

# **Debt and Finance for Development**

## **How does debt measure up?**

### **Jubilee Nederland Report**

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# 1. Introduction

The United Nations (UN) will convene the International Conference on Financing for Development (FfD) in Monterrey, Mexico from 18 to 22 March 2002. At this summit level meeting, Finance and Foreign Ministers will meet to discuss finance and other issues pertaining to global development.

The FfD is an unprecedented event in that the World Bank, the International Monetary Fund (IMF) and the World Trade Organisation (WTO) are actively participating in the meetings, along with civil society organisations and private interests. The occasion of having these three key institutions, UN agencies, and Finance and Foreign Ministers at the same summit is indeed singular.

Six issues have been identified for discussion: mobilisation of domestic resources; private investment; trade; aid; debt; and systemic issues. The issue of debt is on the FfD agenda – but it surely does not hold the spotlight. Unfortunately, the downplaying of debt as a critical issue compromising development efforts is common practice these days.

## 1.1. The Politics of Debt

Some politicians in the developed world, and the leadership of the International Financial Institutions (IFIs), would have us believe that the debt problem has been resolved for the least developed countries. Debt campaigners have continually made reasonable, articulate and detailed arguments showing how the Enhanced Heavily Indebted Poor Countries (HIPC) Initiative is failing HIPCs and does not even address the debt problem of non-HIPCs. Unfortunately, these comments are falling on deaf ears.

Debt campaigners do not claim that unsustainable debt represents all of the development problems of poor countries. Poor countries face a range of problems – many of which are included in the agenda of the FfD. But the debt campaign targeted one, relatively simple issue – that, if resolved effectively, could have given poor countries a real boost toward reaching the Millennium Development Goals (MDGs).

The creditor community's answer to the debt campaigners – the Enhanced HIPC Initiative – did not go far enough. It does not provide adequate debt relief – linked to development resource needs. It relieves the debt of far too few countries. It does not deliver debt relief fast enough. It fails to treat the debt of non-HIPCs.

Also important, the Enhanced HIPC Initiative has not encouraged creditors to accept adequate responsibility for the part they played in the debt crisis. The dialogue around the need for the Enhanced HIPC Initiative has focused on the insolvency and mismanagement of debtor governments and has paid little attention to the important role played by creditors in lending the money and determining how it was spent. This shared responsibility and the injustice of the fact that the poor were paying for the mistakes of their past leaders *and* those of rich countries is something that inspired debt campaigners probably almost as much as the depth of poverty in indebted countries.

But the Enhanced HIPC Initiative was as far as the creditor community was willing to go at the time. And whenever debt has been brought up as a continuing issue of concern, some previously supportive politicians and staffs and representatives of the IFIs have

been quick to tell debt campaigners that debt is no longer an issue to worry about. Instead they have explained to debt campaigners that it is time to turn their attention to other pressing matters – particularly the issues of trade and health.

The placement of debt in the FfD agenda reflects this political reality. Debt is no longer allowed to hold the spotlight.

## **1.2. It's Not Too Late**

A lot of energy and good will went into the work around the debt campaign – and the achievement of the Enhanced HIPC Initiative. But much more still needs to be done in terms of debt relief. It is irresponsible of those previously concerned about the issue to now dismiss it as resolved.

Debt relief is the most immediate and efficient way to mobilise resources for development. HIPC debt relief is only fully released once the debtor government produces a comprehensive poverty reduction strategy. This document links debt relief resources directly to poverty reduction measures. While many debt campaigners think the relationship between the debt relief mechanism and the Poverty Reduction Strategy Paper should be revised – the current relationship demonstrates the direct impact debt relief can have on poverty reduction and that this impact is recognised by the creditor community.

Debt is an issue that has clear linkages to other problems faced by poor countries – like problems with investment, trade and limited aid flows. To have an impact in these other areas we do not need to turn away from debt relief but rather recognise these linkages and approach debt relief in a more holistic way.

This paper will describe just a few ways in which debt is related to other issues on the FfD agenda. It will also argue that, in every case, focusing on increasing debt relief would be a more immediate and effective way to address the financing needs of developing countries. It will then go on to explain how the Enhanced HIPC Initiative is failing. In all, it will show that the debt problem is far from resolved and needs to hold a centre piece in the talks in Monterrey in March.

## **2. Debt and Finance for Development**

### **2.1. Debt and Domestic Resource Mobilisation**

Debt relief is the most effective step the donor community can take to empower indebted governments facing resource deficits. With debt stock relief, as opposed to hopes of investment and broadened tax base, governments can plan into the future with more certainty. Knowing a certain amount of debt will not have to be repaid in the years to come means that the resources that would be used to repay debt can be used for other purposes.

Effective debt relief should also simply improve the general health of the economy and the community. A government freed from a crippling debt should be able to invest more productively into economic infrastructure and the well being of its populace. Healthier, more educated citizens should be more economically productive and provide the government a broader tax base.

Looking at this relationship a different way, high levels of debt limit a government's ability to mobilise domestic resources. A government burdened with debt is forced to invest less in economic infrastructure and cut social spending, possibly narrowing its potential tax base.

While debt relief is not by any means the only thing poor governments need, to make the great strides needed to reach the MDGs – debt relief is the most effective measure the donor community can take to immediately make a real difference. This was partially recognised through the establishment of the Enhanced HIPC Initiative – but only in a half-hearted manner. Donors must not turn away from this obvious opportunity to provide a real boost to financing for development.

### **2.2. Debt and Investment**

Private capital flows – including investments – to most low-income countries are extremely low. By the end of the nineties, private flows to the Least Developed Countries amounted to US\$942 million per year. At the same time, LDCs paid US\$4,4 billion to foreign creditors.

Debt campaigners and others have argued that unsustainable debt creates a disincentive for investment – known as 'debt overhang'.<sup>1</sup> Investors may worry that highly indebted governments will tax their possible earnings extra heavily to help them meet debt repayments. A burdensome debt also simply has a general drain on the health of an economy, negatively impacting government infrastructure and creating a less stable and healthy climate for investment.

In general, a poorly managed economy will discourage investment – and an excessive amount of debt will be seen as one obvious sign of a poorly managed economy. Some would argue that structural adjustment programs also create at least a short term

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<sup>1</sup> See for example: David Woodward: Debt Sustainability and the Debt Overhang in HIPCs – Some comments on the IMF's view. Chapter in Eurodad World Credit Tables 1995/96.

disincentive for investment. The downsizing of governments can have an adverse effect on government infrastructure, again, making for an unstable climate for investment.<sup>2</sup>

One could argue that it is difficult to be certain what will or will not stimulate investment, but this is all the more reason not to depend on investment as a reliable tool for financing development. When considering what measures will provide the most immediate source of development finance to governments, it should be noted that investment has only an indirect impact.

Given the fickle nature of investors, investment – while desirable, cannot be depended upon as a resource for development – making dependable means for financing – like debt relief – all the more indispensable.

### **2.3. Debt and Trade – What a Shock**

Like trade, debt has a clear impact on a country's external account. External debt must be paid in hard currency. One of the few ways a government generates hard currency is through trade. For this reason, one of the two central ways in which debt sustainability is measured is by comparing the amount of debt to export earnings.

Debt campaigners have criticised this approach to measuring debt sustainability because it does not adequately measure the burden of debt on government budgets. Debt campaigners believe that it is through looking at government budgets and the resources needed to reach the MDGs that debt sustainability should be measured.

Nonetheless, there is a relationship between how much a government brings in through trade and how much it can afford to pay out in debt service. And, unfortunately, poor governments are particularly prone to experiencing severe shocks to their export earnings.

One reason for this vulnerability is that many indebted countries export only a few commodities – so that a price or supply drop to one export has serious impact on overall earnings. Another reason is that many of these exports are agricultural and vulnerable to weather events. There is also the problem that so many countries produce the same exports, constantly pushing prices downward. For example, in the Least Developed Countries, commodity prices (except oil) on average declined by 30 percent in the late nineties<sup>3</sup>.

The Enhanced HIPC Initiative is not designed to deal with these shocks effectively. A deeper approach to debt relief could be one obvious way to provide a buffer for governments facing such vulnerability. With the current design of the HIPC Initiative, a relatively modest shortfall in export earnings can send debt ratios soaring – never mind a veritable shock.

The Enhanced HIPC Initiative should therefore be redesigned to account for these shocks. Some of these shocks are predictable and avoidable. For example, some countries regularly experience droughts, and yet IFI export projections fail to figure this

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<sup>2</sup> United Nations Least Developed Countries Report 2000, pg 83-84.

<sup>3</sup> The Least Developed Countries 2000 Report. Overview by the Secretary-General of Unctad. United Nation, 2000.

in. Shocks may also be related to poorly designed policy measures, financed by the IFIs.<sup>4</sup>

In some cases, the Enhanced HIPC Initiative measures debt sustainability against budget revenue. Drops in export earnings can also have serious – if indirect – consequences for a government's budget revenue. Exports may be subject to taxation, imports may drop, or aid may be diverted to repay debt service. Shocks have a negative impact for government access to resources across the board.

Not only do shocks cause debt sustainability ratios to soar. In coping with shocks, a government may borrow extra resources. Dealing with shocks can also crowd out crucial development spending.

Given the impact shocks have on export earnings and budgets and the fact that the Enhanced HIPC Initiative measures debt sustainability against export earnings and budget revenues, deeper debt relief is necessary if the Initiative is to deliver any semblance of debt sustainability.

Focusing on trade policy as a means to generate development finance seems somewhat bizarre given that enhanced trade may only benefit governments marginally. Debt relief, on the other hand, improves government finance directly.

Finally, addressing the development finance issue through trade policy is far more complicated than through debt relief. While trade is of course an important issue for developing economies, the impact of improving trade relations and trade policy will most likely be felt in the medium to long term. Resources are needed for reaching the MDGs now.

## **2.4. Debt and Aid**

Debt campaigners and others have long pointed to the fact that aid has been diverted to repay debt. This was one of the strongest arguments that finally shamed the donor community into designing a more comprehensive debt relief mechanism.

What donors gave to indebted countries in aid with one hand, they took back in debt repayments with the other. This phenomena increased during the 1990s. In 1992, 2.7 percent of aid grants directly went to debt relief. By 1998, this figure had reached 14.1 percent. These figures do not include the contributions made by donors to various multilateral debt-service support schemes.<sup>5</sup> Furthermore, the amount of grants spent on debt *service* is extremely high: 50 cents of every additional dollar of grants appears to be used to finance principal repayments of foreign loans.<sup>6</sup>

Aid receipts are an important form of hard currency desperately needed by indebted governments to repay external debt service, so their use of aid to repay debt was not surprising. But the continuing practice of donors to channel aid resources to debt relief is a nasty business.

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<sup>4</sup> For an excellent discussion of shocks and debt sustainability, see Matthew Martin and Randa Alami, Development Finance International, "Long-Term Debt Sustainability for HIPCs: How to Respond to Shocks". 30 January 2001.

<sup>5</sup> United Nations Least Developed Countries 2000 Report, page 125.

<sup>6</sup> Ibid.

In fact, as it was feared, contributions to the Enhanced HIPC Initiative do seem to be costing aid budgets considerably. That this is occurring regardless of all the assurances made that it would not is extremely disappointing, and indicates that the donor community has learned little from the debt crisis.

High debt levels also impair the quality of aid in a different way. As Unctad points out:

*“Aid effectiveness has also been undermined by the external debt burden, which has not only reduced public and private investment in the LDCs, but also adversely affected the aid practices of official creditor-donors. Since the 1980s there has been a close relationship between the geographical allocation of aid flows and debt service payments. For LDCs, throughout the 1990s, the “debt tail” has been wagging the “aid dog”, as official creditor-donors as a group have been putting money in where they need to get money out”.*<sup>7</sup>

This has, among other things, pushed aid intensity beyond thresholds where it can be effectively absorbed.

The donor drive to give aid rather than debt relief is a self-protective one. While extending aid is seen as contributing to international development efforts, granting debt relief has a more negative association, leading one to question the quality of loans and the prudence of the lender. There are also accounting issues for donor countries, which make it easier to grant aid than take a loss through debt relief.<sup>8</sup>

And despite this fear of donors to compromise their credibility by granting debt relief, through the Enhanced HIPC Initiative it is the debtor’s credibility that is compromised, not the creditor’s. Several HIPC governments have resisted entering the Initiative against best advice due to worries over their creditworthiness (Ghana is one obvious example). Somehow, the role creditors played in the development of the debt crisis was lost in the mix.

Finally, while donors can agree to increase aid flows tomorrow – this may not have an immediate development impact and it would be far from a reliable agreement. The Unctad LDC 2000 report is very clear about this:

*“Foreign aid flows are a major source of external shocks for LDCs. For most LDCs, aid flows are actually more volatile than the extremely volatile export revenues, and are also more volatile than current government revenue.”*

Thus, indebted governments cannot count on aid flows beyond the short term. Aid is also not necessarily given as budget support, but rather may be *tied* to a particular project or purchase of a particular import. Debt stock relief is permanent. Debt relief also frees resources which can be spent on various sectors through the budget. While aid is an important issue for the discussions in Mexico, debt relief should be given more priority.

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<sup>7</sup> Unctad LDC 2000 report, Overview by the Secretary General.

<sup>8</sup> S. Claessens et al. “Analytical Aspects of the Debt Problems of Heavily Indebted Poor Countries” 1997.

## 2.5. How Does Debt Measure Up?

In all the cases mentioned above, debt relief is a more direct, immediate way to increase financing for development. And yet, debt holds a comparatively small place on the FfD agenda. Likewise, there is little challenging in the latest draft of the FfD outcome paper on the issue.

While in earlier drafts of the outcome paper, explicit comments had been prepared calling for further enhancing and expanding of the Initiative, the latest draft is more conservative. It does suggest certain modest improvements:

*“Future reviews of debt sustainability should also bear in mind the impact of debt relief on progress towards the achievement of the development goals contained in the Millennium Declaration. We stress the importance of continued flexibility with regard to the eligibility criteria. Continued efforts are needed to reduce the debt burden of HIPC countries to sustainable levels”.*<sup>9</sup>

But it does not explicitly call for improvement of the Initiative. Instead it is quite positive about the Initiative, reading:

*“The Heavily Indebted Poor Countries’ (HIPC) Initiative provides an opportunity to strengthen the economic prospects and poverty reduction efforts of its beneficiary countries. Speedy, effective and full implementation of the enhanced HIPC Initiative, which should be fully financed through additional resources, is critical”.*<sup>10</sup>

This language is unclear and weak. But perhaps this is not surprising given the low priority debt is given as a critical means of raising financing for development.

And that is the biggest disappointment of all. The singular effectiveness of debt relief as an efficient mechanism to free resources for development is neglected. And the absolute power those attending the summit have over granting debt relief is absolutely ignored.

Unlike all the other potential contributors to development finance – investment, trade, aid – debt relief is the only development resource debtor governments can control. Government ownership and control over development efforts is key to successful implementation of a development strategy. Mobilising the resource that most effectively delivers that control and ownership – debt relief – simply makes sense.

If the FfD approach to the issue of debt relief does not change significantly, this will surely be a missed opportunity.

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<sup>9</sup> International Conference on Finance for Development, Agreed draft text, Advance final unedited version, 27 January 2002.

<sup>10</sup> Ibid.

### 3. After HIPC II: the way forward

As argued in the previous chapter, debt reduction is the most direct, efficient and effective way to mobilise resources for social, human and economic development. But the main debt reduction mechanism currently available to the indebted countries, the Enhanced HIPC Initiative, is failing. Not only on its own narrowly defined economic criteria of reaching a 'sustainable debt level' of 150 percent of exports. But also as a mechanism to break the chain of indebtedness, flawed development and increasing poverty.

#### 3.1. HIPC II fails

The existing framework fails to provide an exit from the debt crisis and it fails to offer a substantial contribution to poverty reduction and economic development (as will be argued in more detail in the paragraph 3.2.2.). The main reason behind the Enhanced Initiative's failure is a political one.

##### 3.1.1. Creditors rule

HIPC II fails because the process is dominated by creditors and creditors' interests. Creditors remain unwilling to come up with sufficient resources and they refuse to consider their own responsibility in the piling up of the unpayable debts. Their responsibility is obvious, though. They have supported projects that in many cases have had adverse ecological and social effects. They financed projects that did not generate the necessary resources to pay back the debt. Moreover, creditors have lent huge sums of money to illegitimate regimes, often out of economic-political interests. For example, US\$5,6 billion of Nigeria's US\$32 billion debt was incurred under the rule of military dictators. The new democratically chosen government is responsible for paying back this debt. At the same time, General Abacha alone has deposited at least US\$4 billion on secret accounts in Western banks.

Another example is Indonesia. About 44 percent of the debts that this country owes to Britain's Export Credit Guarantee Department are debts for military purchases by Suharto. As Binny Buchori of the Indonesian NGO INFID puts it:

*"Indonesia has a huge foreign and domestic debt burden accrued by an undemocratic dictator, who was financed and armed by both Western governments, the IMF and the World Bank. This burden now falls on the shoulders of the poor – the very people who had British Scorpion tanks and Hawks jets turned on them by Suharto and his generals".<sup>11</sup>*

Not only do creditors decide who they lend money to, for which purpose and under which conditions, they also decide whether or not a country's debt will be rescheduled or reduced, to what extent, and what countries must do to be offered such debt restructuring or reduction. In the words of Ann Pettifor of Jubilee Plus:

*"They act as plaintiff, judge and jury in the court of international finance – their own court – and rule on their own claims. (..) It helps explain why, after five years of expensive,*

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<sup>11</sup> Jubilee Plus: Jubilee Plus campaign on Indonesia produces results. October 2001.

*tortured, drawn-out HIPC negotiations, international creditors have not ruled against their own claims, and have not accepted substantial losses for unpayable debts”.*<sup>12</sup>

### 3.1.2. Technical shortcomings

Although the reason behind HIPC II's failure is a political one, it is still relevant to be aware of its technical shortcomings.

The HIPC initiative promise was to achieve debt sustainability, meaning that ‘a country should be able to meet its current and future external debt service obligations in full, without recourse to debt rescheduling or the accumulation of arrears and without compromising growth’. But the initiative fails to meet this promise.

First of all, the amount of debt reduction on offer is too small. The initiative's main aim is to reduce the debt level of selected countries below the arbitrarily defined ratio of 150 percent of exports. But it does not even realise this restricted goal. Six countries will not reach what the World Bank and IMF define as a sustainable debt level, for many years after the Completion Point.<sup>13</sup>

Even worse: this is only the best-case scenario, based on very optimistic projections regarding export and GDP growth. World Bank and IMF estimate that HIPC exports will grow by 8,9 percent in the first decade of this century: more than twice as much as the 4.2 percent growth in the nineties<sup>14</sup>. The optimism, on which the amount of debt relief that countries receive is based, is particularly worrisome in the light of the worldwide economic downturn, which has been pushed further by the 11 September attacks on the US.

Moreover, within a few years, debt levels in the eligible countries will start rising again and for many countries, future debt levels are even higher than current debt levels. This is because countries remain dependent on new borrowing. As the US General Accounting Office has pointed out, debt reduction only frees up resources for additional poverty reduction activities if HIPCs continue to borrow at the same rate as in the past.<sup>15</sup>

Secondly, many countries with an unsustainable debt burden are excluded from the initiative. At least six of the Least Developed Countries that have an unsustainable debt level according to the conservative World Bank and IMF criteria are not categorised as ‘HIPC’ and are therefore not eligible for the HIPC initiative.<sup>16</sup> Besides these six LDCs, many other countries are excluded from the initiative. Nigeria, for example, was removed

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<sup>12</sup> See: Ann Pettifor, Bronwen Thomas and Michela Telatin: HIPC is Dead. HIPC – Flogging a Dead Process. Jubilee Plus, September 2001.

<sup>13</sup> These are Bolivia, Burkina Faso, Chad, Malawi, Rwanda, Niger. Tanzania was on this list too, based on data from its Decision Point document. But at the Completion Point document, (mainly gold) exports were higher than projected, new borrowing was lower than expected, and exchange rates were adjusted, which in the end meant that with the same amount of debt relief as proposed at the Decision Point, Tanzania would cross the 150% threshold level according to the World Bank and the IMF. This seems unlikely, however: according to Jubilee Plus calculations, this would require a 20% increase of export income over the Decision Point projections.

<sup>14</sup> Eurodad: What goes down might not come up. October 2001.

<sup>15</sup> The reason is that before countries received debt relief, they needed to borrow money for several purposes, including debt payments. To meet remaining debt repayments and to increase spending on poverty reduction, these countries need new borrowing after receiving debt relief. See: General Accounting Office Report to Congressional Committees: Debt relief Initiative for Poor Countries. June 2000.

<sup>16</sup> These are Nigeria, Bangladesh, Cambodia, Haiti, Nepal, and Samoa.

from the HIPC list as until 2000, it was not an 'IDA-only borrower'. The debt obligations of Nigeria, a country that ranks 151<sup>st</sup> out of 174 countries on the Human Development Index, are fifteen times the amount it is able to spend on poverty reduction.<sup>17</sup> Another example is Indonesia, a country where two thirds of the population lives on US\$2 or less per day. This country's debt-to-export ratio has been above the World Bank and IMF threshold since more than ten years. Last year, it stood at 247 percent. External debt servicing amounts to 20 percent of the government budget. Another 18 percent is spent on domestic debt, while only 14 percent is available for the development budget.

The main technical reason why the HIPC initiative fails is that it is based on the wrong criterion, the 150 percent net present value of debt to export ratio. As pointed out by Eurodad<sup>18</sup> and others, this approach is inappropriate:

- Increased export income does not automatically mean that the government has more resources at its disposal;
- Commodity prices are far from stable, making medium term predictions on debt sustainability unreliable;
- 150 percent is an arbitrarily set ratio, which contradicts historical evidence<sup>19</sup>;
- Most importantly, poverty needs are neglected.

There is a third problem besides the fact that the HIPC initiative offers too little debt relief while it also excludes a great number of countries in need of debt reduction: the whole process is incredibly slow. Since its inception in 1996 until end - 2001, HIPCs have received US\$1,1 billion in debt relief. In the same period, these countries transferred US\$35 billion to the accounts of foreign creditors.

The main reason why the process is too slow is the complex set of conditions countries must meet before they receive debt relief. Countries have to prepare a Poverty Reduction Strategy Paper (PRSP), which includes macroeconomic, structural, sectoral as well as social elements. This means that in addition to traditional adjustment targets, new conditions must be met. Although the increased emphasis on poverty reduction is to be welcomed, it is clear that the PRSP approach still has major shortcomings, one of which is the fact that macro-economic issues still restrict social ambitions. Furthermore, the need to develop a PRSP delays the road to the Completion Point, the point where countries receive irrevocable debt relief.<sup>20</sup> On the other hand, the quality of the PRSP, including important aspects such as for example consultation and participation, are undermined as countries are in a hurry to get to the Completion Point.

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<sup>17</sup> Kwesi Owusu: Drops of Oil in a sea of poverty. Jubilee Plus, september 2001.

<sup>18</sup> Eurodad: Putting Poverty Reduction First. Why poverty reduction needs must be factored into debt sustainability assessments. October 2001.

<sup>19</sup> HIPC Debt Strategy. Debt Relief International, june 1999.

<sup>20</sup> Uganda for example, has been working on a Poverty Reduction Strategy for five years, and even after this the WorldBank and the IMF were not fully satisfied and demanded more details.

### 3.2. A new framework

Considering the injustice and inadequacy of the current debt relief mechanism, one could welcome the wording of the FfD draft outcome, despite its vagueness:

*“(..) we emphasize the importance of putting in place a set of clear principles for the management and resolution of financial crises that provide for fair burden sharing between public and private sectors and between debtors, creditors and investors. (..) We also encourage exploring innovative mechanisms to comprehensively address debt problems of developing countries, including middle-income countries, and countries with economies in transition”.*<sup>21</sup>

In recent years, worldwide Jubilee campaigns, international experts and Unctad have been pointing out to the need for a new, transparent arbitration mechanism, independent of both creditors and debtors. The new mechanism should take account of both the debtor's as well the creditor's responsibility. It is to be used to decide for each individual country (a) whether it is entitled to debt relief and (b) how much debt relief it needs and (c) under which conditions. In this process, the people in the indebted country will have the right to be heard. Moreover, the responsibility of the creditors would be considered. Furthermore, how much debt relief a country is to receive, would depend on the country's (basic) social, human and economic needs. This could be laid down in a fully country-owned and participatory developed poverty reduction strategy.

The mechanism could for instance be based on the proposal of Kunnibert Raffer<sup>22</sup>, the internationalisation of Chapter 9 of the US legal code.<sup>23</sup> Chapter 9 is a provision that lays down rules for a bankruptcy procedure for American municipalities. The mechanism would include the following elements:

- The debtor has the right to declare a standstill on its debt repayments.
- A neutral, impartial court of arbitration is established. Both the debtor and the creditor appoint the same number of persons, which in turn choose one further member and elect a chair. Alternatively, the debtor and the creditor country could appoint one judge<sup>24</sup>.
- The independent court or panel examines the debt portfolio and makes recommendations, for example on the amount of debt relief needed, conditions, and the provision of necessary funds. The debtor and the creditors have the opportunity to present their case.
- Moreover, the people of the indebted country, for instance represented by trade unions or civil society organisations, have the right to be heard. As is the case in Chapter 9, the court 'depends on the debtors' volition and cannot be extended beyond it'. Thus, the court has no right to interfere with the budgetary choices of

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<sup>21</sup> International Conference on Finance for Development, Agreed draft text, Advance final unedited version, 27 January 2002.

<sup>22</sup> Kunibert Raffer: What's good for the United States must be Good for the World. Advocating an International Chapter 9 insolvency. First published in: Bruno Kreisky Forum for International Dialogue. Vienna 1993.

<sup>23</sup> The New Economic Foundation has recently produced an extensive paper on this: Ann Pettifor: Chapter 9/11. Resolving international debt crises – the Jubilee Framework for international insolvency. January 2002. Available at the Jubilee Plus website: [www.jubileepius.org](http://www.jubileepius.org).

<sup>24</sup> Raffer stresses that this would not require a new international organisation.

the debtor or with the 'choices as to what services and benefits it will provide to its inhabitants'.<sup>25</sup>

It should be noted that the mechanism is quite different from what IMF Deputy Director Ann Krueger proposed in November 2001. She has proposed to allow countries in trouble to put a hold on debt repayments until countries reach a debt agreement with their creditors. Possibly, the mechanism would include capital controls to prevent money fleeing the country. This mechanism is based on Chapter 11, a bankruptcy procedure for private corporations, which does not protect the governmental powers of the debtor and which does not give the people the right to be heard, as Chapter 9 does. In spite of its shortcomings, Ann Krueger's proposal is very important, as it opens the way for effective lobbying for the internationalization of Chapter 9.

The proposed independent arbitration mechanism would be transparent and fair – contrary to the current HIPC II mechanism. But it would also allow poverty reduction to be placed at the centre of debt reduction, as the amount of debt relief would be based on a country's needs. Even the draft outcome paper of the FFD conference acknowledges that there should be a link between debt relief and the achievement of the Millennium goals.

A second step is to ensure that debt relief indeed contributes to social and sustainable development. Debtor government policies need to be more transparent and accountable to their populations and their representatives in democratically elected parliaments. To ensure that debt relief and poverty reduction go hand in hand, a country could work out a participatory poverty reduction strategy. Budgets and spending would have to be transparent and in accordance with the PRS. This should be monitored by an independent entity in the country. The Ugandan poverty action fund could serve as an example.<sup>26</sup> In spite of its involvement in war and corruption, and the absence of a PRSP, Uganda used the PAF effectively to allocate additional resources to poverty alleviation. In a few years time, for example, primary school enrolment more than doubled.

### **3.3. Responsible borrowing and lending**

Many indebted countries remain dependent on new external financing. That is certainly the case if the current HIPC initiative is not changed. But even if poverty reduction is put first and countries can receive 100 percent debt cancellation, some countries will still need external financing to achieve the 2015 development goals<sup>27</sup>. Clearly, it is important to think of ways to prevent the debts from piling up again.

If an international arbitration mechanism would be established, this could indirectly contribute to more responsible borrowing and lending. In the current situation, bilateral and multilateral lenders decide what the borrower is to use the loan for. At the same time, if anything goes wrong, they are still allowed to claim their money back. They bear no responsibility and carry no risk. As Kunnibert Raffer points out:

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<sup>25</sup> Raffer (1993).

<sup>26</sup> The key elements of the Poverty Action Fund is that (a) it is integrated in the national budget; expenditures being funded are included in the overall development/poverty reduction strategy of the country; (b) disbursement and reporting procedures ensure that the funds allocated to poverty reduction are truly additional; (c) the poor are involved in the monitoring of the structure. (Eurodad LDC paper)

<sup>27</sup> Out of 20 HIPCs, these include Burkina Faso, the Gambia, Guinea-Bissau, Malawi, Rwanda, and Tanzania. Eurodad: Putting Poverty Reduction First. October 2001.

*“This is a system absurdly at odds with the Western market system. It is the most basic precondition for the functioning of the market mechanism that economic decisions must be accompanied by (co) responsibility: whoever takes economic decisions must also carry financial risks”.* An international arbitration mechanism could change this, as creditors would have to pay for their own mistakes.

### 3.3.1. Guidelines for responsible borrowing and lending

To increase responsible borrowing and lending, several changes could be made. The following suggestions could be helpful to raise the debate.

1. Creditor countries should change export credit guarantee policies. The problem with export credit guarantees is the complete lack of transparency of the transactions involved. Although a large part of the bilateral debts of the poorest countries result from export credit guarantees, in most countries no-one, not even members of parliament, know which projects and which companies are supported. Furthermore, the transactions are not tied to clear and binding criteria to prevent adverse social or environmental effects<sup>28</sup>. To ensure that export credits contribute to sustainable development, the transactions should be tied to social, developmental and environmental criteria. Transparency and public accountability should be ensured, especially since export credit guarantees involve public (tax payers) funds.
2. Governments should not borrow without the authority from parliament. This is already the case in for example Uganda. Here, the constitution says that the ‘government shall not borrow, guarantee or raise a loan on behalf of itself or any other public institution, authority or person except as authorised by or under an Act of Parliament’. Public scrutiny could prevent irresponsible lending.
3. Loans should have a ‘productivity conditionality’ attached to them: loans should be used for activities which generate sufficient resources to pay back the loan. Responsible borrowing and lending requires that the type of finance is adjusted to its spending purpose. A distinction could be made between three different purposes of external finance<sup>29</sup>:
  - *External grant finance for non-income generating purposes.* This includes humanitarian and disaster assistance, as well as finance for education and health. Finance for these non-income generating purposes should take the form of grants. At the very least, highly concessional loans (IDA) could be used.
  - *External concessional finance for indirectly income-generating projects.* These type of projects include for example the building of roads and other infrastructure development projects. These programs should be financed by concessional loans with long grace periods. Repayments should not fall due before the loan starts to generate income.
  - *Commercial loans for directly income-generating projects,* such as for instance the building of factories. Income-generating projects can be

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<sup>28</sup> Export credit agencies in OECD countries have agreed not to issue ‘non-productive credits’ to HIPC. However, ‘non-productive’ only covers military exports.

<sup>29</sup> This is a very basic model that is the result of a discussion at the annual conference of Eurodad in 1998.

financed by non-concessional loans. However, there should be a risk assessment by borrowers and lenders and if the program fails, both borrowers and lenders should share this risk. The government of the developing country should not bear the full responsibility, as is the case now, and be obliged to repay a disproportionate share of the loan. Moreover, the government should never be forced to use money that is earmarked for other sectors, such as health and education, for the repayment of the loan.

It should be clear that this model can only make sense if sufficient grant financing is available. Regrettably, this is not likely to be the case. Much more grant financing could be available if all donor countries do what has been internationally agreed: to spend 0,7% of GNP on Official Development Aid (ODA).

4. Finally, to ensure proper use of external finance, it would be very helpful if the country has developed a poverty reduction strategy, as monitoring could be linked to the poverty reduction strategy. Responsible borrowing requires that:
  - The internal disbursement of external finance is carried out in an accountable and transparent manner
  - The use of funding is consistent with a country owned and participatory developed poverty reduction strategy.
  - A monitoring system – involving civil society and parliament, similar to the Ugandan PAF – is put in place to allow for the monitoring of internal disbursement at the national, regional and local level.

## 4. Recommendations

The need to find a solution for the debt problem should remain high on the international agenda for reasons of international justice, human rights and development needs. As has been argued in this paper, this implies a major reform of current debt relief mechanisms which do not recognise the co-responsibility of creditors and offer debtor countries too little, too late.

### ***Jubilee Netherlands calls for:***

#### **1. A fair and transparent decision making process**

The current situation, in which creditors play the role of plaintiff, judge and jury, needs urgent revision. The draft Monterrey Consensus 'encourages exploring innovative mechanisms to comprehensively address debt problems of developing countries, including middle-income countries and countries with economies in transition'. There are different proposals for a new mechanism, such as the IMF proposal for an orderly debt work-out. Unctad and civil society organizations are promoting proposals that build on domestic insolvency procedures and emphasise independent arbitration. For Jubilee Netherlands, crucial features of a new mechanism would be:

- Open to all countries with serious debt problems;
- Including an independent decision making body;
- Recognising creditors' and debtors' shared responsibilities for both the problem and the solution; both parties are accountable for the implementation of a fair solution;
- Providing room for civil society priorities and concerns;
- Including the possibility for a moratorium for a number of years.

#### **2. Debt reduction as a necessary condition to achieve social and sustainable development**

Debt reduction should be recognised as an essential condition to finance development and achieving the Millennium Goals. It makes funds free to be used for essential development activities, including – but not limited to – the strengthening of the local economy. It reduces a crucial stumbling block for economic development, as – for example – a too large debt burden scares off foreign and local investors and crowds out government investments. Debt relief should be based on the following principles:

- Safeguarding of government expenditures in essential fields (with the Millennium Goals as bottom line);
- Realistic economic projections, taking into account the impact of external shocks;
- Involvement of all sovereign debts: private, bilateral and multilateral;
- Bilateral and multilateral debt relief should be financed with additional resources; using IFI reserves and bilateral contributions additional to current ODA spending

Creditor countries should not wait for international agreements on deeper and broader debt relief. They could start by cancelling bilateral debt service, while they continue to

push for improved international agreements that also include multilateral and private debts. Creditor countries should immediately cancel illegitimate and odious bilateral debts<sup>30</sup>. Creditor countries, as the major shareholders, should also assume co-responsibility for 'failed' IFI lending, i.e. loans that have not contributed to social and sustainable development.

### **3. Increased quality for future borrowing, lending and spending by increased transparency and accountability**

Increased scrutiny by parliaments in both creditor and debtor countries is crucial for enhancing political and financial accountability and ensuring that civil society priorities and concerns are reflected in lending and borrowing.

Future problematic and irrelevant lending and borrowing should be avoided. This implies:

- On export credits: host countries should adopt clear and binding criteria for Export Credit Agencies to ensure transparency and public scrutiny, and for ensuring that only those credits qualify for back-up guarantees from governments, that contribute to social and sustainable development. This should pave the way for international binding regulation of ECAs to avoid adverse social and environmental impacts of these transactions.
- On IFI loans: shareholders should ensure that IFI programmes and conditions support the implementation of national development strategies, while IFI's should accept responsibility for the poverty impact of their programmes and policy advise.
- On bilateral ODA: loan dependence should be decreased through increasing available grants for national development strategies. OECD countries should achieve the 0,7% ODA target on a timeframe consistent with achievement of the Millennium Goals.
- On borrowing: decisions concerning new government loans should be made subject to public scrutiny and be based on democratically developed and agreed upon priorities and criteria. The use of borrowed funds should be closely monitored.

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<sup>30</sup> Odious debts result from credits which in retrospect should never have been given, taking into account the high chance that they were not going to be used for the purpose for which they were given. Creditor countries should retain the right, however, to move against those individuals who misused these funds and enriched themselves. They should not get away with it.