NOTE FOR THE SHADOW G8

On Debt Relief

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In June 2005 at the Gleneagles summit, the G8 proposed to cancel all debt owed by post-completion point HIPC countries to the IMF, IDA, and African Development Bank. The deal initially included 18 countries, for a total write-off of US $40 billion over 40 years. The IMF forgave its portion of the debt January 2006, and World Bank and African Development Bank began to deliver their portion of debt cancellation in July 2006. In addition, two non-HIPCs, Cambodia and Tajikistan, were included in IMF debt write-downs.

The Multilateral Debt Relief Initiative (MDRI), as the proposal has come to be called, was a positive step in relieving the debt burden of some of the poorest heavily indebted countries – and an acknowledgement that the prior system of debt write-offs had not led to debt sustainability. But the MDRI has significant limitations that need to be addressed. It only covers a limited portion of a country's debt, is only granted to a limited number of countries, and ties debt relief to aid and conditionality.

The MDRI is an ad-hoc response to debt relief, rather than a solution to the problem of debt overhang. The G8 needs to look to a comprehensive framework of how to handle sovereign debt restructurings – one that defines how risk should be shared between all debtors and all creditors.

Problems associated with the MDRI include:

1) The IDA and African Development Bank debt relief replaces new funds. The IFIs have reduced disbursements for every dollar of debt service relief given.[1] In essence, the countries have paid for their own debt relief[2].

2) The MDRI only encompasses IDA, IMF, and AfDB loans (although, in November 2006, the InterAmerican Development Bank agreed to cancel US$2.1bn of the US$3.5bn owed by the five Latin American HIPCs.) Because the debt cancellation only covers a portion of the debt the actual amount of the debt write-off has been significantly under 100%. For African countries this has amounted to debt servicing savings of 40%, on average[3].

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[1] New funds have been made available to the institutions, but these funds are being reallocated to all IDA and AfDB recipient countries based on performance allocation criteria.
[2] See Jurgen Kaiser 2005
[3] CITE – Eurodad paper?

3) The canceled amounts range from 20% for some countries and 80% for others. The MDRI doesn't address how much debt cancellation a country 'needs' – and how to achieve it. Many countries need additional debt cancellation; some could need less. What is clear is that a broader framework that takes debt sustainability as defined by the ability of a country to grow (and reach the MDGs) post relief into account is needed.[4]

4) Many countries have replaced the loss of new funds with new loans, running up debt numbers again. The MDRI obviously does not include new debt contracted, including debt from China and other creditors that are not part of the G8. This underscores the importance of having a broader group of creditors as part of the process – and, more generally, a broader group of countries as part of the G8.

   In addition, some countries have begun to run up domestic debt. While the shift to domestic debt is a positive step in terms of reducing currency risk, countries might soon be facing domestic debt problems.

5) Only post-HIPC countries that have reached their completion point are included in the MDRI, leaving out many low- and middle-income heavily indebted countries that need debt relief. The inclusion of two non-HIPC countries, Cambodia and Tajikistan, in IMF debt relief is an important step in expanding the countries, but many more countries are not included – and more importantly a framework for all heavily indebted countries needs to be developed.

6) Debt relief as part of the MDRI is tied to conditionality.

The above limitations of the MDRI point to the importance of a comprehensive framework for debt restructuring. The issue of some form of a broad framework for debt restructuring should be back on the G8 agenda. This approach could have the further benefit of helping to separate debt relief from the aid allocation process.

As is well-known, however, when the IMF proposed an SDRM in 2001 opposition to the proposal made it impossible to implement. Some of this was due to the specifics of the IMF's SDRM, but much of the opposition was against any statutory approach. This doesn't mean that it shouldn't be on the agenda, but does mean that we also need to look for intermediate steps that can serve a similar function of better risk sharing between creditors and debtors.

One such proposal is GDP-linked bonds. There has been much discussion of GDP-linked bonds for countries with market access. There has been less discussion of how useful this instrument would be for loans to low-income countries from bilaterals and multilateral institutions. This is especially true for loans given with conditionality. GDP-linked bonds (or similar instruments, depending on the conditionality) would share the risk that

[4] For debates on how debt sustainability is defined see the upcoming IPD Debt Task Force Volume.

conditionality fails between debtors and creditors. For example, if the IFIs gave a country a loan tied to macroeconomic conditionality, the IFIs would then share the risk that the conditions weren't appropriate for the country and wouldn't lead to the expected growth.

One response that we've heard to this proposal is that the IMF and World Bank can't take on the risk that all debtor countries would have a slowdown in GDP at the same time, depleting the Fund or Bank's capital. But, not only is this risk easily hedge-able -- this is precisely the point of GDP linked loans: to transfer the risk of a slowdown from those least able to bear the risk to those more able. More importantly, as above, the IFIs could easily hedge this risk.

The current system of debt forgiveness is inefficient and does not address the needs of most heavily indebted low and middle income countries. The risk is that the MDRI will lead creditor nations to believe that the debt problem has been solved, when what is really needed is a true framework.