

**Debt and Conditionality:
Multilateral Debt Relief Initiative and
Opportunities for Expanding Policy Space**

CELINE TAN

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Third World Network

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Chapter 1

INTRODUCTION

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 four multilateral financial institutions – the International Development Association (IDA), the concessional lending arm of the World Bank, the International Monetary Fund (IMF), the African Development Fund (ADF) and the Inter-American Development Bank (IDB)¹ – and is separate from but linked operationally to the enhanced Heavily Indebted Poor Countries initiative (HIPC-I).

This debt reduction is additional to the debt relief granted under the HIPC-I and taken together, it is expected that an estimated 40 eligible countries have already been or will be relieved of a significant amount of debt stock in the near future. The World Bank and the IMF estimate that both the HIPC-I and the MDRI will clear a total of close to US\$90 billion in debt owed by developing countries to bilateral and multilateral creditors (Eurodad,

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¹ The IDB is the latest multilateral institution to announce its participation in the MDRI. The institution issued a statement on 17 November 2006 announcing the decision to extend debt cancellation to five eligible Latin American countries – Bolivia, Guyana, Haiti, Honduras and Nicaragua – pending agreement on the modalities to be negotiated in January 2007 (IDB, 2006; Eurodad, 2006). This decision was confirmed by the IDB governors in March 2007 (IDB, 2007).

2006; IDA and IMF, 2006: paras 27-32). Twenty-one countries have already had their eligible debt from the IDA and the IMF written off and nine other countries are expected to complete the process in the near future. A further 10 countries have met the eligibility criteria for HIPC and are potentially eligible for MDRI relief in the future.

A critical question arising from these recent developments in debt relief is whether – aside from relieving the debt overhang of indebted countries and therefore clearing fiscal space for more productive and redistributive expenditure – the cancellation of debt, particularly from the international financial institutions (IFIs), results in greater policy autonomy for the countries concerned.

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 countries have had to implement stringent economic conditionalities – especially those set by the World Bank and the IMF – in their bid both to renegotiate debt and to secure resources necessary for generating economic growth and financing social expenditure.

However, the recent series of debt cancellations – under both the enhanced HIPC and the 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.

This paper examines the key aspects of the MDRI and considers the opportunities this framework and completion of the enhanced HIPC initiative create for indebted countries to expand their policy space.

Chapter 2

THE MULTILATERAL DEBT RELIEF INITIATIVE (MDRI)

THE Multilateral Debt Relief Initiative is essentially a HIPC-plus initiative. It extends cancellation of multilateral debt to HIPC-I-eligible countries² that have successfully completed their HIPC-I programme and have been granted irrevocable debt relief by participating bilateral and multilateral creditors under this programme.

Eligibility of Countries

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, the ADF and the IDB, total debt disbursed before end-December 2004; and (b) for the IDA, total debt before end-December 2003 and which is still outstanding to the institution at the time of country qualification (IDA and IMF, 2006: Table 1; IDA, 2006: para 11; IDB, 2007). Credit amounts not disbursed as of the cut-off dates and new credits approved after these dates would not qualify for cancellation.

² The exception is that non-HIPC countries with per capita incomes of below US\$380 are also eligible for debt relief from the IMF under the MDRI to ensure uniformity of treatment in the use of IMF resources among members – the IMF funds part of the MDRI relief through sales of gold and the rest is funded through bilateral contributions. Consequently, two non-HIPC countries – Cambodia and Tajikistan – are eligible for IMF debt cancellation under the MDRI (see IDA and IMF, 2006: para 5, footnote 2; also IMF, 2006a).

Twenty-one countries have already reached ‘completion point’ under the HIPC initiative and have received or are receiving irrevocable debt relief committed at ‘decision point’ (see Table 1). These countries have also received debt stock reductions from the IDA and the IMF and are expected to receive ADF relief soon (IDA and IMF, 2006: para 9). Eligible Latin American countries will also receive IDB debt relief retrospectively from January 2007. Nine countries which have reached ‘decision point’ under the HIPC-I will receive MDRI debt cancellation once they reach ‘completion point’ (see Table 1). Ten other countries meet the eligibility criteria for the HIPC initiative and may eventually qualify for MDRI relief (ibid).

Under the HIPC initiative, eligible countries – IDA and PRGF³-eligible countries with debt indicators above HIPC thresholds⁴ – start receiving interim debt relief from bilateral Paris Club and multilateral creditors at ‘decision point’ after they have demonstrated (1) a track record ‘of reform and sound policies’ through IMF or IDA-supported programmes and (2) development of a Poverty Reduction Strategy Paper through ‘a broad-based participatory process’ (IMF, 2006b). However, the debt relief here is conditional upon fulfilment of certain conditions.

In order to reach ‘completion point’, countries would have had (1) to demonstrate a further track record of ‘good performance’, including meeting structural and macroeconomic policy reforms, under IMF and IDA programmes; (2) implemented key reforms agreed at the ‘decision point’ to the satisfaction of the IMF and the IDA; and (3) ‘successfully’ implemented a Poverty Reduction Strategy Paper (PRSP) for at least a year (IMF, 2006b).

At this stage, the amount of debt relief agreed at the ‘decision point’ (with bilateral, multilateral and some commercial creditors) becomes irrevocable. Bilateral creditors have also pledged to grant additional debt relief beyond that committed under the HIPC initiative (IDA and IMF, 2006: para 34).

³ The IMF’s Poverty Reduction and Growth Facility, formerly the Enhanced Structural Adjustment Facility (ESAF).

⁴ Usually taken as ratios of the country’s net present value (NPV) of debt to exports exceeding 150.

Post-‘completion point’ countries will **further qualify** for multilateral debt relief under the MDRI 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 (IDA and IMF, 2006: para 9, footnote 7; IMF, 2006a).

Table 1: Breakdown of MDRI-Eligible Countries		
Countries Eligible for MDRI Relief as of November 2006	Countries Eligible for MDRI Relief Upon Reaching ‘Completion Point’ under the HIPC-I	Countries Eligible for HIPC-I Relief and May Qualify for MDRI at a Later Date
Benin, Bolivia, Burkino Faso, Cameroon, Ethiopia, Ghana, Guyana, Honduras, Madagascar, Malawi, Mali, Mauritania, Mozambique, Nicaragua, Niger, Rwanda, Senegal, Sierra Leone, Tanzania, Uganda, Zambia	Burundi, Chad, Democratic Republic of Congo, Republic of Congo, The Gambia, Guinea, Guinea-Bissau, Haiti, São Tomé and Príncipe	Central African Republic, Comoros, Cote d’Ivoire, Eritrea, Kyrgyz Republic, Liberia, Nepal, Somalia, Sudan and Togo

Source: IMF, 2006a: Table 1.

Modalities of Debt Cancellation

MDRI-qualifying countries will have their eligible debt stock irrevocably cancelled upfront by the four institutions, which means that 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. Therefore, the MDRI represents

a cancellation of multilateral debt financed primarily through bilateral sources (although a portion of it will also be funded by the institutions' own resources).

(a) IMF 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 both MDRI Trusts therefore 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' (Section 3(a) of the Instrument to Establish the MDRI-I Trust and the Instrument to Establish the MDRI-II Trust).

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 (IMF, 2005a: para 7d). Although 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', 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 (IMF, 2005b).

(b) IDA debt relief

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' (IDA, 2006: para 14) 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', includ-

Table 2: Main Features of Debt Relief under the HIPC-I and MDRI		
	HIPC Initiative	MDRI
Country Eligibility	IDA and PRGF-eligible countries with debt indicators above the HIPC thresholds and which can demonstrate a track record of 'satisfactory' performance under IDA or IMF programme and 'successful' implementation of a PRSP	HIPC countries having reached 'completion point' and whose macroeconomic performance, implementation of PRS and public expenditure management have not deteriorated since
Participating Creditors	Multilateral, official bilateral and commercial creditors of external debt to HIPCs	Only IDA, IMF, ADF and IDB
Eligible Debt	Portfolio of external public and publicly guaranteed debt decided at 'decision point' necessary to bring debt to 'sustainable' levels	IMF and ADF: All debt disbursed before end-December 2004 IDA and IDB: All debt disbursed before end-December 2003
Debt Relief Provided	Debt reduced to HIPC thresholds as calculated at 'decision point'	Total cancellation of eligible debt outstanding at the time of qualification after the provision of HIPC-I relief
Modalities of Delivery	Different modalities dependent on creditors; interim relief on debt servicing provided at 'decision point'; irrevocable relief at 'completion point'	Irrevocable relief of debt stock at 'completion point'

Source: IDA and IMF, 2006: Table 1; Eurodad, 2006.

ing all principal repayments and credit charges, but 'without affecting the other provisions of the credit agreements' (ibid).

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’ (IDA, 2006: para 22).

(c) ADF and IDB debt relief

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 (ADF, 2006: paras 3.1 – 4.6). The debt relief framework of the IDB debt deal mirrors that of the IDA and the ADF, through its Fund for Special Operations (FSO) (IDB, 2007).

Chapter 3

MDRI AND POLICY SPACE

AS highlighted 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 caused by a number of different factors, notably external pressures resulting from the asymmetrical structure of the international trade regime and the international financial architecture.

These restrictions on national policy space have been exacerbated by conditional debt relief operations, notably under the HIPC initiative, and conditions attached to debt rescheduling, such as those undertaken by the Paris Club creditors. 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.

Debt, Conditionality and Shrinkage of Policy Space

Many countries have had to rely on concessional financing from the multilateral financing institutions, chiefly the IDA and the IMF, or from financing from bilateral donors linked to a Bretton Woods institution-supervised programme to mobilise resources needed for economic growth and meeting public expenditure. Moreover, as many countries also borrowed from the multilateral financing institutions to keep themselves current on

bilateral and commercial debt, this reliance on the IDA and the IMF has resulted in greater encroachment of the institutions into the national policymaking space of debtor countries via the ever-widening remit of policy conditionalities⁵ attached to such financing.

The impact of conditionality is further felt by efforts to restructure debt, including the debt relief negotiations under the HIPC-I and the MDRI. The previous section demonstrated that the process of securing debt cancellation for indebted countries has been quite an arduous process, entailing not only significant political and technical negotiations between bilateral, multilateral and a fraction of private creditors and debtor countries, but also involving the implementation of a range of policy and operational reforms in these countries.

In order to secure debt relief under the HIPC initiative and, consequently, the MDRI, countries have had to implement a plethora of economic conditionalities which, like the structural adjustment programmes which accompanied much of the multilateral debt that is now the subject of debt relief, have resulted in the shrinkage of national policy space. HIPCs have had to undergo extensive macroeconomic and structural reform, including trade liberalisation, privatisation and state retrenchment, and liberalisation of exchange rates and capital accounts, as conditions for debt relief. They have also had to implement prescriptive public expenditure reforms necessitated by the Poverty Reduction Strategy Paper (PRSP) framework.

As a requirement for debt relief, countries have had to implement an IMF programme – specifically under the Poverty Reduction and Growth Facility (PRGF) – for a period of three years to the satisfaction of HIPC-I

⁵ Countless studies have shown the detrimental impact of policy conditionalities on developing countries and the resulting squeeze these policies have on the ability of countries to formulate their own national development strategies (see, for example, the report of the Structural Adjustment Participatory Review International Network (SAPRIN) in SAPRIN, 2004 and also UNCTAD, 2002). These policies have included reforms related to the ‘restructuring and privatization of public enterprises, deregulation of markets, trade regimes, pricing and marketing policy, public sector management, public safety nets, the agricultural sector, the energy sector and more recently issues of political and economic governance’ (UNCTAD, 2002: 16-17).

authorities and the implementation of a Bank and Fund-supervised Poverty Reduction Strategy (PRS) which aims to allocate government expenditure in priority social expenditure areas, such as health and education. This is regardless of whether the country was in actual need of Bank or Fund financing. For example, a number of larger HIPCs had no real need for IMF resources and only assumed liabilities under a PRGF loan to fulfil the criterion under the HIPC initiative.

PRGF conditionalities have included the standard IMF policy prescriptions of tight fiscal and monetary policies which have been shown to have a negative impact on countries' ability to stimulate economic growth and generate resources for social expenditure. This has, ironically, often been at odds with the priorities of the PRSP framework – which is an integral component of the HIPC initiative as well as the PRGF – with its emphasis on poverty reduction.

In fact, the United Nations Conference on Trade and Development (UNCTAD)'s assessment of the PRSP framework in 2002 pointed out that the disjuncture in the restrictive macroeconomic policies espoused by country PRSPs (and operationalised through PRGF financing) and the new emphasis on poverty reduction may have led to trade-offs between capital investment and social spending with consequences for overall economic growth and poverty reduction. According to UNCTAD:

... the emphasis placed on achieving quick results by redirecting public expenditures to social sectors may necessitate large cuts in overall volume of public investment with attendant consequences for sustaining poverty reduction programmes over the longer term (UNCTAD, 2002: 26).

UNCTAD's report also found that close examination of the macroeconomic and structural adjustment policy content of PRSPs demonstrates that 'there is no fundamental departure' from the policies espoused under the old structural adjustment programmes underpinned by the 'Washington Consensus' approach to economic reforms designed to 'get prices right' (ibid: 6-7). Instead, the policies of this 'post-Washington Consensus' involve an ad-

ditional focus on country institutions – ‘getting institutions right’ (ibid) – with a focus on strengthening domestic institutional frameworks to support the macroeconomic and structural reforms of the previous generation of adjustment.

Consequently and paradoxically, while the HIPC-I, PRGF and the other elements of the process of debt relief and this ‘new architecture of aid’ accompanying the PRSP process, were supposed to be based on principles of ‘country ownership’ and ‘participatory policymaking’, there has been no real expansion of policy space nor reduction in the conditionalities attached to stabilisation or adjustment programmes.

According to the same UNCTAD report, ‘the autonomy of countries in designing their own growth and development strategies is circumscribed by the same considerations that dominated the structural adjustment programmes over the past two decades’ although the study, along with some NGO reports, have recognised that countries may have more autonomy in two areas – designing short-term safety nets to offset the costs of adjustment reforms and developing instruments for delivering better redistributive policies, such as expanding and tracking social sector spending (UNCTAD, 2002: 4; 19).

Post-Debt Relief – Expanded Policy Space?

The completion of the HIPC debt relief programme and the irrevocable and upfront cancellation of eligible multilateral debt stock under the MDRI may enable countries to graduate from the economic supervision of the Bretton Woods institutions. While freeing up fiscal space previously occupied through debt service will free up more government resources, the expanded policy space which accompanies the debt relief will facilitate greater government autonomy on how those resources can be utilised and enable the development of national development strategies to generate further new resources.

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 to fund economic growth and poverty reduction.

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, without the constraints of a structural adjustment programme, governments will enjoy more freedom to choose from various options in its macroeconomic policy, social policies, and medium- and longer-term development policies and strategies, including sectoral plans for agriculture, industry and services. In other words, countries may now have the space to formulate national development strategies which are properly tailored to country circumstances.

Lastly, 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.

However, it is also 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 and, more importantly, also be cognisant of corresponding measures currently pursued by the Bretton Woods institutions and other bilateral and multilateral creditors to circumscribe this newly expanded policy autonomy.

(a) Loosening the IMF grip

One of the most important consequences of the MDRI has been and will be 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 fewer 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.

However, there are a number of qualifications to the opportunities for this new policy space.

Firstly, although post-debt relief countries no longer need the resources or a Fund-supervised programme of economic reform for debt relief operations, the IMF still plays an important **signalling**⁶ role for other forms of official development financing, notably from other multilateral creditors, including the IDA, and bilateral donors and creditors, as well as forming a condition for other debt rescheduling at the Paris Club. Therefore, countries which seek financing from these quarters may still require an IMF programme for this purpose unless alternatives to the IMF signalling are explored.

Secondly and consequently, some countries have either implemented or are thinking about implementing the newly established **Policy Support Instrument (PSI)**. The PSI is essentially a non-borrowing or non-financing

⁶ The Fund defines ‘signalling’ as ‘the information that Fund activities can indirectly provide about countries’ performances and prospects’ (IMF, 2005c).

Fund-monitored programme of reforms that a country enters into voluntarily with the institution. Presently, four countries, including two HIPC – Nigeria, Uganda, Cape Verde and Tanzania – have adopted the PSI in the year since its introduction. A number of other post-‘completion point’ HIPCs whose PRGF programmes have expired or are expiring have also expressed interest in implementing a PSI, including Burkina Faso and Ghana.

According to the IMF, the PSI was ‘designed to meet the needs of “mature stabilizers” – countries with an adequate level of official international reserves, and have begun to establish external and net domestic debt sustainability’, including those who ‘no longer need IMF financial assistance and have indicated their desire to “graduate” from the PRGF, while wishing to maintain a close relationship with the Fund, including an endorsement of their policies and performances’ (IMF, 2005c).

Accordingly, the PSI aims to:

- (i) provide a close policy dialogue between the IMF and a member country;
- (ii) provide more frequent Fund assessments of a member’s economic and financial policies than is available through the regular consultation process, known as surveillance;
- and (iii) deliver clear signals on the strength of these policies (ibid).

The PSI is therefore a non-financing, voluntary adjustment programme for all PRGF-eligible Fund members aimed at developing ‘a policy framework that focuses on consolidating macroeconomic stability and debt sustainability, while deepening structural reform in key areas’ (IMF, 2005d: para 2).

Policy reforms will carry the same discipline as that of regular upper credit tranche conditionality, including the fulfilment of policy conditionalities – performance criteria, prior actions, indicative targets and structural benchmarks – within the timeframe established essential for successful completion of programme reviews (ibid: paras 3 & 8). Countries must also complete a PRSP or Interim-PRSP from which the conditionalities are drawn (ibid: para 19).

A PSI can last from one to three years and may be extended to up to four years and reviews are conducted semi-annually (ibid: para 3). Successful completion of a programme review by the IMF Executive Board ‘would signify the Fund’s assessment that the program is on track’ (ibid: para 8), similar to reviews under financed Fund programmes – the only difference being that this does not trigger tranche disbursements.

If a country fails to complete two scheduled reviews, the Fund would assume that ‘this signals substantial shortcomings in the member’s policy implementation and/or the Fund’s capacity to assess the PSI-supported program’ and ‘would therefore signify the lack of Board endorsement of the member’s policies’ (ibid: para 11). For the purposes of signalling, this could mean that any bilateral or multilateral aid or credit financing tied to this programme could be suspended.

In other words, 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, a role which may not be necessary if alternatives to such ‘signalling’ are developed to serve as alternative indicators of economic performance or if bilateral donors begin to untie financing from the IMF’s ‘seal of approval’.

While being cognisant of the impact of the PSI, it is worth bearing in mind that the PSI remains a **voluntary** instrument which, in itself, does not carry financial penalties and while negotiations for external financing may be based on macroeconomic indicators from the Fund, this does not necessarily require such an extensive monitoring device as the PSI.

Moreover, the expanding policy space generated by debt relief and increased creditworthiness will also enable countries to diversify their sources of financing, including from international financial markets and other official bilateral donors, including from China, which may have alternative indicators for rating countries and which may not require an IMF signal as a prerequisite for financing.

(b) Lessening reliance on World Bank financing

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-and-benefit analysis of different forms of external financing to see which best suits the country.

Post-'completion point' countries may, in any case, be limited in the financing that they will receive in the future from the IDA given the impact of the MDRI on new financial flows from the IDA⁷. Under the terms of the MDRI, countries with eligible debt cancelled under the initiative will also see the amount of their foregone debt service in any given year being deducted from its annual financing allocation from the IDA (IDA, 2006: para 31). The compensatory financing provided by bilateral donors to fund the debt relief will then be reallocated to countries in accordance with their performance, including assessments of their policies and institutions (*ibid*). Thus, according to the IDA:

⁷ Similar conditions will be applicable to future flows from the ADF and the IDB whereby the institutions are expected to cut the amount of new financing to client countries by the amount of debt service forgone for each year (see ADF, 2006; Eurodad, 2006).

...new IDA allocations on annual basis to countries receiving debt relief will be composed of their 'gross' PBA [performance-based allocation]-based yearly allocations, minus their debt service foregone in the same year, plus their share of reallocated compensatory donor resources (ibid)⁸.

Under this situation, some countries may receive less total financing from the IDA as they would have had there been no debt relief. Furthermore, the new financing from the IDA would be based on the new Bank and Fund-initiated debt sustainability framework (DSF) which will assess, among others, countries' ability to absorb new debt based on the performance of the 'quality' of their policies and institutions and rewarding countries which perform well under the Country Policy and Institutional Assessment (CPIA) with larger volumes and more flexible modalities of financing (see Tan, 2006: 5-8).

The CPIA has been criticised for its lack of transparency and coherency in performance indicators. 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.

⁸ IDA's resources are allocated to member countries through a combination of: (a) **basic allocations**; (b) **performance-based allocations (PBA)**; and (c) **IDA replenishment conditions**. Each IDA member is allocated a basic resource envelope with special considerations being given to 'blend' countries who may receive less than their quota due their ability to raise financing elsewhere; and to post-conflict countries and countries facing the aftermath of natural disasters who may require more (IDA, 2003: paras 4-5). The IDA's Performance-based Allocation (PBA) is centred on the World Bank's **Country Policy and Institutional Assessment (CPIA)** which 'assesses a country's present policy and institutional framework for fostering poverty reduction, sustainable growth and the effective use of development assistance' (IDA, 2003, para 2) but is also guided by the World Bank's Annual Report on Portfolio Performance (ARPP) which is 'used to determine a score for each country's implementation performance' (IDA, 2003: para 3). A complex scorecard is then determined through the assessments of the CPIA (making up 80%) and the ARPP (20%) and 'a weighted average rating' is calculated based on these ratings and is then multiplied by the IDA's 'governance factor' – a score 'derived from the country's average rating for seven governance criteria that are part of the PBA system' (IDA, 2003: para 3).

The CPIA is also particularly intrusive as it assesses a range of economic and governance issues, such as a country's 'economic management', including scores for its 'management of inflation and macroeconomic imbalances' and 'fiscal policy'; the country's 'structural policies', including scores for 'competitive environment for the private sector' and 'goods and factor markets'; as well as the country's 'policies for social inclusion/equity', such as 'gender', 'social protection and labour', and 'public sector management and institutions', including assessing the country's 'property rights and rule-based governance', 'quality of public administration' and 'transparency, accountability and corruption in the public sector' (World Bank, 2005).

Countries therefore need to be cognisant of forms of conditionality which may accompany 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. Moreover, debt relief operations may have also increased the general creditworthiness of countries on the international financial markets, creating a greater portfolio from which countries, especially more mature HIPC's, may be able to secure financing on less onerous terms.

Chapter 4

CONCLUSION

THE recent upfront and irrevocable cancellation of debt of the 21 post-‘completion point’ countries and the potential debt relief for the nine ‘decision point’ countries in the near future under the enhanced HIPC initiative and the MDRI will create opportunities for greater policy space in these countries. 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 effect of their economic policy prescriptions.

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.

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 asymmetri-

cal 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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DEBT AND CONDITIONALITY: MULTILATERAL DEBT RELIEF
INITIATIVE AND OPPORTUNITIES FOR EXPANDING POLICY SPACE

THE Multilateral Debt Initiative (MDRI) was introduced in September 2005 to operationalise the political outcome of deliberations at the G8 summit in Gleneagles in July that year. The MDRI is to provide 100% cancellation of eligible debt stock owed by eligible countries to four multilateral financial institutions, including the World Bank and the International Monetary Fund (IMF), and is separate from but linked operationally to the enhanced Heavily Indebted Poor Countries (HIPC) initiative.

A critical question arising from these developments in debt relief is whether – aside from relieving the debt overhang of indebted countries and therefore clearing fiscal space for more productive and redistributive expenditure – the cancellation of debt, particularly from the international financial institutions (IFIs), results in greater policy autonomy for the countries concerned.

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 stringent economic policy prescriptions accompanying debt renegotiations and access to financing from the IFIs. However, the recent series of debt cancellations – under both the enhanced HIPC and the 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 not allowed under the restrictive conditionalities of the Bretton Woods institutions.

This paper examines the key aspects of the MDRI and considers the opportunities this framework and completion of the enhanced HIPC initiative create for indebted countries to expand their policy space.

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