CSIS AFRICA NOTES
A publication of the Center for Strategic and International Studies, Washington, D.C.

Number 189 October 1996

Africa's Debt Burden: Proposals for Further Forgiveness

by Jonathan E. Sanford

At their October 1996 joint annual meeting, the World Bank and the International Monetary Fund (IMF) will consider a new proposal for reducing the foreign debt burden of the world's poorest countries. Sub-Saharan Africa would be the principal beneficiary.

The African Situation

Most analysts agree that sub-Saharan Africa is seriously burdened by foreign debt. (Unless otherwise noted, all figures on sub-Saharan Africa appearing in this paper exclude South Africa and Namibia, in order to give a more accurate picture of the situation facing Africa's nonindustrial countries. "Africa" is sometimes used as shorthand for the sub-Saharan region.) The problem is not the absolute size of the debt ($199 billion). Other regions owe much more. Rather, the burden arises from the size of the debt relative to the area's struggling economies. As Table 1 indicates, the region's 1995 debt equaled 119 percent of its combined gross national product (GNP)—three to four times the ratio for most other developing areas. Similarly, sub-Saharan Africa's debt was almost four times as large as its export income. Although Africa spends a lower proportion of its export income on debt service than does Latin America or South Asia, the Latin region has a higher per capita income and South Asia's record of sustained economic growth has eased its debt-repayment burden. Africa, by contrast, has experienced grinding poverty and persistent economic decline. The subcontinent is simply too poor to service its debt and meet its basic economic requirements at the same time.

Unlike some developing regions, sub-Saharan Africa owes most of its long-term foreign debt (81 percent) to official bilateral or multilateral creditors rather than to private lenders (see Table 2). This means that creditor country governments will have to play a leading role in any alleviation of African debt.

The multilateral development banks (MDBs) and the IMF are currently the only categories of foreign creditors whose new lending to Africa exceeds repayments to them in connection with old loans (i.e., they are making a positive net transfer of resources to the region). In 1994, the MDBs disbursed $4.901 billion in new money to the sub-Saharan region while they received $3.369 billion in debt-service payments. The World Bank accounted for most of the MDB total. Nearly all its loans to Africa were made on concessional terms. The IMF disbursed $918 million for new "purchases" while it received $598 million for "repurchases" and charges. Most of the IMF's new credits to the region are via its concessional loan "window," the Enhanced Structural Adjustment Facility (ESAF).

Bilateral creditors disbursed $1.34 billion in new money to the sub-Saharan region in 1994, while receiving $1.893 billion in principal and interest payments. Bilateral loans are not the whole picture, however. According to the World Bank, outside governments made grants totaling $11.5 billion in 1994 and $13 billion in 1995 to aid sub-Saharan Africa. As described below, they also forgave several billion dollars in bilateral debt owed by African and other low-income countries.

Private creditors disbursed $804 million in new money to the subcontinent in 1994, while taking out $2.31 billion in debt service. They also forgave about $2.68 billion owed them by African countries between 1991 and 1995 and extinguished $189 million through debt swap agreements, thereby eliminating some 7.8 percent of the total that had been owed to them in 1990.

Access to Imports

Sub-Saharan Africa's ability to import would probably be enhanced by a reduction of its debt-service burden. Those countries currently servicing their debts could free up some of the money hitherto spent for that purpose to purchase imports needed for development. For those countries not servicing their debts, a debt reduction might remove a factor discouraging investment by private investors and lenders.

Such outcomes are not automatic, however. Countries would need to discipline themselves so that, after debt forgiveness, money now earmarked for debt service would not be dissipated on consumption or military equipment. Likewise, African countries wanting to attract investors would still need to adopt policies fostering economic growth as well as political reforms promoting stability, accountability, and effective government.

Bilateral Debt Forgiveness

For several years, creditors have realized that many severely indebted low-income countries cannot repay all they owe. The Group of Seven (G-7) countries—the United States, Germany, Japan, France, Britain, Italy, and Canada—have taken the lead in devising plans to deal with this situation. Those plans have been put into effect by the Paris Club, an informal forum where debtor countries can reschedule or restructure the debts they owe bilaterally to foreign governments.

In 1988, following a G-7 meeting in Toronto, the Paris Club approved a menu of options, known as Toronto Terms, whereby creditor countries could forgive up to one-third of the net present value of eligible debt owed them by low-income countries. Normally, the Paris Club only reschedules debt payments either currently in arrears or due in the next 18 to 24 months. Previously rescheduled debt and payments for debt contracted after a cutoff date (usually one prior to the country's decision to seek Paris Club help) are generally not eligible for rescheduling. Between 1988 and 1991, the Paris Club rescheduled on Toronto Terms $5.4 billion owed by 19 African countries and $0.3 billion owed by one other country.

In 1991, following a G-7 meeting in London, the Paris Club agreed to expand its debt forgiveness menu. Called Enhanced Toronto Terms (or, more recently, London Terms), the new arrangement provides for forgiveness of up to half the debt eligible for rescheduling owed by low-income countries. Between 1991 and 1995, under Enhanced Toronto Terms, the Paris Club rescheduled about $5.5 billion owed by 20 African countries and $3.6 billion owed by three other countries.

In December 1994, following an earlier G-7 meeting in Naples, the Paris Club agreed that, instead of simply writing off some arrears and upcoming payments, creditors could eventually forgive as much as two-thirds of the total debt owed them by eligible countries. In 1995, the Paris Club rescheduled on Naples Terms $987 million owed by eight African nations and $476 million owed by four other countries. Another $110 million of Uganda's debt was rescheduled immediately.

Until 1993, the United States chose not to forgive any debt through the Paris Club. In 1989 and 1991, however, Congress adopted legislation authorizing the president to forgive debt owed by low-income countries. Under these rules, the United States forgave $2.65 billion owed by low-income countries (including $1.08 billion owed by sub-Saharan African nations). Many of these countries had all or most of their debt forgiven.

In 1992, according to U.S. Treasury figures, the 28 countries that seemed eligible for Paris Club debt forgiveness owed the United States $4 billion. Almost three-quarters ($2.8 billion) was owed by four countries (Liberia, Somalia, Sudan, and Zaire) that lacked governments or had governments that few wished to reward through debt forgiveness. Bilateral debt owed to the United States amounted to only a small fraction of the $71 billion the 28 countries owed their bilateral creditors or the $104 billion they owed all official creditors.

In 1993, the Clinton administration announced and Congress approved plans for U.S. participation in Paris Club debt forgiveness agreements. In 1993 and 1994, the U.S. government forgave through the Paris Club another $1.7 million each owed by Niger and Senegal.

The Traditional Multilateral Stance

Opposition to Forgiveness/Rescheduling. Thus far, the international financial institutions have rejected any notion of writing off debt owed them by borrower countries. The IMF says that its key role in the world monetary system precludes such concessions. The MDBs, meanwhile, have argued that debt forgiveness might force them to pay more for their loans and that they would have to pass this increased cost on to their borrowers. This would amount to asking middle-income countries to pay the price of forgiving debt owed by low-income borrowers.

CSIS AFRICA NOTES is a briefing paper series designed to serve the special needs of decision makers and analysts with Africa-related responsibilities in governments, corporations, the media, research institutions, universities, and other arenas. It is a publication of the African Studies Program of the Center for Strategic and International Studies, Washington, D.C. CSIS is a private, nonpartisan, nonprofit policy research institute founded in 1962.

Editor: Chairman of African Studies Helen Kitchen
Deputy Editor: J. Coleman Kitchen

SUBSCRIPTION RATE: *CSIS Africa Notes* is sent first class to subscribers worldwide. The annual subscription price for 12 issues and occasional supplements is $60. Please make checks payable to:
CSIS Africa Notes, 1800 K Street, N.W., Washington, D.C. 20006, U.S.A.
Telephone: (202) 775-3219. Telex: 7108229583.
Cables: CENSTRAT. Fax: (202) 775-3199.

ISSN 0736-9506

Expanded MDB Lending. Instead of forgiving debt, the MDBs have lent more to low-income areas. Disbursements to sub-Saharan Africa from the World Bank's concessional loan "window," the International Development Association (IDA), grew from $424 million in 1980 and $1.69 billion in 1988 to $2.89 billion in calendar 1994. An additional $928 million was disbursed to these countries in 1994 by the African Development Fund (the concessional loan "window" of the African Development Bank) and other multilateral institutions (mostly Arab-financed).

IDA loans are available only to the world's poorest countries. They are repayable over a period of up to 50 years without interest but with a three-fourths of 1 percent annual service charge. The amount owed by African countries to IDA grew tenfold between 1980 and 1994, from $2.58 billion to $25.16 billion. Their annual debt-service payments to IDA grew correspondingly from $22 million in 1980 to $251 million in 1994. The annual net transfer on debt from IDA to sub-Saharan Africa has grown from $403 million in 1980 to $2.64 billion in 1994.

Meanwhile, because the World Bank is making few loans to these countries through its market-rate loan "window," the International Bank for Reconstruction and Development (IBRD), their outstanding debt to the IBRD has declined from a peak of $9.18 billion in 1990 to $8.07 billion in 1994. IBRD disbursements fell to $392 million in 1994; African repayments to the IBRD exceeded this amount by $1.37 billion. The other MDBs received $152 million more from Africa in 1994 for debt service on market-rate loans than they disbursed in new loans.

Other Steps. In 1989, the World Bank created a Debt Reduction Facility for IDA-Only Countries, to help low-income countries retire at deep discounts some of their debt to commercial banks. It transferred $100 million to the Facility that year, using some of the IBRD's net income, and transferred another $100 million to the Facility in 1994 from the same source. Using these funds and money contributed by donor countries, the Debt Reduction Facility made grants through August 1996 totaling $361 million to 12 low-income countries. With this help, the recipients were able to buy back and extinguish (at an average 13 cents per dollar) $2.82 billion in principal owed to commercial banks. Eight sub-Saharan African countries expunged $1.11 billion in debt.

The World Bank has also sought to help some of its low-income borrowers handle their outstanding IBRD debt. In 1988, it created the Fifth Dimension program, which assists heavily indebted poor countries that were previously creditworthy enough to borrow from the IBRD but are now eligible to borrow only from IDA. Under the program, they can borrow extra money, as part of new IDA adjustment loans, to cover the current interest cost of their old IBRD loans. In effect, the program turns IBRD debt into IDA debt for a year, at least as far as interest costs are concerned. Between 1989 and 1994, these loans financed roughly 25 percent of the IBRD debt service due from participating countries. Of the 17 recipients of Fifth Dimension loans, 11 were African countries.

The New World Bank/IMF Proposal

Since 1994, the United Kingdom and subsequently other major industrial countries have been pushing the multilateral institutions publicly to do something about the multilateral debt problem. Consequently, in 1995 and 1996, the World Bank and the IMF started drawing up a plan.

On September 14, 1995, the *Financial Times* (London) reported on a draft World Bank internal study of the debt issue. In July 1995 a Bank task force had proposed that the Bank and the IMF create a new multilateral debt facility (MDF) to help poor countries retire some of their debt to the multilateral institutions. The World Bank staff estimated that $11 billion—obtained from IBRD net income and contributions by bilateral donors—would be needed over several years. The IMF, Japan, and other major countries reportedly opposed the proposal, although U.S. officials said they were "cautiously positive."

On March 6, 1996, the World Bank and IMF staffs sent a revised plan entitled *A Proposed Initiative for Assisting Heavily Indebted Poor Countries* to their executive directors. The principal goal remained reduction of overall poor-country debt to sustainable levels. Now, however, a multistage process was envisaged in which most of the debt reduction would be carried out through increased forgiveness by bilateral and commercial creditors. Debt owed to the multilateral institutions would be reduced only after the other creditors had written off most of the debt the poor countries owed to them.

The World Bank and IMF executive boards endorsed the debt plan in early 1996. Subsequently, the joint World Bank/IMF Development Committee—a high-level panel composed of finance ministers from key World Bank and IMF member countries—approved the plan's basic principles at its April 23, 1996 meeting in Washington, D.C., but called for refinement of certain details. The Development Committee asked the World Bank and IMF staffs to consult broadly and prepare an action program for consideration at the next IMF/World Bank annual meeting.

At a late June 1996 economic summit meeting in Lyons, France, the leaders of the G-7 countries announced their support for the World Bank/IMF debt plan, endorsed a proposal that the IMF sell some of its gold ("resources held by the IMF") to finance increased ESAF lending, and concurred that bilateral creditors should go "beyond the Naples terms" in forgiving bilateral debt owed by poor countries.

World Bank President James Wolfensohn announced, at the G-7 meeting, that he would ask the Bank's governing board to transfer $500 million from IBRD net income to help finance multilateral debt relief. The G-7 welcomed his proposal and suggested that the World Bank allocate $2 billion for this purpose in future years. They said that the regional MDBs should take similar steps to alleviate the debt burden of their poorest borrowers.

Sustainability and Eligibility. Under the World Bank/IMF plan, each participating borrower would have enough debt forgiven to reduce its debt burden to sustainable levels. The

Table 1

Income and Debt Burden of Developing Areas (1995)

Region	Foreign Debt ($ billion)	Debt per Capita ($)	Debt-GNP Ratio (%)	Debt-Export Ratio (%)	Debt-Service Ratio (%)	GNP per Capita ($)	Avg.Annual Growth (1980-93) (%)
Sub-Saharan Africa*	199	384	119	389	20	362	-0.8
Latin America	607	1,302	40	254	30	1,003	-0.1
East Asia/Pacific	373	276	29	83	11	951	6.4
South Asia	168	140	39	246	25	362	3.0
Eastern Europe/ Central Asia	380	768	36	145	15	2,127	-0.3
Middle East/ North Africa	217	827	40	137	14	2,054	-2.4

*Excluding South Africa and Namibia (except for annual growth rate figure).

SOURCES: *World Development Report* 1995 (World Bank); Africa data supplied by World Bank.

plan defines "sustainability" as a situation in which the ratio of the present value of a country's foreign debt to its export income is in the 200 to 250 percent range and the country's debt-service ratio (the ratio of debt-service payments to export income) is between 20 and 25 percent. Criteria for eligibility include a per capita income below the IDA operational threshold ($865 per year) and an economy that is not creditworthy. The latter criterion excludes "blend" countries (which borrow some of their World Bank funds from the IBRD) such as India, China, Nigeria, and Zimbabwe. The World Bank and IMF staffs estimate that 8 to 12 countries have "unsustainable" debt burdens, as defined by the plan, and that another dozen are "possibly stressed" and might need debt relief under the plan.

Amount and Pace of Forgiveness. In the first stage of the World Bank/IMF plan, the Paris Club would continue rescheduling poor-country debt on Naples Terms. Creditors would then conduct a case-by-case examination of each debtor's situation. If the Paris Club's application of Naples Terms had brought a country's debt ratios down to sustainable levels, no further forgiveness by the multilateral institutions would be contemplated. However, if a country's debt-service or debt-export ratios were still too high, or if special problems made its situation precarious even at "sustainable" levels, the World Bank/IMF plan provides for a new round of debt forgiveness.

In this second stage, all bilateral creditors would be asked to reduce the net present value of the debt owed them by the debtor country by 90 percent of its original level. Commercial creditors would also be asked to write off 90 percent of the debt owed them. In some instances, this could be accomplished by broadening the list of debt eligible for adjustment through the Paris Club process.

Table 2

Sub-Saharan Africa's Long-Term and IMF Debt (1994)

Creditors	Share of Debt (%)	Share of Repayments (%)	Net Transfer on Debt ($ billion)
Bilateral	46	23	-0.55
MDBs	31	41	1.53
Private	19	28	-1.50
IMF	4	7	0.32
(Amount in $ billion)	(162.5)	(8.2)	(-0.20)

SOURCE: World Bank.

At the end of three years, if 90 percent of the bilateral and commercial debt had been written off and if the country had successfully implemented the required reforms (see below), the World Bank and the IMF would take another look at the country's debt situation. Only at this point, if the debt burden were still too heavy, would the World Bank expunge enough debt to make the burden sustainable.

The IMF plays a crucial role in the multilateral debt plan. To receive Paris Club debt forgiveness, countries must have in place a stabilization or adjustment program approved by

the IMF. Most heavily indebted low-income countries cannot afford the rate (4.3 percent annually, as of July 1996, repayable three years from the date the funds are drawn) the IMF charges for its regular standby loans. Consequently, the IMF provides most of its assistance to these countries via the ESAF, its concessional loan facility. ESAF loans are repayable over 10 years at an interest charge of one-half of 1 percent. Under the World Bank/IMF plan, the ESAF's resources would be expanded substantially and the repayment period for ESAF loans would be doubled to 20 years.

The IMF estimates that by 2005, as the flow of repayments increases from the Structural Adjustment Facility (the ESAF's predecessor), the ESAF will be largely self-financing. The ESAF's existing resources will be largely exhausted, however, by 1999. Between that year and 2005, the ESAF will have insufficient funds to meet the increased pace of new IMF financing that the World Bank/IMF debt plan will require. Under the plan, the IMF will be expected to provide a major share of the funding needed to close the anticipated gap in ESAF resources.

Conditionality. To qualify for second-stage debt relief under the plan, debtor countries would need to undertake a three-year program of economic adjustment and reform in "partnership" with the World Bank or the IMF. The goals and performance criteria for the three-year program would probably be comparable to those of regular adjustment (standby or ESAF) programs.

Who Pays? No debt owed to the MDBs or the IMF would be formally forgiven. Instead, the World Bank would channel contributions from IBRD net income and bilateral donors into a special fund that would be used to pay off some of the debt owed to the MDBs. The IMF would also reduce the net present value of its claims on a country by making it new ESAF loans. Thus, the poor countries' debt burden would be reduced in a manner that allowed the international financial institutions to preserve their record of never rescheduling or forgiving debt.

IMF Managing Director Michel Camdessus proposed in early 1996 that the IMF use 10 percent of its gold reserves to help close the anticipated gap in ESAF resources. The IMF lists most of this gold on its books at the original value of SDR 35 (about $50.78 as of mid-1996) an ounce. Camdessus said that some IMF gold could be sold (the market rate being about $395 an ounce in mid-1996), with the proceeds going to the ESAF to fund additional concessional lending to low-income countries.

The IMF articles of agreement require an 85 percent vote by the membership before the IMF can sell gold. Several countries (notably Germany, France, and Switzerland) have expressed strong reservations. Some have suggested that the IMF should instead borrow money, using part of its gold as collateral. That money could be used directly (or it could be invested and the profits lent instead) to facilitate debt relief for poor countries. Camdessus has reportedly decided, meanwhile, that fewer countries than he originally thought are likely to contribute to the ESAF. Consequently, he has reportedly proposed that the IMF sell or pledge more gold (perhaps 15 percent of the total) to help finance the anticipated increase in ESAF lending.

The World Bank and IMF staffs say that the debt plan will require an additional $7 billion to $8 billion in debt forgiveness (in present value terms) over and above the forgiveness already available from the Paris Club on Naples Terms. If bilateral and commercial creditors write off 90 percent of the debt owed to them, multilateral debt relief will (the IMF and World Bank staffs estimate) account for about one-third of the above total.

Alternatives to the World Bank/IMF Plan

Many analysts consider the official World Bank/IMF debt relief plan incomplete and inadequate. A number of alternative plans have been circulated that call for greater levels of multilateral debt relief. Four examples:

Option 1: A Multilateral Facility to Cover Payments. One option would have the multilateral institutions manage a fund to cover the poor countries' multilateral debt payments for an extended period. To qualify, debtor countries would need to undertake major reforms in their economic policies, procedures, and institutions.

One proponent of such a solution is Matthew Martin (a British international financial analyst). In a recent report prepared for the "Group of 24" developing countries, he endorses the World Bank staff's July 1995 proposal that the Bank and the IMF create a multilateral debt facility, but argues that the $11 billion price tag cited at the time was unnecessarily alarming. Because the MDF would not cancel debt up front, the full $11 billion would not be needed right away. Rather, Martin says, the money would be spent over the course of 15 years (at a rate somewhere between $467 million and $734 million annually) to help poor countries make their scheduled multilateral debt payments as long as they continue pursuing acceptably sound economic policies.

It is important, Martin emphasizes, that the resources used to fund multilateral debt relief be "additional"—not the same resources the MDBs and the IMF would otherwise use to fund new loans to poor countries. A considerable amount of aid is currently being lost, he claims, to "subtractionality." Bilateral aid is diverted from development purposes to help poor countries meet their multilateral debt-service obligations. Many MDB loans are defensive in nature, designed mainly to help countries meet their multilateral payments. Multilateral debt forgiveness would mean that new bilateral and multilateral aid could go for development programs rather than for merely paying the cost of old aid loans.

Option 2: A Multilateral Facility to Clear Debt. A second option would have the multilateral institutions create a multilateral debt facility for the purpose of reducing the size of the poor countries' multilateral debt. Arguably, this would cut debt-service payments and lay the groundwork for new inflows of foreign private credit and investment. Percy Mistry, a British international financial analyst and former World Bank staffer, is a proponent of this

view. He characterizes the World Bank/IMF plan as seemingly having been designed more to protect the multilateral institutions than to help the poor countries. He wants his proposed MDF to be independent of the MDBs and the IMF, to keep them from using it to protect themselves at the expense of other creditors.

Option 3: Forgive More MDB Debt Promptly. The third option would cut the poor countries' debt to multilateral institutions promptly and substantially, targeting the benefits of debt relief primarily to the poor. One adherent of this view is the charitable organization Oxfam International, which argues that the World Bank/IMF plan underestimates the number of countries likely to qualify for assistance and the cost of providing relief.

While agreeing that debt relief should be conditioned on debtor willingness to adopt needed policy reforms, Oxfam does not accept that the IMF should take the lead in monitoring compliance or that the IMF's standard prescription for stabilization or adjustment should be the benchmark for measuring cooperation. Instead, Oxfam argues that the conditions for debt relief should be based on targets that reflect local conditions and are consistent with the goal of reducing poverty. In particular, the multilateral institutions should require debtors to use any funds freed up by debt forgiveness for new investments aimed at meeting basic human needs.

Option 4: Forgive All Debt Owed by Poor Countries. Some observers want multilateral creditors to forgive much or all poor-country debt. Proponents of this view include the Fifty Years Is Enough Campaign and the British-based Jubilee 2000 Campaign, as well as many church bodies.

The Fifty Years Is Enough Campaign calls on the World Bank to write off everything owed to the IBRD by severely indebted low-income countries (per capita GNPs below $675) and half of the IBRD debt owed by severely indebted middle-income countries (per capita GNPs between $676 and $2,695). The Campaign also wants the IMF to forgive all low-income country debt and half of all middle-income debt. If this were done, the World Bank would forgive about $7 billion owed by low-income countries and about $17 billion owed by middle-income countries. The IMF would write off $6.7 billion owed it by low-income countries and $13.4 billion owed it by middle-income debtors. For sub-Saharan Africa alone, the World Bank would write off about $7.9 billion and the IMF $6.3 billion in debt.

The Jubilee 2000 Campaign calls for the extinguishing of all debt owed by 35 African countries to private or official creditors—a step that would expunge (using World Bank figures for 1994) some $74 billion owed to bilateral creditors, $50 billion owed to MDBs, $7 billion owed to the IMF, and $31 billion owed to commercial creditors (see Table 2).

Many proponents of maximum debt relief want all multilateral debt forgiveness to be unconditional, often arguing that the economic policies associated with adjustment or stabilization plans hurt the poor and inhibit real development. In addition, they see debt reduction as only a first step. The Jubilee 2000 Campaign, for example, says that increased flows of assistance from the creditor countries will be needed for many years to produce long-term improvements in the borrower countries' situation.

Can Debt Relief Succeed?

Amount and Pace of Forgiveness. Sub-Saharan Africa's debt problem is probably more a symptom than a cause of the region's prolonged economic malaise. Nevertheless, most analysts agree that the debt burden is a major impediment to economic development and some type of debt forgiveness is required.

Should most of the debt owed by poor countries be expunged or should it simply be reduced to "sustainable" levels? In many respects, as Christopher Barrett, an economics professor at Utah State University, notes in a paper prepared for the 1996 International Studies Association conference, the "central point of confusion in the debate about African debt forgiveness is the amount of growth stimulus one can reasonably expect." Some analysts argue that a substantial and rapid reduction of the poor countries' stock of debt is a prerequisite for sustained economic growth. Others say that more real growth will result if the forgiveness process is gradual and focused primarily on reducing the poor countries' annual debt-service obligations.

Each side quotes econometric studies supporting or rejecting the proposition that the ratio of debt to income (the "debt overhang") is high enough in the case of the heavily indebted poor countries to harm economic development by discouraging investment and economic policy reform. The sides also disagree on the economic impact of other factors besides debt (e.g., corruption, political instability, and regional conflict) and on the possible impact of debt forgiveness on such concerns.

In addition, there is controversy over which option would better promote debtor-country adoption of new economic policies and procedures. Some argue that the debtors will adopt major economic reforms voluntarily once they are freed from the burden of excessive debt. Others believe that once a debt is forgiven, the creditor loses its leverage on the debtor country; therefore debtors will be more likely to adopt and follow through on reforms (which may be painful and costly in the short run) if creditors make their willingness to continue the process of expunging debt over time conditional on continued reform. The latter approach would probably be more acceptable to creditor-country governments, in part because gradual debt forgiveness would cost them less.

Both strategies seek to reduce debt-service payments, encourage economic reform, and attract private investment in the low-income countries. Large amounts of concessional debt would have to be forgiven up front to produce a modest decline in a country's annual debt payments. The same effect could be achieved by guaranteeing coverage for the poor countries' debt payments as they come due and requiring good performance as a condition for continued eligibility. Thus, the proponents of rapid and substantial

debt reduction have not yet made the case that their approach would be more effective than a gradual one.

Most analysts see continued infusions of bilateral and multilateral aid and private loans and investments as important to the development of the poor countries once their debt burden has been relieved, but foreign aid donors and private-sector entities might be less inclined to put money there after having written off large debts by these countries. Low-income countries could find themselves worse off if debt relief means that new aid flows decline along with their indebtedness.

In the United States, for example, Congress must appropriate a sum equal to the actual present value of a bilateral loan before the loan can be forgiven. This appropriation will probably be charged against the budget of the agency on whose books the loan is carried. If large amounts of debt are written off, agencies may have little money available to fund other activities.

As of December 1994, countries in sub-Saharan Africa (not all of them eligible for Paris Club forgiveness) owed $5.951 billion to the United States for long-term foreign aid or export finance loans. If the net present value of this debt were, say, half its face value, Congress would have needed to appropriate about $3 billion to cancel the loans. In fiscal 1994, the U.S. government committed $3.25 billion for development, food aid, and emergency relief programs around the world. Thus, a 1994 decision to forgive all long-term African debt would have left almost nothing to fund U.S. aid anywhere in the world. (It should be noted that, in most cases, the annual debt payments made by African countries to Washington are only a small fraction of what they receive in new grant aid.)

The multilateral banks too have limits on their ability to absorb losses. Debt written off by their market-based loan programs (IBRD, etc.) would have to be charged against the banks' reserves or other assets. The multilateral development banks finance their market-based loans with borrowed funds. Even if they appraised the loans they forgave at less than face value, the MDBs would still have to pay their creditors the full face value of the debt they had incurred to fund those loans.

If the MDBs use an excessively large share of their financial assets to fund debt relief, their creditors will probably demand higher interest rates on the bonds the MDBs sell to fund their operations. This in turn would force the MDBs to charge higher rates of interest to middle-income borrowers. The middle-income countries would probably oppose any plan that might lead to such an outcome. Likewise, the advanced industrial countries, which own a majority of the World Bank's voting stock, are unlikely to support any plan that substantially increases their financial risk and IBRD liability.

In short, a debt plan aimed at immediate reduction of debt overhang may be too expensive to be workable. In contrast, a plan that focuses on reducing the burden of debt service would not require large up-front expenditures. A creditor could simply agree to waive collection of debt payments as they come due. Spreading the process out over time would make debt reduction affordable. Moreover, private entities might be more willing to risk money in a country if they knew that its future debt payments would be "sustainable" for a significant period than if they knew only that its debt burden was "sustainable" at one particular time.

Sustainability and Eligibility. The question of what constitutes a "sustainable" level of debt (the criterion that largely determines whether a country is considered eligible for multilateral debt relief) is marked by some controversy, but the differences between the World Bank/IMF position and those of most critics do not appear significant. Everyone seems to agree that whatever threshold is eventually adopted should not be applied mechanistically and that other factors should also be taken into account in determining relief eligibility.

The World Bank and the IMF seem to believe that they should be the final judges of whether a country's debt burden is "sustainable," while others argue that debtor countries should have a say in the determination, on the grounds that they know their situation best. Concern has also been expressed that the multilateral institutions might be tempted to protect their own interests at the expense of the debtors if they had sole power of judgment. The fact that the World Bank and the IMF claimed that only 12 countries were clearly eligible and another 12 were possibly eligible for relief under their debt plan might give some credence to this argument. The data in the World Bank's 1995 *World Debt Tables* show that many other countries not on the Bank/IMF list had debt ratios well in excess of the Bank/IMF's stated threshold for "sustainability." Evidently, countries are considered ineligible if they are already undertaking reforms. Some of the countries that do seem eligible will likely be disqualified because of their reluctance to reform.

It remains unclear whether bilateral aid should be counted in the calculation of a country's debt "sustainability." The World Bank/IMF plan appears to assume that present levels of bilateral aid will continue and that the aid can be used to offset debt-service obligations. Critics argue that bilateral grant aid is likely to decline in future years due to budgetary pressures in donor countries and that in any case these funds are not always available to help countries service debt because they are often earmarked for particular development projects. Neither argument seems fully convincing; uncertainties and counterarguments abound. How this question is resolved will have a strong impact on the ultimate feasibility of the World Bank/IMF plan and on the number of countries that will qualify for debt relief under the plan.

Who Pays? The World Bank and the IMF assume that they will need to spend about $2.3 billion to $2.6 billion to reduce the poor countries' debt to sustainable levels. The Fifty Years Is Enough Campaign argues that they should spend $13.7 billion to forgive debt owed by low-income countries and another $30.4 billion to help heavily indebted middle-income countries. Other analysts quote price tags ranging from $7-$11 billion (payable over 15 years) to $15-$18 billion (payable now).

The multilateral institutions could use several resources to help offset the cost of a debt-reduction program. Prominent among these are their financial reserves. Many analysts say these should be depleted, in whole or in part, to fund multilateral debt relief for poor countries.

The Fifty Years Is Enough Campaign calls on the World Bank to deplete its IBRD reserves to cancel debt owed by low- and middle-income countries. This proposal may be based on a misperception of the role of the Bank's reserves. The IBRD would probably not go out of business if it depleted its reserves in this manner, but it almost certainly would have to raise its interest charges and substantially restrict its operations. This would considerably reduce its effectiveness as a development and lending institution.

Other analysts suggest that the IBRD could spend $2-$4 billion from its reserves to fund debt relief for poor countries without injuring its financial stability. This may be feasible. The IBRD's retained earnings (the largest component of its reserves) totaled about $15.5 billion in 1995; the ratio of retained-income reserves to outstanding loans was 10.4 percent. Reducing IBRD reserves by $2.5 billion, as Matthew Martin proposes, would lower the reserve-to-loan ratio to 8.4 percent. Reducing IBRD reserves by $4 billion, as Percy Mistry and Oxfam suggest, would lower the ratio to 7.2 percent. Such a ratio might be enough to cover present contingencies, but it might not be sufficient for the future. The Bank evidently plans to continue transferring a major portion of its net income each year to IDA, debt relief, and/or other special programs. If its reserves are not increased, the IBRD's reserve-to-loan ratio will decline as its outstanding loan balance increases, shrinking to perhaps 4 percent by 2000.

The Fifty Years Is Enough Campaign calls on the IMF to use its "$35 billion" reserves to cancel debt owed it by low- and middle-income countries. This proposal seems to be based on a misperception. The IMF does not have $35 billion in reserves. Its total subscribed quota in 1995 was worth about $227.8 billion. This money belongs to the member countries. When the IMF makes a loan, it borrows from the account of one country (paying interest) in order to obtain the funds it needs to execute that loan. If the IMF were to cancel repayment of debt owed to it, it would be unable to repay its own debt to its member countries. The IMF would have to add the cost of servicing that debt permanently to its operating budget or ask the United States and other creditors to forgive repayment of the IMF's debt. The IMF's reserves, about $2.8 billion in 1995, would be insufficient to cover the cost of funding debt forgiveness.

As of June 1995, the IBRD had a $3.74 billion loan loss reserve (separate from its main reserves). It was owed $4.47 billion by the 24 countries (18 African, 6 other) that seem eligible for assistance via the Fifth Dimension program. Use of about $1 billion to $1.5 billion from the loan loss reserve to write off some of the debt owed by these countries to the IBRD might be a reasonable step and perhaps a pragmatic acknowledgment that countries too uncreditworthy to qualify for new IBRD loans may also be too poor and uncreditworthy to repay their old IBRD loans.

How MDB bondholders would react to such an action is uncertain. They might regard debt reduction for poor countries as a way of strengthening the IBRD portfolio. On the other hand, bondholders might be upset (and demand higher interest in the future) if they see this as a first step toward eventual broader reduction of debt owed by middle-income countries.

An equally serious concern is the MDBs' future relationship with the former debtors. Should they make new loans, as though nothing had happened, or (consistent with their policy on overdue loan payments) should they stop all new lending? The answer may determine whether using the loan loss reserve to write off debt is a good idea from the perspective of borrower countries.

The IMF owns 103.44 million ounces of gold, worth about $40.88 billion. Most member countries now seem to agree that the organization should sell or pledge a limited share of this stockpile to finance debt relief through increased ESAF lending. This step could generate $3.6 billion to $5.3 billion for use in funding multilateral debt relief (once the IMF is reimbursed for the modest book value it accords its gold holdings).

The World Bank evidently plans to fund its participation in the Bank/IMF debt reduction plan with money from its annual net income. As noted earlier, Bank President Wolfensohn announced in June 1996 that he would ask the World Bank governing board to transfer $500 million for this purpose. (In 1995, the IBRD transferred from its net income $300 million to IDA and $20 million for emergency assistance to Rwanda. In 1994, it transferred $465 million to IDA, $100 million to the Debt Reduction Facility for IDA-Only Countries, and $50 million for aid to Gaza.) This annual amount could pay for major debt-overhang reductions in no more than a few countries, but it would be enough to let the Bank cancel a sizable share of poor-country debt payments as they became due during the next decade.

Critics argue that any funds used to forgive debt must be new money, not money that the MDBs would have otherwise used to help low-income countries. This seems a reasonable point. If one assumes that the IBRD will continue to transfer $300 million or more annually from its income to IDA, then an annual contribution for debt reduction (such as that proposed by Wolfensohn and the G-7 countries) would come from money that would otherwise go to IBRD reserves, not from funds otherwise destined to help low-income countries.

Except for the African Development Bank and the European Bank for Reconstruction and Development, the multilateral banks keep their books in U.S. dollars but use a variety of currencies in their operations. As the relative values of these currencies fluctuate, the values of MDB assets change accordingly. The banks record this change in their translation adjustment accounts. For the most part, any gains or losses are only hypothetical, because the MDBs do not trade currencies in order to realize in cash increases in the paper values of their currency translation accounts.

In 1995, the value of the World Bank's translation account

increased by $1.9 billion to a cumulative total of $3.3 billion. The currency translation account for the Asian Development Bank increased by $72 million in 1995, to $307 million. On the other hand, the Inter-American Development Bank's account declined by $28 million in 1995, to $144 million. The changes were reportedly due mainly to a decline in the value of the U.S. dollar (down 1.8 percent in 1995 relative to the SDR.)

Some observers have proposed that the MDBs use the money in their currency translation accounts to fund debt forgiveness for poor countries. If the banks do this, they will in effect be betting that the U.S. dollar will never increase in value again. Few currency experts would make this bet. If the dollar were to increase in value at some point after all or part of the translation accounts had been cashed in and used for debt relief, MDB assets would decline in value (in dollar terms). The resulting losses would have to be charged against paid-in capital or retained earnings. Thus, using temporary surpluses in the translation accounts to finance permanent debt reductions would be imprudent.

The World Bank/IMF plan (as well as some of the alternative proposals) assumes that donor countries will contribute several billion dollars to support debt reduction. Any such bilateral contributions may be smaller than anticipated, however. For example, it is noteworthy that U.S. Secretary of the Treasury Robert Rubin said in April 1996 that meeting the cost of reducing multilateral debt "should be done with the resources, or at least predominantly with the resources, of the IMF and the World Bank. We do not think [it] should require contributions from the donor nations." In June 1996, the leaders of the G-7 countries announced, at their summit meeting in Lyons, that they would support more bilateral debt forgiveness—if it were done "in conjunction with a maximum possible contribution by the World Bank and IMF."

Many Paris Club creditors believe that the World Bank and the IMF—which seem reluctant to forgive debt themselves—have not acknowledged the major effort these creditors have already made to provide debt relief. Many of these creditors want to see first what the World Bank and the IMF are willing to do before they commit themselves to any formal arrangement.

There seems to be no provision in the World Bank/IMF plan for securing the participation of non-Paris Club creditors. For some debtors, the amounts owed to these creditors (Russia in particular) are substantial.

What about the plan's request that private creditors forgive 90 percent of the debt owed them by poor countries? If bilateral and multilateral creditors forgive a major share of the debt owed to them, the debt owed to private creditors is more likely to be paid. Thus, private creditors might be tempted to refrain from joining in a campaign of debt forgiveness.

Through August 1996, the World Bank's Debt Reduction Facility for IDA-Only Countries helped poor countries write off $2.82 billion owed to private creditors, at a cost to the Facility of $361 million, half of which came from the IBRD and half from bilateral donors. As of 1994, African countries owed private creditors $31 billion. Therefore a major new infusion of funds would be required if the Bank were to seek expansion of the Facility with an eye to helping extinguish 90 percent of this debt. It seems unlikely that bilateral donors would agree to cover half the cost, given the substantial burden they would have already assumed.

In effect, the World Bank/IMF plan makes the multilateral institutions the forgivers of last resort. The MDBs recognize that bilateral and commercial creditors may not agree to write off 90 percent of the debt owed to them. "It should be stressed," the World Bank and the IMF observe at the end of their official explanation of the plan, "that this share [a presumed one-third share for the multilaterals in the total cost of the plan] would be significantly higher if this assumption [90 percent forgiveness by other creditors] is not realized."

Conditionality. Some analysts want the multilateral institutions to forgive poor-country debt unconditionally. They either assume that removal of the debt will be sufficient to rectify the borrowers' problems or that the poor countries will take the right steps once they are freed from debt. Other observers, however, doubt the truth of both assumptions. In any case, the multilateral institutions and their major member countries will almost certainly require debtor countries to adopt new economic policies and procedures as a condition of debt relief.

What should those conditions be? Critics condemn the adjustment policies traditionally sponsored by the World Bank and the IMF on the grounds that austerity and budget cuts hurt the poor. The international financial institutions (IFIs) and their supporters, on the other hand, argue that countries experiencing chronic inflation and balance of payments deficits must inevitably undergo some form of adjustment. Having a program in place to shape and guide the adjustment process is better, they say, than allowing it to occur in a piecemeal and haphazard fashion.

Kinder, Gentler Adjustment? The IFIs have sought to include "safety nets" in their recent adjustment programs, in order to protect poor and vulnerable people. Critics argue that these "safety nets" do not always work and are at best only a mild antidote for the severe stresses that adjustment imposes on a borrower country. The IFIs and their supporters retort that the critics have proposed few alternative plans that will help poor countries improve their economic situations over a reasonable length of time without long-term foreign subsidies and without austerity or other negative economic effects.

Nevertheless, the multilateral institutions and their major member countries may find it difficult to build support for the World Bank/IMF debt plan if their critics (in debtor countries and in nongovernmental organizations) are concerned that a key element of that plan (increased ESAF lending by the IMF) could do more harm than good. A number of steps can be taken to ease this anxiety.

When ESAF assistance is being contemplated, the World Bank and the IMF collaborate on the preparation of a Policy

Framework Paper (PFP) for the borrower country. Technically, the PFP is a statement by the borrower about its future plans and priorities. In practical terms, the IFIs have a major role in the PFP's preparation because of their leverage and because the borrower country often lacks sufficient capacity to prepare the paper itself. The IFIs could promote broader public understanding and soften resistance on the part of critics by making the PFP preparation process more transparent and by increasing the public availability of information about the terms and goals of ESAF adjustment programs.

Adjustment programs seek to change economic conditions in borrower countries. Unless resources, contacts, and skills are available, however, the borrower may not be able to take advantage of the improved environment. Thus, any country getting an ESAF adjustment loan should also get a parallel adjustment loan from IDA to facilitate the reforms and investments needed to expand production and promote the transfer of resources to more efficient uses. IDA might also make project loans in the borrower country to address needs and opportunities anticipated by the ESAF and IDA adjustment plans.

The debt-plan proposal to double the repayment period for ESAF loans to countries receiving debt forgiveness would diminish the repayment burden associated with these loans. The longer repayment period would also give the IMF a chance to lengthen the period within which the borrower is required to complete the adjustment process funded by the loan. Such an easing would make implementation less painful.

A final step addressing concerns about the impact of IFI involvement with poor countries would be for multilateral creditors to strengthen the "safety net" dimension of their programs by converting some of the debt owed them by poor-country governments into local-currency debt (rather than forgiving it outright). The repayments from this local-currency debt could be granted back to the debtor country to help boost spending on development projects, human capital investments (health, education, etc.), or poverty alleviation programs. Alternatively, they could be forgiven outright to encourage the borrower's attention to particular issues or if the inflow of local currency exceeds the amounts the IFIs can use. Moreover, ending the borrower's need to use often-scarce hard currency for multilateral debt payments would make those resources more available to the private sector. The multilaterals could make this expanded access a condition of their plan.

In Sum

Debt relief will probably be more costly and the multilateral institutions will have to pay a higher share of the cost than the World Bank and the IMF now expect. Moreover, the process of forgiveness will need to be stretched over more time than either the IFIs or their critics assume if it is to be both affordable and effective.

In any case, reducing sub-Saharan Africa's debt-service burden is only a first step. The region needs new exports, new productive facilities, better communications/transportation infrastructure, and programs to expand worker productivity. Any debt-reduction plan that fails to take these needs into account is unlikely to be sustainable in the long run.

Jonathan E. Sanford has focused on multilateral development bank (MDB) issues for more than 20 years. Except for a stint in 1981 as staff director of the U.S. House of Representatives banking subcommittee responsible for MDB legislation, he has served since 1973 in the Foreign Affairs and National Defense Division of the Congressional Research Service at the Library of Congress. Besides CRS reports, he has authored a book on U.S. foreign policy toward the MDBs and several academic articles on MDB and developing-country debt concerns. This issue of *CSIS Africa Notes* is based on a longer forthcoming CRS report about multilateral debt forgiveness. The views expressed here are those of the author and are not necessarily those of the Congressional Research Service, the Library of Congress, or the U.S. Congress.