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**The European Union preliminary views
on
“External debt”**

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In preparation for the Doha Review Conference – external debt and systemic issues, the European Union is organizing some internal working meetings, which are yet to take place. In addition, some other international events in the near future may bring additional contribution to the Monterrey Consensus Review process. The European Union will therefore produce a more substantial contribution on external debt and systemic issues later in the spring.

External debt

The Monterrey Consensus contains five important paragraphs on external debt. Much has been done to implement these paragraphs. But even if important initiatives and events have unfolded since then, the importance of long term debt sustainability for development remains. Both lenders and borrowers must share responsibility in creating the conditions for it.

What has been done since Monterrey?

The HIPC Initiative is being successfully implemented. The Heavily Indebted Poor Countries (HIPC) Initiative was proposed by the World Bank and the IMF in 1996 following a G7 invitation as a co-ordinated approach to reduce poor countries' external debt to sustainable levels. The initiative involves both bilateral and multilateral public creditors as well as commercial creditors. At the 1999 Cologne Summit, G7 leaders agreed to a revised framework, the enhanced HIPC Initiative, which provides faster, deeper and broader debt relief.

The HIPC initiative has multiple dimensions, emphasising debt relief but linking it to poverty reduction, macroeconomic stability and structural adjustment, including social policy reform, as inscribed in the context of an adopted Poverty Reduction Strategy Paper (PRSP).

Originally intended to be a temporary action for a limited period of time, the Initiative has been extended four times for meeting the eligibility criteria (in 1998, in 2000, 2002 and in 2004). The sunset clause of the HIPC Initiative took effect in December 2006. All potentially eligible countries that have been assessed to have met the income and indebtedness criteria at end-2004 were "grandfathered" and could still benefit from HIPC debt relief if the other required criteria were met (i.e. track record with IMF/WB, multilateral arrears clearance and satisfactory implementation of poverty reduction strategy).

The ongoing HIPC initiative can be qualified as a success and continues to show encouraging results. As of December 2007, twenty three out of the forty one HIPCs had reached completion point under the Initiative. Nine countries were between decision and completion point, being eligible for interim debt relief. Debt-service payments have declined as a result of debt relief under the Initiative while pro-poor expenditure programmes have continued to increase. So far, the debt stocks of the post-decision-point HIPCs are projected to decline by almost 65% in end-2006 NPV terms under traditional debt relief and HIPC Initiative assistance. Also, in average terms, their debt-service-to-exports ratios have been reduced from over 18% before decision point (DP) to 8% 4 years after DP. Projections show that the average debt-service-to-exports ratio of the post-DP HIPCs is expected to fall from 9.7% in 2005 (year before MDRI) to around 3.3% in 2011. Debt relief has contributed to a significant reduction of debt service payments and has thus helped to set free important resources allowing developing countries to increase their poverty related expenditures and investments, in line with the

national poverty reduction strategies. Furthermore, it is encouraging to see that some post Completion Point-HIPCs are now able to cautiously access capital markets, and that Foreign Direct Investment flows to Low Income Countries are on the rise.

The overall already committed debt relief under the Initiative amounts to around US\$64 billion.

The Evian approach by the Paris Club: The creditor countries of the Paris Club met in Paris on October 8, 2003 and agreed on a new approach to deal with non-HIPC countries. In this context, the Paris Club aims to take into account debt sustainability considerations, to adapt its response to the financial situation of the debtor countries, and to make a contribution to the efforts to make the resolution of crises more orderly, timely and predictable. Paris Club creditors agreed to adopt a more tailored response to ensure that debtor countries that sign appropriate level agreements with the IMF receive debt treatments that reflect both their current financial needs and the long term debt sustainability of their external debt.

This approach allows the Paris Club to better address the debt problems of those low and middle income countries, which do not have access to the HIPC Initiatives and MDRI.

The Multilateral Debt Relief Initiative (MDRI): At the July 2005 G8 Summit in Gleneagles, Scotland, G8 leaders pledged to cancel the debt of the world's most indebted poor countries. Debt cancellation would be provided by the International Development Association (IDA) of the World Bank, the International Monetary Fund and the African Development Fund to countries that have reached the completion point from the Heavily Indebted Poor Countries (HIPC) Initiative. In March 2006, donors agreed to a financing package for the MDRI that stipulates additional donor contributions over time to compensate for debt relief if the IFIs. The main goal is to provide additional resources for poverty reduction in HIPC countries. Compensatory financing over the duration of the cancelled loans is based on strong commitments already made. The delivery of compensation commitments is still partly outstanding.

To date, all post-completion-point HIPCs have qualified for MDRI debt relief. The remaining HIPCs will qualify for debt relief under the MDRI once they reach their completion points under the HIPC Initiative.

In March 2007 the Inter American Development Bank agreed on its own debt relief initiative providing 100% debt relief on eligible credits to post-completion point HIPCs.

The total cost of debt relief under the MDRI and IADB is estimated at US\$47.9 billion in nominal terms, which is additional to the relief granted under the HIPC initiative.

Since 2005, EU member states have provided large amounts of debt relief, and more will be provided in accordance with our firm commitments under the MDRI. The main goal is to free up domestic resources to allow for increasing spending in areas that are crucial for achieving MDGs. In addition, the European Commission was the first multilateral creditor to go beyond the HIPC terms with the decision of 2003 of 100% cancellation of the special loans for the Least Developed Countries eligible for HIPC Initiative.

Joint World Bank–International Monetary Fund Debt Sustainability Framework (DSF): In April 2005, the Executive Boards of the International

Monetary Fund and the World Bank endorsed a joint framework for debt sustainability assessments (DSAs) in low income countries. The debt sustainability framework (DSF) for low income countries was reviewed by the Boards in April 2006, as well as the implications of the MDRI. In November 2006, the Boards discussed further the challenges arising from the perceived increase in borrowing space created by debt relief in some low income countries, the emergence of new creditors, and the rising weight of domestic debt. While welcome, these developments also raise new risks. In light of this, the Boards called for improving the rigor and quality of debt sustainability analyses (DSAa) and increasing their effectiveness by fostering their use by borrowers and creditors.

The primary aim of the DSF is to guide borrowing decisions of low income countries in a way that matches their need for funds with their current and prospective ability to service debt, tailored to their specific circumstances. Given the central role of official creditors and donors in providing new development resources to these countries, the framework simultaneously provides guidance for their lending and grant-allocation decisions to ensure that resources to low income countries are provided on terms that are consistent with their long term debt sustainability and progress towards achieving the MDGs. The forward-looking nature of the DSF allows it to serve as an "early warning system" of the potential risks of debt distress so that preventive action can be taken in time.

Remaining challenges and further implementation of Monterrey Consensus

The Post-HIPC/ MDRI challenges on how to maintain long term debt sustainability for low income countries, as well as ensuring that HIPC countries are able to realise the full benefits of HIPC debt relief can surely be considered as "new challenges and emerging issues" that we could and should tackle in the run-up to Doha.

Ensuring long-term debt sustainability

Maintaining debt sustainability in the long run remains an important challenge and requires close cooperation of debtors and creditors. Based on the assessments made under the DSF of the World Bank and the IMF, a significant number of low income countries continue to face a risk of renewed debt distress. As the implementation of the HIPC initiative progresses, responsible borrowing and lending becomes an even more decisive factor in avoiding the accumulation of unsustainable debt burdens. Several developing countries have reduced their external public debt but increased their relative share of domestic debt in their total debt burden. While this switch in debt structure substantially reduces the foreign exchange risk of public debt liabilities it also calls for a **reinforcing capacity to manage the new levels of domestic debt in order to maintain the overall public debt sustainability**. The latter depends, inter alia, on the economic growth, mobilization of domestic resources, export prospects of debtor countries and on the creation of an enabling international environment.

In this context, developing countries should be encouraged to **develop sound financing and debt strategies** (covering domestic and external resources and debt), which are in line with the recommendations made under the DSF and their respective national development strategy. This should be complemented by further **strengthening public debt management capacities**. The EU therefore welcomes the work of UNCTAD, the World Bank, the International Monetary Fund and other agencies in this

area and asks them to further step up their efforts. In addition, monitoring the contraction of new debt should be strengthened and be complemented by **improved transparency** in the area of public finances. However, the long term debt sustainability will only be achieved if the **economies of developing countries** are being **diversified further** and thus made more resilient to external shocks, and if public finances are made to rely more prominently on the generation of own revenues. Nevertheless, it is encouraging to see that many low income countries have already improved their macroeconomic performance, i.e. by increasing reserves which has boosted growth and made them less vulnerable to economic shocks.

Efforts by debtor countries have to be complemented by efforts of creditor countries. There is concern that debt sustainability might continue to be put at risk by creditors granting loans of unsustainable quantity or without the required level of concessionality to low income countries. In this context, we welcome the decisions of the International Development Association and the African Development Fund to use the results of debt sustainability assessments to determine whether to provide resources as credits or as grants.

All lenders and borrowers should include debt sustainability considerations into their lending/borrowing decisions, making the best use of the guidance provided by the DSF and following the steps undertaken by the OECD Export Credit Group, such as the adoption of a Statement of Principles against support for Unproductive expenditure and the Principles and guidelines to promote responsible lending and practices in the provision of officially supported export credits to low income countries. Increasing transparency of lending/borrowing decisions would be another important step which could help to prevent renewed over-indebtedness of developing countries.

Ensuring that HIPC countries are able to realise the full benefits of debt relief (comparable treatment)

The delivery of debt relief by non Paris-Club bilateral creditors and commercial creditors is improving but remains too low. A concerted effort to encourage full creditor's participation is indispensable for reaching the initiative's objectives. The EU urges all bilateral official creditors and commercial creditors to contribute their share in the HIPC debt relief efforts. In this regard, UN GA Resolution 62/189 of 5 December, 2007 "invites creditors, both private and public, that are not yet fully participating in debt relief initiatives, to substantially increase their participation, including by providing comparable treatment to the extent possible to debtor countries that have concluded sustainable debt relief agreements with creditors, and invites the international financing institutions and the donor community to continue to provide adequate and sufficiently concessional financing".

The challenge stemming from aggressive commercial creditors' lawsuits against HIPCs has the potential to threaten the achievements of the initiative as it prevents spending resources freed by HIPC for poverty reduction. The EU pledges to refrain from selling claims to creditors which are not willing to participate fully under the HIPC initiative and urges all other creditors to do the same. The EU furthermore supports intensified efforts to discourage aggressive litigation against HIPCs.