commodity price shocks.

However, African governments reject these measures as tacking only a small part of the problem and highly inadequate if the international community wishes to take comprehensive steps to help countries achieve the MDGs. They suggest instead that:

1. ***all ‘likely shocks’ must be in baseline scenarios of BWI programmes, including:***
 - *the impact of HIV/AIDs on poverty for countries with prevalence of 5%;*
 - *regular or frequent disasters (eg droughts or floods twice in a decade);*
 - *average volatility of commodity prices over the last 10 years;*
 - *average aid shortfalls compared to projections.*
2. ***nevertheless, these baseline scenarios must attain the MDGs (and other national poverty reduction goals) for all African countries.*** A Fund Board paper this year suggested that countries which could not mobilise financing to attain MDGs or were projecting over-optimistic growth might project “alternative realistic baseline” scenarios which would not reach the MDGs, as the basis for PRGFs. Subsequently many African countries faced IMF pressure to be “realistic”, leading to abandonment of the MDGs, without discussion with donors or civil society.
3. ***baseline scenarios should also contain realistic measures to reduce vulnerability to shocks,*** eg implementing the recommendations of the World Bank Task Force on Commodity Risk Management, focussing PRSPs on export diversification into higher value-added products, and opening OECD markets for such products.
4. all PRGF alternative scenarios should also aim to reach the MDGs, regardless of the scale of potential less likely shocks presented, with explicit discussions of the need for government measures or donor financing to accelerate poverty reduction.
5. programme documents should include much broader contingency measures to protect against shocks, quantifying possible additional necessary external and budget financing, and mobilising up-front pledges by donors, through contingency tranches of donor funding which can be disbursed (eg by the EU, IMF, WB and other donors’ budget support) to offset shocks immediately.

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