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Introduction

Jubilee 2000 was by far the most successful industrial-country movement aimed at combating world poverty for many years, perhaps in all recorded history. It succeeded not just in changing official policy, but in arousing a measure of concern among the world's rich about the state of the world's poor that had been conspicuously lacking for many years.

Jubilee promised to wind itself up at the end of 2000, but in the event it reconstituted itself (temporarily) as Drop the Debt and (more permanently) as Jubilee Plus. The decision to reincarnate appears to have been driven by two considerations. One was a belief that Jubilee's objectives had not been adequately realized, because many low-income countries still had what was judged to be an excessive debt burden, despite what is called the enhanced HIPC Initiative (''HIPC'' stands for heavily indebted poor country or countries; see box 1.1). The other was a realization that the movement had achieved such political momentum that it would be a mistake to waste its potential to secure further gains.

Group A versus Group B

Both the authors of this study have devoted much of their professional careers to efforts to promote development. We therefore unreservedly welcome Jubilee's success in mobilizing concern for the cause of combating poverty. At the same time, we come from the universe of what Ravi Kanbur (2001) has characterized as Group A (''finance ministry types''), as opposed to the Group B (''civil society types'') that drove Jubilee and Drop the Debt and are now driving Jubilee Plus.

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Box 1.1 The enhanced HIPC Initiative

HIPC is an ugly acronym that stands for heavily indebted poor country (or countries). The enhanced HIPC Initiative is the latest international effort to provide debt relief to the group of 42 countries (at last count) known as HIPCs, 34 of them in Africa. It was first agreed on at the Group of Seven summit in Cologne in 1999, and then formally endorsed by the IMF and World Bank at their annual meetings in September that year.

Countries seeking to participate in the HIPC Initiative submit Poverty Reduction Strategy Papers drawn up on the basis of consultation with civil society representatives that describe their proposed economic and social policies and programs to reduce the poverty of their citizens, including how they propose to spend money that they no longer have to devote to debt service. When such a paper has been approved by the boards of the World Bank and IMF, the country in question is entitled to debt relief of at least 90 percent from official bilateral creditors as well as relief from the multilateral creditors meant to reduce its debt stock to what is supposed to be a sustainable level.

Although individuals from both groups may be equally concerned about poverty, they bring different perspectives to policy debates. This study was motivated by a conviction that the debate on debt relief needs a fresh look, one in which Group A analysis of the risks and trade-offs of any particular solution are more explicitly linked to our common objectives—which, it must be said, have been more passionately proclaimed, and with notably greater political effect, by Group B.

Thinking about HIPC has led us to many of the questions that are commonly asked about the debt of poor countries. Appendix 1.1 summarizes our answers to ten of these questions.

In particular, our analysis highlights two shortcomings of the current HIPC debt program. First, though more ambitious than past programs in promising more and faster debt relief for more countries, it is not grounded analytically in a realistic conception of the amount of debt reduction needed for most countries to achieve a sustainable path of growth and poverty reduction.

Second, though the HIPC program is described as part of a new approach to development assistance in the poorest countries, its design focuses on improving the performance of recipient countries. It does not change the perverse political and bureaucratic incentives that led the official donors and creditors to provide the stream of loans that became unmanageable debt in the first place. In our analysis and recommendations, we therefore focus on the merits of debt reduction not only as part of a larger effort to create the conditions for sustainable growth in recipient countries, but as a critical first step in the building of a "new aid architecture."

To understand where to go next, one should first ask how the HIPCs got to where they are today. We therefore give a sketch of the evolution of the HIPC Initiative to date. We then ask whether the HIPCs and other

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poor countries still need more help from the donors than they are currently getting, including what they received as a result of the enhanced HIPC Initiative. Two criteria that have been widely endorsed by the international community are used to make this evaluation. One is whether debt burdens are sustainable, which is the criterion explicitly stated to be the rationale for the enhanced HIPC Initiative. The other is whether these countries would have access to enough external resources to achieve the Millennium Development Goals, if they make maximum domestic efforts to that end. We conclude that there is indeed a compelling case for further action on the basis of those two criteria.

In our view, that conclusion does not suffice to make a case for further debt relief; it is also necessary to ask whether debt relief is the right *way* to deliver additional help, the alternative being a stepped-up foreign aid program. We use five criteria to judge the relative merits of these two approaches. The first is political resonance: whether and why debt relief has more political appeal in donor countries than foreign aid. The second is additionality: whether, given the answer to the first question, debt relief will bring extra resources to the cause of development or simply substitute for what might have been larger future aid flows.

The third criterion is redistribution: to the extent that additionality is less than 100 percent, one has to ask who will pay for debt relief and worry that debt relief for some poor countries (e.g., Nicaragua and Uganda) might come at the expense of equally poor countries whose governments avoided acquiring unsustainable debt (e.g., Bangladesh and India). The latter group might after all make better use of the resources in reducing poverty. The fourth is efficiency: whether and in what ways debt relief can lead to greater development effectiveness than an aid program of the same size and whether debt reduction in some circumstances could encourage additional private investment. The fifth is donor selectivity: whether debt relief can free donors from defensive lending driven by a desire to avoid defaults, and enable them to direct aid to those countries best able to use it to reduce poverty.

We conclude that some measure of debt reduction has certain advantages over simply increasing foreign aid by an equivalent amount. These advantages justify a greater and more predictable degree of debt reduction than currently envisioned (though not a complete write-off). In particular, debt reduction is a much more efficient form of transfer than traditional project-based foreign aid and loans in countries that can manage the resources well. It has the peculiar advantage of automatically improving donor coordination and enabling borrower ownership of reform programs, thus reducing the bureaucratic and management costs of a process that generally taxes rather than supports recipient countries' limited institutional capacity.

Moreover, debt reduction enables donors and creditors to escape their own bad (though generally well-intentioned) tendency of defensive lend-

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ing to heavily indebted countries. In effect, sufficient debt reduction could put all the low-income debtor countries (some of which are not included in the current HIPC program) in a position to meet reasonable tests of performance in managing resources well. It would free creditors to be more selective with new grants and loans, channeling aid to those countries that both need additional resources and actually do perform. A clearly manageable debt might also encourage the ultimate keys to growth in these countries, namely, greater investor confidence and increased private investment. We conclude that it makes sense to provide for some additional debt reduction—enough to ensure that the remaining debt burden is predictably and visibly sustainable in all low-income countries.

Expanding Debt Relief

We therefore suggest expanded debt relief along the following lines:

- enlargement of debt reduction if debt service still exceeds 2 percent of GNP, to ensure that a country's budget is not made unmanageable by debt service;
- expansion of eligibility for the HIPC Initiative, and indeed our expanded proposals, to all low-income countries; and
- creation of a contingent facility to safeguard countries for 10 years against being pushed back into unsustainable debt levels by circumstances beyond their control.

Over and above the current estimated cost of the enhanced HIPC program of $29 billion (in net present value terms),[1] we estimate that these proposals would entail additional costs of between $30 billion and $80 billion (the latter including Indonesia) plus the cost of the contingency facility. The amount is large relative to the size of the planned reduction under the enhanced HIPC program, but it is not particularly large relative to current total estimated official development assistance (ODA) of $56 billion a year.

We set out proposals for financing this additional relief that we believe are financially reasonable and politically achievable, particularly if they manage to attract the support of Group B debt and development activists. Mobilization of IMF gold could cover the IMF's share of the cost of deepening and including additional countries in the initiative, and the

1. The amount of debt is often expressed in net present value terms. The NPV takes into account the fact that amounts owed in the future impose less of a burden than an equal amount owed now, for the same face value. The NPV of HIPCs' current debt is about $107 billion.

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contingency facility. These costs would be about $9 billion, plus that of the contingency arrangement, which we estimate at $5 billion.

Beyond the IMF costs, our proposals imply an additional contribution by donors of between $20 and $70 billion (again depending on Indonesia) above the $29 billion that they have already pledged. Some of this cost (approximately $11 billion) has already been agreed to in principle by the bilateral donors that have pledged a 100 percent write-off of HIPC debts owed directly to them and through a Paris Club deal with Pakistan in December 2001. Furthermore, much of this ''cost'' in forsaken bilateral debt service payments is fictitious. The loans in question really ought to be written off, because the only way that the donors can ever expect to collect the debt service due is by continued defensive lending to give poor countries the foreign exchange to pay them. Writing off those loans does not involve increased donor outlays, if the donors decide not to replace the defensive lending. Finally, higher interest rates on multilateral bank loans to the upper-middle-income countries could complement allocation of a part of the additional aid to the World Bank's trust fund to pay for multilateral debt cancellation; that could finance an additional $4 billion in debt reduction over 10 years.

But debt reduction alone is not enough to get development in the poorest countries back on the rails. Central to our recommendations is our view that debt reduction should be only a first step in the reinvention of the development assistance process. After all, the fact is that the debt problem in the poorest countries reflects an unpleasant reality. Billions of dollars and hundreds of development loans for dozens of donor-driven programs during more than three decades have in many countries not resulted in sustainable growth and poverty reduction but in the accumulation of unmanageable debt. This is not true everywhere. Countries such as Bangladesh, India, and (at least until 1997) Indonesia made sufficiently good investments to enable them to service low-interest-rate loans without difficulty. But in a large number of the world's poorest countries, most of them now HIPCs, years of development assistance have not worked.

There are many possible explanations for the failures of development assistance. We return to these in our discussion of the critiques of the HIPC Initiative in the next chapter. Suffice it to say here that countries ran into difficulties in servicing their debts for various reasons: because some loans served to sell goods that were of little use to the recipient country; because some leaders were crooks who stole the money; because some loans were made to satisfy political and bureaucratic rather than development imperatives of donors; because some leaders were misguided and adopted unwise policies that blocked development; and because many countries suffered unfavorable shocks.

When it became difficult to service the debt, the first reaction of donors was to evergreen the loans; the second to reschedule the debts; the third

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to lower interest rates; the fourth to convert new loans to grants; and fifth, beginning in the late 1980s, to negotiate multiple rounds of debt rescheduling and debt-service relief. By the 1990s, the debt overhang of the poorest countries had become more and more visible and embarrassing. The donors and debtors seemed caught in burdensome rounds of negotiation, as well as pressure for new lending to finance countries' debt service.

The response of the international donor community has been to place its bets on two new steps. The first is to give countries a supposed fresh start by writing off "enough" of their debt through the HIPC Initiative. The second is a new kind of poverty-oriented conditionality meant to change the incentives faced by recipient countries. Countries are required to prepare a Poverty Reduction Strategy Paper (a PRSP; see box 1.1), through active citizen and civil society participation, demonstrating "ownership" by participant governments of adequate strategies. The PRSPs are meant to guide both debt relief under the HIPC Initiative and to trigger and guide new lending and grantmaking from the donor-creditor community.

The new approach is a step in the right direction. But it adds to the immediate administrative burden on the borrowers without acknowledging any responsibility of the official creditors for the unsustainable debt. In particular, the new approach fails to recognize more explicitly that official debt is for all practical purposes uncollectible (without imposing impossible burdens on already impoverished populations). Perhaps as a result, it does not build in mechanisms for greater future discipline on the part of official creditors. We are concerned that without broader reforms there is not likely to be any break from the past practices of poor donor coordination and lack of discipline in lending due to political and bureaucratic pressures. And without demonstrated improvement in the effectiveness of development assistance, we doubt that donor allocations for the poorest countries will rise.

Reinventing the Aid Architecture

Thus, we conclude that debt reduction should be seen as only a first step in a larger reinvention of the international aid architecture. In this book, we do not address the changes needed in the recipient countries, namely, critical reforms in their governance and institutions as well as their social and economic policies; that is more than one other study in itself. However, we do outline the essential features of an aid architecture that would create the right incentives for donors to support fully and effectively those countries that are making progress in reducing poverty and improving human development indicators, while discouraging finance to the governments of countries that are not.

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Our most dramatic (though not new) recommendation is for increased reliance by bilateral donors on a multilateral approach, including subscribing to a ''common pool'' in which they would abandon project financing and tied aid, placing their funds in a pool that the government of a country making progress could spend as it saw fit. Our proposal also includes eliminating the PRSP as a necessary trigger for debt reduction. This, among other things, would recognize more explicitly the uncollectibility of much official debt and thus the creditors' as well as debtors' responsibility for past failures.

We also propose allowing the International Development Association (IDA) and the other concessional windows in the regional banks to make grants as well as loans, which we believe would have the advantage of increasing the pressure to be selective. Finally, we propose shifting the resources of the IMF's PRGF to the World Bank to make the Bank more singularly accountable for the effectiveness of what are now combined IMF and World Bank responsibilities and financing in the HIPCs.

As and when a new approach to dispensing aid begins to yield real benefits in terms of faster development and poverty reduction, we expect it to become easier to make the political case in donor countries for a greatly increased level of aid to the poorest countries, beyond that which we recommend for additional debt-stock reduction. That is also an essential element of a new aid architecture.

Meanwhile, increased aid can be directed to programs that are less dependent on the policies of a single recipient government, such as the fight against malaria, tuberculosis, and HIV/AIDS, as advocated by the World Health Organization's Commission on Macroeconomics and Health (WHO Commission 2001).

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Appendix 1.1
Ten Questions about Debt and Debt Relief

1. How much debt is there, and to whom is it owed?

Debt owed by the HIPCs is about \$170 billion (in 1999 nominal terms). Almost 50 percent of this is owed to bilateral creditors—mostly the United States, Japan, France, and other countries of Europe. Another 37 percent is owed to multilateral creditors: the World Bank, IMF, and the regional and subregional development banks; and 13 percent to private creditors (almost all of which is backed by a sovereign guarantee).

The debt of the HIPCs represents only 8 percent of the developing world's approximate \$2 trillion debt, and only 35 percent of the debt of all the low-income countries (using the World Bank's country classification of low-income, which includes India, Indonesia, Nigeria, and Pakistan: See appendix B). For the developing world as a whole, about 25 percent of debt is owed to bilaterals, 17 percent to multilaterals, and the remaining 60 percent to private creditors (half of which is not covered by a sovereign guarantee). For a breakdown of the debt owed by each HIPC, see table 2.4.

2. What portion of the debt stock of the poorest countries would be deemed uncollectible and written off or canceled if conventional accounting practices of commercial banks were followed?

Commercial banks would eventually be required to provision against debt that has lost much of its value. One measure of the value of commercial debt is the price it commands in the market. In the late 1980s, \$1 of commercial debt of countries like Bolivia and Nicaragua (now HIPCs) was worth as little as 10 cents on the dollar in the market. This means that the market judged about 90 percent of its value to be uncollectible.

Most HIPC debt is owed not to commercial but to official creditors, so there is no such market measure. However, the US government—which is congressionally mandated to estimate the present value of its loan portfolio and expense reductions in value as they occur—applies a 92 percent discount to the HIPC debt. Yet in 1999, HIPCs paid about 85 percent of the debt service they were due to pay—but they were only able to do this because of big receipts of new aid.

3. What portion of the debt of the poorest countries would be labeled "unjust" or "odious" by reasonable observers?

''Odious'' debt has been legally defined as debt assumed by governments without the consent of the people and not for their benefit. During the past three decades, as much as 60 percent of private and public loans were committed by creditors to countries subsequently labeled as not free, or corrupt in the year of the commitment, according to some international indices. In the Democratic Republic of Congo (formerly Zaire), Nicaragua, Pakistan, and other heavily indebted poor countries, there were periods when governments borrowed heavily to purchase military equipment of

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little benefit to ordinary citizens (Nicaragua in the 1970s), to invest in white elephant projects (Pakistan in the 1970s), or to pad the foreign bank accounts of corrupt dictators (Zaire under Mobutu). (See appendix C.)

One approach is to label as odious all debt assumed by ''odious'' governments—because even borrowing for good projects by odious governments may have simply made it easier to steal or misuse domestic resources. A simple measure of odious or unjust debt might then be all debt assumed by such governments. Unfortunately, labeling and quantifying odious debt does not provide much useful guidance on how much to forgive now—as we explain in the text.

4. Who should be asked to pay for debt relief?

In a conventional bankruptcy proceeding, the creditors are expected to recognize that their assets are worth less than face value, and have them scaled down to what the debtor can afford to pay. Almost all of the debt of the poorest countries is owed to official, not private commercial creditors. That means that it has been rich-country governments that have either loaned directly to poor-country governments, or have allowed the World Bank, IMF, or other institutions that they control to make the now ''bad'' loans. So when push comes to shove, the taxpayers of rich countries are the creditors of poor-country governments, and thus have to bear the costs of debt relief, except insofar as they might authorize the IMF to sell some of its gold or choose to shift the burden to other poor countries.

5. What about loans to purchase G-7 goods? How should they be treated in an analysis of debt relief?

The HIPC Initiative involves a 90 percent write-off of bilateral debt (Paris Club Cologne terms), and a number of countries, including the United Kingdom, have moved unilaterally to completely write off their bilateral HIPC debts. This means in a sense that the past sins of tied aid are wiped clean.

We have argued that one of debt relief's central advantages over additional new aid is the efficiency gain that comes from releasing poor countries from the kind of nonsense involved in aid contracts mandating the purchase of high-priced Western goods and services. We also support the common pool proposal (see chapter 6) to avoid unreasonable pressure on borrowers to buy from lenders at high prices. The OECD countries have pledged to end the practice of tied aid, but they have not yet applied this pledge to the two most insidious areas: technical cooperation and food aid.

6. How much good would it do the debtor countries if their debt were completely instead of partially written off? What negative effects would result in the creditor countries?

In 1999, the HIPCs paid about $8 billion in debt service on their outstanding stock of debt ($170 billion, nominal). If the debt stock were to

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be completely eliminated, then would the HIPCs get an immediate $8 billion-a-year windfall? We doubt it. During the past two decades (as we explain below and in table 2.1), the HIPCs have continued to receive large positive net transfers of resources—on the order of $10 billion in the second half of the 1990s—over and above their debt-service payments.

We doubt that donor governments (who would have to show in their own budgets the "cost" of the unpaid debt) and multilateral creditors (who would no longer need to make new loans to help countries pay back old loans) would refrain from cutting back, at least somewhat, on new disbursements. In fact (table 2.1) that seems to have already happened in the late 1990s, when despite higher debt relief, total transfers including debt relief not only failed to rise but actually fell. The effects on creditor countries are so tiny in financial terms that it makes no sense to quantify them. And even if the HIPCs got a full $8 billion windfall, there would be a question of equity if part of it came at the expense of other poor countries—countries that may have made better use of the resources in stimulating development and combating poverty.

7. Why is debt a worthwhile focal point when talking about development in poor countries?

Although debt relief is just another form of resource transfer to poor countries, there are (as we explain in chapter 4) good reasons to favor somewhat more debt relief over new grants or loans. Yet even complete debt relief would be only a small step toward reducing poverty and advancing development, and would be small in comparison with the potential benefits of better market access. Even with more debt relief, a seriously stepped-up rich-country effort to commit new resources is crucial.

8. Are children really dying because of the debt burden imposed on poor countries?

We think it is wrong to assert that. Why? Because the poorest, most indebted countries have generally been receiving much more aid each year than what they pay in debt service (table 2.1). In the worst cases, much of their new aid was needed to pay their debt service—but even then they ended up at least slightly ahead. There are, of course, other more fundamental reasons why children are dying, and insufficient resources is one of them.

9. Who are the central players in the debt relief debate, and who should the central players be? Who has the voice, and who should have the voice?

The big players in the debate about debt relief have been:

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(1) the large donor countries—to whom much of the debt is owed, and who have the most influence in the World Bank and the IMF, the institutions that manage the HIPC program—and

(2) nongovernmental activist organizations such as Jubilee, Eurodad, and others mentioned in the text (and see the references), based mostly in those rich countries but with local affiliates in many debtor countries.

Group 1 has been a quiet but powerful player—proceeding with deeper debt relief when it became obvious that the shell game of making new grants and loans to finance debtors' debt service was undermining the logic and effectiveness of development assistance, though then only at a pace and on terms they could financially and politically "afford." Group 2 has created the persistent and healthy pressure on Group 1 needed to make the process deeper, broader, and more transparent.

10. What steps would most advance development in poor countries? Would debt relief even be one of them?

Five steps most critical to reducing poverty and advancing development in today's poor countries are:

- stable and honest government that commands the assent of the governed;
- entrepreneurship to generate good investments and jobs;
- a social contract: adequate health, education, and other social investments that provide economic and social opportunity for all;
- good access to rich-country markets; and
- an additional $50 billion a year in development assistance to build the institutions and finance the programs noted above that can help them escape poverty traps.

But these reflect the opinions of the authors; others might choose other steps.

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