Oxfam International

G7 differences threaten to sink debt relief hopes

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On June 18th, national leaders from the world's largest economies have an opportunity to end the debt crisis crippling many of the world's poorest countries. But there is a real danger that current proposals within the G7 will fail to deliver. Without active, personal engagement by the G7 leaders, the Cologne summit will mark a damaging reversal in international efforts to resolve the debt crisis.

This briefing note outlines the issues at the heart of pre-summit negotiations in three key areas: the level of debt relief, the time frame for delivery, and financing.

Over the next ten days, negotiators from G7 finance ministries will put the finishing touches on a joint communiqué covering each of these issues. The deal could be sealed as early as the June 12 G7 finance ministers' meeting in Cologne. At issue is how to expand the Heavily Indebted Poor Country Initiative (HIPC), launched in 1996 but now recognized as a failure by creditor and debtor nations. Even the staff of the World Bank and IMF have acknowledged HIPC's failure to significantly reduce debt burdens.

In the past few months, most G7 leaders have made bold pledges to reform the program. For example, in announcing the U.S. plan at a meeting with African finance ministers, President Bill Clinton stated that the goal was to ensure *"no country committed to fundamental reform is left with a burden that keeps it from meeting its peoples' basic human needs and spurring growth*."

At best, leaders are likely to announce a deal that would double the amount of debt relief being provided under the current HIPC program. On the surface, this may appear to be a significant improvement. But behind the financial statistics and the big numbers lies the reality that poor, indebted countries will still be diverting far too much of their scarce resources to debt repayment, crowding out needed investment in the education and health of their people.

Even if the G7 were to adopt the best proposal on the table – from the British government -- countries will still on average pay roughly 18% of their revenue in debt service, down from approximately 22.5 % under the current framework. Under the U.S. proposal, which appears to be gaining in support -- average debt service would be roughly 21%. Japan and France – the largest creditors – are most resistant to reform. Both are reluctant to agree to deeper debt relief unless they are assured that the United States will contribute its fair share of the cost.

Oxfam believes tinkering on the margins will be ineffectual, and that 10 to 15 percent of national revenue is a sustainable debt burden.

A lack of political will and dissension over cost sharing among the G7 is likely to produce a lowest common denominator outcome which will do little to translate debt relief into poverty reduction. Rather than addressing the debt crisis from the perspective of what countries can afford to pay, the world's richest countries are instead asking themselves what they are willing to forgive, and defining "debt sustainability" to match their level of generosity.

In the face of French and Japanese resistance, the United States, Canada, Germany and Britain have failed to develop a shared strategy for overcoming opposition.
Debt relief could mobilize the additional resources needed to meet the United Nations targets of providing all children with primary education and cutting world poverty in half. But for this to become a reality, there are two fundamental requirements for a new debt relief plan:

- The program must mobilise enough resources to do the job.

- The program must ensure that savings from debt relief are invested in human capital, rather than military spending and other non-productive uses.

All G7 governments have called for a greater link between debt relief and poverty reduction. Mechanisms for securing this link are schedule be developed after the Cologne summit. But if debt relief remains within the range currently being discussed by the G7, linking relief to poverty programs will be irrelevant.

Oxfam will gauge the G7 agreements on debt based on whether the following criteria are met:

- Faster debt relief: earlier than three years, as opposed to the current six years.
- Deeper debt relief: to reduce debt servicing to a maximum of 10-15% of government revenue[1]
- Closer links to poverty reduction through investing debt relief in a poverty reduction plan developed jointly by government, donors and civil society.

How many countries will benefit and how much debt relief will countries receive?

Bilateral Debt Relief

Close to half of the outstanding debt of HIPC countries is owed to other governments, with the bulk owed to the Group of Seven countries. Canada, Great Britain, Japan and the United States have all announced support for 100% cancellation of bilateral loans made on concessional terms. Various proposals are also on the table to provide reductions of up to 90% - or more - of such loans made on non-concessional terms, such as export credit programs. Japan and France have argued that burden sharing should be based not on the percentage of debt the creditor is owed but rather based on the GDP of the creditor. The United States, with the largest GDP and one of the smallest debt exposures, has been adamant that the existing burden sharing arrangement be retained.

Multilateral Debt Relief

Adjustments to the HIPC debt sustainability thresholds are at the heart of the pre-summit horse-trading between the G7 countries. While the issues at stake appear to be technical, the outcome will have a profound bearing on the life-chances of vulnerable communities in many of the world's poorest countries. This is because the debt sustainability thresholds will dictate how much debt relief countries receive.

Because HIPC was originally designed to get rid of the debt stock that was unlikely ever to be paid, rather than relieving the budgetary burden of actual debt servicing, HIPC has made little difference to the public finances of the few countries that have begun to benefit from the program.

[1] This implies ratios of approximately 100-140% NPV debt/revenue, and around 100% debt/exports

Under the current HIPC program, average debt service been reduced by less than 2 per cent. Some countries will have a higher debt service bill *after* receiving debt relief under the current system.

Mozambique – among the poorest countries in the world -- stands to save only $10 million a year on a debt service bill of $120 million.

Uganda, the first country to qualify for HIPC, has now reverted to an unsustainable debt position since prices for coffee, its chief export, have dropped.

All creditors have at least rhetorically acknowledged that HIPC is providing too little relief. But deep differences remain over where the reformed debt sustainability thresholds should be set. The two core indicators are the ***debt as a percentage of exports*** and the ***debt as a percentage of budget revenue.***

Debt as a percentage of exports

Oxfam has argued that countries that are committed to poverty reduction should have their debt reduced so that total debt does not exceed 100-150% of exports.

Britain, the US and Canada are in agreement that the debt/export threshold should be lowered to 150 per cent from the current range of 200-250%. Germany is arguing for 170 per cent.

France, Japan and Italy have argued for a 200 per cent debt/export threshold. Since most countries that have been through the program already have had their debt reduced to within the lower range, in effect, this would leave the current framework intact.

When the debt relief is calculated

The World Bank has argued for an additional element which would deepen the level of debt relief provided. In brief, it wants to see the level of debt relief calculated from the Decision Point – three years into the current process, rather than from the Completion Point -- six years into the current process. This apparently technical change would carry important benefits. At present, export growth between the decision point and the completion point reduces the level of debt relief received (by lowering the debt/export ratio). The Bank's proposal would therefore provide more debt relief and enable countries to retain the benefits of export growth. The United States and Britain support this approach.

Debt as a percentage of revenue

Oxfam argued that more attention must be paid to the burden debt places on government budgets. Countries committed to poverty reduction should have their debts reduced to a level such that no more than 10-15% of government revenue should be diverted toward debt service[2]. **Many HIPC countries - such as Niger, Ethiopia, and Mozambique - are currently allocating more than one quarter of revenue to debt service.**

Under Oxfam's proposal, Sub-Saharan Africa stands to save up to an additional $4bn a year[3]. In a region where half of all children are out of school, and the education

[2] This would equate roughly with the range of 100-140 per cent debt to revenue.

[3] Assuming that roughly 80% of HIPC costs would cover sub-Saharan Africa.

infrastructure is collapsing, the potential human development gains are enormous. Four billion dollars represents more than the financing requirements for achieving universal primary education within a decade.

- **Zambia has been spending around 45% of government revenue on debt servicing. If this was reduced in line with Oxfam's proposal, the budget savings from one year alone would make it possible to reverse the growth in number of children out of school, and deliver universal primary education and higher level progression in schooling, by 2005.**

None of the G7 proposals goes this far. The best, but still insufficient option is the British proposal to lower the debt/revenue threshold from the current level of 280 per cent to around 200 per cent. The British Government has also supported lowering the eligibility requirements for the fiscal threshold.

At present, the HIPC framework requires debtor countries to meet a revenue/GDP target of 20 per cent and an export/GDP target of 40 per cent. The British proposal would remove the export requirement altogether, and lower the revenue/GDP requirement to 10 to 15 per cent.

Reforming the fiscal criteria of HIPC accomplishes two things: it increases the number of countries that would receive debt relief and increases the amount of relief countries receive. In a number of cases, countries otherwise eligible for relief under the export criteria would receive even deeper relief under the fiscal criteria.

The British proposal would extend HIPC coverage to countries such as Togo, Ghana and Chad, which were judged under the current program to have "sustainable" debt. It would also allow countries such as Honduras to enter under this criteria, and receive more relief.

If adopted, the British proposal would result in some 19 heavily indebted countries receiving improved treatment, 8 more than under the US terms. Under this proposal, the effect would be to limit the amount of revenue which they transfer to creditors, to around 18 per cent of budget revenue.

The United States, concerned with the increased cost of altering the fiscal thresholds, is calling for keeping the target at 250 per cent debt to revenue, while reducing the export threshold to 30 per cent exports/GDP and the revenue threshold to 15 per cent revenue/GDP. Under this proposal, countries would on average be required to transfer 19 percent of budget revenue to creditors. Compared to the British proposal, countries such as Cameroon, Ethiopia, Ghana, and Malawi would be excluded from benefiting from the fiscal criteria.

US Treasury officials state that they are unable to agree to the British proposal for fear that Congress would reject it on cost grounds. There is, however, evidence of growing Congressional support for debt relief. James Leach, chair of the House Banking Committee, has built a bipartisan coalition in support of the Debt Relief for Poverty Reduction Act (H.R. 1095). The bill provides deeper debt relief than any of the G7 proposals – by instituting a 10% cap on the amount of government resources countries must divert toward debt service – provided that governments agree to transfer the savings from debt relief into a Human Development Fund.

Other countries have gravitated from different starting points towards the US position. France is opposed in principle to significant adjustment of the fiscal criteria, mainly because this will expose it to higher costs resulting from bilateral debt exposure. The German government has failed to prioritise fiscal debt relief, despite public commitments to deepen debt relief. It can be confidently predicted that both Italy and Japan will come in behind whatever position offers the least by way of additional debt relief.

How long will countries have to wait?

In the three years since HIPC began, only three of the eligible countries have begun to receive debt relief. Many will have to wait several more years before reaping any benefits. Oxfam believes countries that agree to transfer the savings from debt relief into poverty reduction programs should not have to wait more than one to two years to benefit from HIPC. G7 governments have collectively acknowledged that the current pace of debt relief is unacceptably slow, but are divided over how to improve the current framework.

At present, countries are required to complete two successive three-year IMF reform programs before receiving debt relief under the program. The first phase (up to the Decision Point) culminates in reduction of 67% net present value of debt by members of the Paris Club, an informal group of creditor nations that includes all of the G7. The second phase (up to the Completion Point) ends in coordinated action by both bilateral and multilateral creditors to meet HIPC debt sustainability targets.

The high level of interruption in IMF programs has had the effect of extending the time-frame beyond six years, as has happened to countries such as Tanzania, Mozambique and Zambia. From Oxfam's assessment, Tanzania has already built a track record of over eight years, more than the six years presently required under HIPC.

Britain, Canada and Germany have proposed shortening the time-frame by eliminating the second phase. However, while France, Japan and the US have paid lip service to the need for earlier debt relief, their negotiating positions point in the opposite direction.

The United States has proposed what it describes as a 'floating time-frame' under which countries would receive cash flow relief – i.e. debt service reductions -- during the first phase of the HIPC program, but would not receive the full debt stock reduction until certain specified targets are met. This proposal is also referred to by some as the 'floating tranche proposal.' Under this proposal, the current second phase could be shortened or extended on the basis of whether or not the targets were met. These targets may include 'exceptional performance' under IMF programmes - a phrase which appears to extend from progress in strengthening social sector spending to accelerated privatisation, civil service reform and trade liberalisation.

Both France and Japan are broadly in line with the US position. The French government, for example, wants to see earlier debt relief provided for 'exceptional performance' (thus far undefined) on a case-by-case basis.

Whatever the outcome of the dispute over the time frame, the G7 communique is likely to include broad language calling for IMF programs to be reformed to be more "poverty focused", including protection and/or increase of social expenditure, more transparency in budgeting, more flexibility in the timeframe for achieving macroeconomic targets, and efforts to strengthen local ownership of the economic reform program. Specifics would then be worked out over the summer with the aim of reaching agreement at the annual meetings of the World Bank and the IMF in the fall of this year.

The problem with the US-Japan-France position is that it is a thinly-disguised attempt to use debt relief as a lever for pursuing broader economic reform objectives going far beyond even the parameters of existing IMF programmes. If this position is adopted, it will raise the possibility of further delay in the provision of debt relief.

The Bottom Line: How much will reform of HIPC cost and who pays?

Much has been made of the financial implications of reforming the HIPC framework. The message from several G7 finance ministries has been that substantial reform is unaffordable. This assessment is based on a politically motivated misrepresentation of the facts - and has been designed to dampen public pressure for HIPC reform.

At the heart of the misrepresentation has been the recourse to headline figures which grossly exaggerate the real annual costs of HIPC reform.

According to estimates by IMF/World bank staff, the costs of implementing HIPC reforms which approximate to those proposed by the British Government would amount to around $42bn in net present value terms, and for the US $36bn (for all 41 HIPC countries). Oxfam's proposals, although not costed by the IMF/World Bank would amount to more than $51bn[4]. However, this does not represent an up-front financing requirement for the following reasons:

- **Around half of the costs of debt relief will be absorbed by bilateral donors in the form of 'losses' to export credit agencies and other loan departments, or through writing off aid loans. These are nominal yearly losses which will be absorbed through accounting exercises, rather than real expenditure.**

- **Much of the additional financing required to meet the costs of multilateral debt relief can be met through sales of IMF gold and the transfer of World Bank net income. The remainder would need to be met through bilateral contributions.**

- **Since the costs of debt relief will be spread over several years, they can be absorbed on an annualized basis. Over a ten-year period, the additional real costs of HIPC reform for the Oxfam proposal would be around $2.5bn a year.**

G7 leaders must be up front about the real cost implications of an improved debt relief framework. Put in proper context:

- The $2.5 billion cost of the Oxfam proposal is less than the $2.7 billion in Poland debt that the U.S. cancelled in 1991.

- It is only a fraction of the $7 billion in debt cancellation that the United States provided to Egypt and Jordan after the Gulf War.

- The $2.5 billion cost of the Oxfam proposal represents around 5 percent of aid flows - and only 10 per cent of the amount *cut* from the aid budgets of the industrialised countries since 1992.

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[4] Costs are from the 'HIPC Initiative: Perspectives on the Current Framework and Options for Change, with Supplement on Costing', IMF/World Bank, April 1999; for all 41 countries, with 2nd stage eliminated. Although US does not advocate for elimination of second stage, we are assuming that interim financing would equate to the same costs as eliminating the 2nd stage.

If other creditors followed the British government's commitment to increase aid in real terms by 25 percent over the next three years, roughly restoring flows to their 1992 levels, there would be no financing gap for HIPC reform.

Such facts graphically illustrate that now, as in the past, the real barrier to effective debt relief in the poorest country is not a shortage finance, but a chronic lack of political will.

Intervention is needed now to salvage the G7 agreement

G7 leaders are now faced with two choices: step in and take advantage of the momentum generated by the unprecedented global citizen movement for debt relief, or step aside and allow the HIPC initiative to join a long list of failed attempts by the creditors to put an end to the vicious cycle of debt and poverty in the Third World.