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Debt-Relief Countries Can Make Use of More Policy Space

by Celine Tan

The recent series of debt cancellations under the enhanced Heavily Indebted Poor Countries Initiative (HIPC-I) and the Multilateral Debt Relief Initiative (MDRI) may offer eligible countries opportunities for expanding domestic policy space, enabling countries greater freedom over their macroeconomic and development policies, including options which were prohibited under the restrictive conditionalities of the Bretton Woods institutions.

Specifically, the debt relief will facilitate the release of countries from the economic strictures of conditionality and debt which have crippled economies in developing countries due to the damaging effects of their economic policy prescriptions.

Twenty countries have now reached the end of their HIPC-I process and have been, or will shortly be, granted debt relief from both bilateral and multilateral creditors under the HIPC-I and from four multilateral creditors – the International Monetary Fund (IMF); the International Development Association (IDA), the World Bank's concessional lending arm; the African Development Fund (ADF); and most recently, the Inter-American Development Bank (IDB) – under the MDRI.

Nine other countries are expected to complete the process in the near future and a further 11 countries have met the eligibility criteria for the HIPC-I and are potentially eligible for MDRI relief in the future. In total, 40 countries are eligible or on their way to becoming eligible for debt relief under these programmes. Additionally, two non-HIPCs – Cambodia and Tajikistan – have also received debt cancellation from the IMF under the MDRI.

A significant constraint on national policy space in developing countries in the past two decades has been the uncompromising debt burden shouldered by these countries and the policy prescriptions which accompany country attempts to: (a) reschedule debt owed to external creditors; and (b) mobilise additional external financial resources to meet their resource gaps.

Indebted developing countries have had to implement stringent economic conditionalities (set especially by the IMF and the World Bank) in their bids to renegotiate debt and to secure

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resources necessary for generating economic growth and financing social expenditure.

The completion of the HIPC-I debt relief programme and the upfront and irrevocable cancellation of eligible debt stock under the MDRI may now enable these countries to graduate from the economic supervision of the Bretton Woods institutions. This may provide countries the space to develop their own national development strategies alternative to the policy prescriptions of the World Bank and the IMF.

However, these countries need also to be on their guard in relation to attempts by both the IMF and World Bank to establish new measures and instruments to retain their ability to determine the countries' policies, even after debt relief is implemented.

Increased Policy Space

Post-debt cancellation countries can enjoy more policy space in several ways. Firstly, debt relief frees up fiscal space previously occupied by debt service, as more resources are now available to the government budget.

Secondly, the expanded policy space which accompanies debt relief can facilitate greater government autonomy on how those resources can be utilised. For example, governments now have greater freedom to determine their own priorities for the government expenditure in the budget.

Thirdly, governments now have more freedom to choose from various options for macroeconomic policy, social policies, and medium- and longer-term development policies and strategies, including sectoral plans for agriculture, industry and services.

Fourthly, governments will now have more freedom to choose from a wider range of financing options for project and national development plans from a variety of different sources. The freedom of debt servicing and increased creditworthiness as a result of debt cancellation may lessen countries' reliance on financing from institutions which attach onerous conditions to their lending and grant aid, such as the IDA or the IMF. Countries now have a broader menu of financing options to choose from.

The Multilateral Debt Relief Initiative (MDRI)

The Multilateral Debt Relief Initiative (MDRI) was introduced in September 2005 to operationalise the political outcome of deliberations at the G8 summit in Gleneagles in July 2005. The MDRI is to provide 100% cancellation of eligible debt stock owed by eligible countries to the aforementioned three multilateral financial institutions and is separate from but linked operationally to the enhanced Heavily Indebted Poor Countries (HIPC) initiative.

Under the MDRI, countries which have reached 'completion point' under the HIPC initiative will see their eligible debt stock owed to the IDA, IMF, ADF and IDB cancelled once they qualify.

The debts eligible for cancellation are: (a) for the IMF and the ADF, total debt disbursed before end-December 2004; and (b) for the IDA and the IDB, total debt before end-December 2003 and which are still outstanding to the two institutions at the time of country qualification. Credit amounts not disbursed as of the cut-off dates and new credits approved after these dates would not qualify for cancellation.

Post-'completion point' countries would also have seen their debt stock reduced by the amount decided at their 'decision point' in agreement with bilateral and multilateral creditors. Furthermore, some bilateral and multilateral creditors have granted additional debt relief to the amount agreed to at 'decision point'. Countries had also received some interim and conditional debt relief between 'decision point' and 'completion point'.

In order to reach 'completion point' under the HIPC initiative, countries would have had to demonstrate, among others, that they:

(1) have had a track record of compliance with macroeconomic and structural reforms under an IMF-supported programme - namely under the Poverty Reduction and Growth Facility (PRGF) - for usually three years;

(2) have implemented key reforms agreed at 'decision point' to the satisfaction of the IMF and IDA; and

(3) have 'successfully' implemented a Poverty Reduction Strategy Paper (PRSP) for at least a year.

At this stage, debt relief becomes irrevocable under the HIPC initiative. The debt involved encompasses bilateral, multilateral and commercial debt but in practice, it is mostly bilateral debt from the Paris Club creditors.

These countries will further qualify for multilateral (MDRI) debt relief from the four institutions – the IDA, IMF, IDB and ADF – after reaching completion point if they can demonstrate they have complied with the following criteria:

(1) Their performance had not deteriorated substantially in the following areas: (a) macroeconomic performance; (b) implementation of a poverty reduction strategy (PRS) or similar framework; and (c) their public expenditure management (PEM); and

(2) They are current on their obligations to the financial institutions.

Modalities of MDRI Debt Cancellation

MDRI-qualifying countries will have their eligible debt stock irrevocably cancelled upfront by the four institutions: the IDA, IMF, IDB and ADF. This means that the countries are no longer liable for the debt service falling due on the eligible credits or loans once the decision to cancel has been made. This cancellation is given after any relief is provided under the HIPC initiative. Compensatory financing will be made by bilateral donors to the relevant institutions to finance this debt relief.

At the IMF, the debt relief is provided in the form of a 'trust grant' from the MDRI Trusts of the specified amount to the IMF on behalf of the eligible member state. Section 3(a) of the MDRI Trust Instruments provides that the 'trustee' (in this case, the IMF on behalf of its members and bilateral donors) 'shall repay to the Fund, on behalf of the member, an amount equivalent to the member's eligible debt'.

It would appear therefore that, subject to certain qualifications on HIPC 'topping up assistance', the MDRI Trusts will repay the debt stock owed by eligible countries to the IMF in their entirety. Some Executive Directors at the Fund had considered phased debt relief and/or 'the use of ongoing conditionality linked to the successful implementation of an IMF programme'.

However, the final agreement reflects the majority decision and the proposals outlined in the initial IMF staff paper on MDRI modalities that 'the MDRI should be implemented so as to allow early repayment of the full stock of eligible debt owed to the Fund once the countries qualify for such relief', enabling the MDRI to be implemented 'over a relatively brief period' and minimising administrative costs for the Fund.

Debt relief at the IDA under the MDRI is slightly different as it covers 'all remaining debt service obligations on eligible IDA credits, through the end of their maturity' rather than a cancellation of debt stock outright. This means that under the MDRI, as was its practice under the HIPC initiative, the IDA will provide debt relief 'by irrevocably cancelling the borrower's payment obligations under the eligible credits', including all principal repayments and credit charges, but 'without affecting the other provisions of the credit agreements'.

This means that the MDRI will vary the terms of the individual credit agreements to waive the borrowers' obligations to repay but the effect will be similar to that of debt relief under the IMF, that is, the eligible debt stock will be cancelled upfront. Also like the Fund, once the decision has been made to cancel the debt service obligations, the debt relief is irrevocable. On the accounting front, this means that the debt service obligations are initially classed as 'loan loss' provisions in the IDA's balance sheets and then replaced by 'credit write-offs at the implementation date when each cancellation becomes effective'.

Modalities for debt cancellation under the ADF operate along similar lines as that of the IDA's

with similar impacts on the debtors' future concessional financing flows from the institution, that is, future country allocations by the ADF will be reduced by the amount of debt relief provided and additional resources from the donors will be reallocated to countries using the ADF's own performance-based allocation (PBA) mechanism. The debt relief framework of the recently announced IDB debt deal is also expected to mirror that of the IDA and the ADF.

Post-Debt Relief — Expanded Policy Space?

As discussed earlier, one of the significant constraints on national policy space in developing countries over the past two decades has been the impact of the debt overhang in these countries. This has been both a contribution to and a result of reliance on external development financing to fund the resource gaps faced by countries due to a number of different factors, notably external pressures resulting from the asymmetrical structure of the international trade regime and the international financial architecture.

Relieving countries of their debt overhang therefore may result not only in an increase in domestic fiscal space but also in the expansion of national policy space to enable countries to design appropriate development strategies for economic growth and genuine poverty reduction.

One of the most important consequences of the MDRI is the 'graduation' of post-'completion point' countries from compulsory IMF programmes. As mentioned earlier, for a number of HIPCs, there was little need for a Fund-financing programme as resources from such loans were comparatively minimal.

However, the requirement of an 'on track' IMF programme was critical to a country's efforts to reach 'completion point' under the HIPC initiative and, consequently, to obtain debt relief under the MDRI. All HIPCs therefore had to demonstrate satisfactory performance under a PRGF programme to qualify for irrevocable debt relief under the HIPC initiative and under the MDRI.

Irrevocable and upfront debt relief from the HIPC-I and MDRI eliminates the need for a mandatory IMF programme in countries. The freeing up of fiscal space as a result of resources saved from debt relief means that countries face less balance-of-payments problems and have less need for external resources, including from the Fund.

Meanwhile, the completion of the debt relief process frees countries from the strictures of mandatory IMF supervision of economic policies. The 20 post-'completion point' countries should theoretically not require any monitoring relationship with the Fund aside from their mandated Article IV consultations and the nine 'decision point' countries will do so as soon as they reach 'completion point' and have their eligible debt under the HIPC-I relieved and MDRI cancelled.

The debt relief operations under the HIPC-I and the MDRI may also enable countries to lessen their reliance on other multilateral financing with onerous terms, such as the World Bank's policy-based lending with its stringent policy conditionalities. With increased fiscal space freed up by the elimination of debt servicing, countries may become less dependent on external financing, and particularly balance-of-payments support from the IDA with its policy conditionalities, to meet their resource gaps.

This opens up greater space not only for policy alternatives but also for consideration of alternative forms of financing from different sources, including from international financial markets and a wider pool of official bilateral and multilateral creditors. Countries should take advantage of this expanded policy space to undertake a cost-benefit analysis of different forms of external financing to see which best suits the country.

Cancellation of debt stock has not only enabled the freeing up of fiscal resources in a number of previously heavily indebted developing countries but has also afforded opportunities for expanded policy space for countries to develop national economic policies alternative to the 'Washington Consensus' policy prescriptions which have accompanied financing from the Bretton Woods institutions.

It will also enable the diversification of external financing sources for these countries, enabling

countries to seek resources with more favourable financing terms and the decoupling of financial resources with economic policy reforms. Countries should take advantage of this increased policy autonomy to develop more appropriate policies which will generate economic growth in favour of social and economic development.

New IMF, World Bank Measures to Retain Influence

However, it is crucial that post-'completion point' countries which have had their debt stocks cancelled under the HIPC initiative and the MDRI manage this policy space appropriately.

They should also be aware of and be on guard against corresponding measures currently pursued by the Bretton Woods institutions and other bilateral and multilateral creditors to circumscribe this newly expanded policy autonomy. The IMF and World Bank may want to continue to determine policies in the countries that have had their debts cancelled, in some cases even if these are not tied to new loans.

The measures used by these institutions to ensure their continued influence include:

(1) The introduction of the Policy Support Instrument (PSI) by the IMF, a non-borrowing Fund-monitored programme of reforms that a country may enter into voluntarily with the institution, and

(2) The IDA's new modalities of aid allocation based on the performance of the 'quality' of their policies and institutions and rewarding countries which perform well under the controversial Country Policy and Institutional Assessment (CPIA) with larger volumes and more flexible modalities of financing.

The CPIA has been criticised for its lack of transparency and coherency in performance indicators and the controversial breadth of its coverage, including prescriptions on a range of economic and governance issues, such as a country's 'economic management' and 'quality of public administration' as well as its 'policies for social inclusion/equity'.

Although the CPIA indicators are not formally 'conditionalities' per se, there is pressure for countries to implement certain policies due to its link to World Bank, and especially IDA, financing.

Meanwhile, the PSI enables the IMF to act as a credit-rating agency for low-income countries by signalling economic health to potential creditors and investors. Policy reforms under a PSI will carry the same discipline as that of regular upper credit tranche conditionality and successful completion of a programme review by the IMF Executive Board 'would signify the Fund's assessment that the program is on track', similar to reviews under financed Fund programmes - the only difference being that this does not trigger tranche disbursements.

In light of the policy space freed up by debt relief, countries therefore need to be cognisant of forms of conditionality which may accompany either the 'signalling role' of the IMF or the new financing from the IDA in the post-debt relief period and weigh the cost and benefits of contracting new lending from the Bretton Woods institutions, bearing in mind the expanded space available from debt relief for diversifying sources of financing.

After all, the objectives of debt relief are not only about increasing revenue flows to developing countries but also freeing countries from the economic and political coercion of debt, including redressing the asymmetrical relationship between debtor and creditor nations and debtor nations and international financial institutions. This recent debt cancellation may afford developing countries the opportunity to break out of the cycle of debt and conditionality and to engender genuine 'country ownership' of economic policies.

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