

Informal Summary of General Assembly Review Session 3
10-11 March 2008

Chapter V of the Monterrey Consensus, "External debt"

I. Introduction

The informal G.A. review session on Chapter V of the Monterrey Consensus, held on 10 and 11 (morning) March 2008, was chaired by H.E. Ambassador Maged A. Abdelaziz of Egypt and H.E. Ambassador Johan L. Lovald of Norway. The meeting consisted of an initial panel discussion followed by an interactive dialogue by all stakeholders. The panel presentations were made by Mr. Thomas Courbe, Secretary General, Paris Club, France; Mr. Deepak Nayyar, Professor of Economics, Jawaharlal Nehru University, India; Ms. Martine Guerguil, Chief of Official Financing Division, Policy Development and Review Department, IMF; Mr. Hitoshi Shoji, Adviser, Development Assistance Strategy Department, Japan Bank for International Cooperation; and Mr. Léonce Ndikumana, Chief, Macroeconomic Analysis, UN Economic Commission for Africa. (The views of the panelists in response to questions from the floor are also included in section II – Panel presentations). After the panel presentations, which were highly appreciated by the attendees, a policy discussion took place among participants, including representatives of governments as well as institutional and non-institutional stakeholders.

II. Panel presentations

a) External debt of developing countries and related policies since 2002

1. The Heavily Indebted Poor Country initiative (HIPC) and the Multilateral Debt Relief Initiative (MDRI) operate under an equal burden-sharing arrangement. Preventing debt crises is a shared responsibility of creditors and debtors. The Monterrey Consensus (MC) follows the principle of “the logic of collective action” in debt relief, that is, welfare of the parties concerned improves with coordinated action, not through unilateral action. Yet, coordinated action has seldom been put into practice up to now.

2. A Paris Club (PC) debt relief programme for the HIPCs has been in operation since Monterrey. In 2007, PC debt treatments for the 23 post-Completion Point countries totaled \$7.6 billion. Total MDRI debt relief reached \$37.6 billion. Debt service for the 32 Decision Point HIPCs fell considerably as a percentage of exports: from 16.6 per cent in 2000 to 5 per cent in 2007. Poverty-reducing expenditures in post-Decision Point countries, as a percentage of GDP, rose also during the same period from 6.8 per cent to 9.4 per cent. Six countries have benefited from “topping up” schemes, which provided additional funds to Completion Point HIPCs to help them deal with external shocks.

3. Nine debt-distressed countries received “Evian debt treatment”, including non-HIPC countries. The Evian approach groups developing country debtors into two classes, those whose debts are sustainable and those with unsustainable debt. For countries with

the most serious debt problem, the most generous implementation of existing terms is applied. Treatment under unsustainable debt situations is delivered with a strong focus on the link between economic performance - under an IMF-sponsored programme - and public debt management. Debt relief terms are determined on a case-by-case basis. Under the Evian treatment, Nigeria's debt stock fell sharply from 2000 to 2007. Countries granted goodwill clauses under the Evian approach did not have to use it.

4. Early repayment of official loans of about \$70 billion was made possible by the improvement in the economic situation of some developing countries. The PC supports this if it is an integral part of a country's long-term debt management strategy. The PC accepts early repayments under two arrangements: early repayment at par, and buyback at market rate.

5. Challenges to resolving the debt problem entail fully implementing debt relief efforts, including the full delivery by all non-PC bilateral creditors and private creditors of their share in debt relief. This requires increased inter-creditor coordination, particularly taking into account the increasing role of private creditors and emerging bilateral creditors, such as China and India.

6. The problem of aggressively litigating creditors against some developing countries, including HIPCs, has to be addressed. Efforts needed to deal with this problem include moral suasion, debt buybacks and Paris Club creditors not reselling claims in secondary markets. Technical assistance to HIPCs in capacity building in debt management and sound legal expertise to respond to litigators is important as well.

Notwithstanding overall progress, the debt picture is still mixed. In Africa, debt levels have declined but private debt remains high and is rising. In some cases, debt relief volumes provided have been too little, too late. While debt relief has provided more fiscal space for poverty reduction expenditures, the impact is limited. A key issue has been sidelined – often debt relief has not taken into account financing needs for productive and infrastructure investment.

7. The problematic political, economic and security situation of many of the remaining HIPC countries hinders restoration of debt sustainability. Conflict and post-conflict countries need debt relief beyond what is provided in existing programmes.

8. Since the international financial system does not provide insurance for future economic shocks, international reserves are being accumulated by numerous developing countries as self-insurance against potential debt crisis. This diverts financial resources from financing investment in development. Proper management of reserves and their productive use are equally important for development financing.

b) New challenges and the way forward

9. Low income countries have huge investment needs in infrastructure and the social sector but face problems of unchanged economic structure and low domestic saving. In

general, they have scant access to international financial markets and limited grant financing. At the current juncture, volatility in commodity and energy prices could undermine debt sustainability of these countries. Financial shocks that raise international interest rates could also derail efforts in reducing financial pressures from debt relief, maintaining debt sustainability and achieving development goals.

10. Borrowing to finance development must take into account sound macroeconomic principles and take into consideration that it can be sustainable where credit is used for investment with a rate of return greater than the interest rate of the loan. If borrowing is cross-border, the country needs to transform domestic resources into external resources to meet the liability. As returns to investment in the social sector are generally lagged and intangible, financing from domestic public debt or increased tax revenues is more appropriate for this sector.

11. HIPC debt treatment is based on policy conditionalities ensuring repayment not development aims. Overly strict application of conditionalities have often resulted in compressed public spending to balance the budget, squeezing much-needed infrastructure investment and social sector spending. Streamlining conditionalities or shifting to outcome-based conditionalities to revive economic growth by taking into account development needs is, therefore, desirable.

12. With the private sector in middle-income countries (MICs) becoming a major debtor, new risks are emerging and the need for risk mitigation measures is increasing. MICs' vulnerabilities to external debt are often triggered by liquidity problems as a result of the level, currency denomination and maturity composition of debt. To access international financial markets, these countries are obliged to maintain high interest rates to provide attractive returns and a strong exchange rate to inspire confidence; but these macroeconomic policies undermine competitiveness and stifle economic growth. Greater policy space is needed to allow a focus on debt crisis prevention as well as remedy, considering that sustained higher growth generally tends to reduce debt pressures.

13. As MICs and some low income countries are not part of the HIPC initiative, other options to reduce debt and help achieve development goals should be used more extensively, including debt swaps and bilateral debt relief agreements.

14. The way forward in restoring and maintaining debt sustainability involves a commitment or recommitment to the following principles: joint responsibility of creditors and debtors; development needs rather than financial needs as the foundation of debt reduction and cancellation; responsible lending practices in extending new loans to countries emerging from debt crisis; transparent national and international financial institutions, particularly banks; additionality of debt relief to ODA; and application of the Paris Declaration principles of ownership, management for development results, mutual accountability, alignment and harmonization to achieving debt sustainability;

15. With an increasing number of emerging economies holding large accumulations of foreign exchange reserves, they can provide financing for distressed indebted

countries. This creates competition to financing by the international financial institutions (IFIs), which is a good thing, as it can help make them more responsive to the needs of developing countries.

16. Some post-debt relief low-income countries are vulnerable to medium or high risk of debt distress. There needs to be a focus on prevention of a relapse into unsustainable debt by making available grants or concessional loans. Access to additional lending in large volumes or unfavourable terms should be very cautious and gradual.

17. Net financial transfers on debt in many developing countries, including some African countries, are negative due to high debt service. Illicit capital flows also contribute to net negative financial transfers. In most African countries, domestic public debt is a concern as it crowds out private sector borrowing. MICs without access to financial markets have to similarly depend on domestic credit, leading to a credit squeeze on private sectors.

18. Capital flight needs to be stemmed through improved investment conditions, a deep financial system, anti-corruption measures and accountability of all domestic and external parties. There is also a need for international mechanisms for repatriation of assets - the Task Force/Leading Group on International Illicit Financial Flows initiated by the “Leading Group on Solidarity Levies” should be supported by countries and multilateral organizations. Additional research on the volumes and mechanisms of illicit financial flows is needed.

19. Development partners should go beyond establishing emergency global funds for LICs to set up growth-supporting global funds for investment in infrastructure, energy and skills development to boost growth as a means of poverty reduction.

20. More resources are needed to finance debt relief for HIPC countries that are in conflict or post-conflict situations as their political, security and economic situations are challenging and have long-standing arrears with multilateral institutions. Selling more IMF gold to finance debt relief for these countries could be an important option to consider, subject to member country agreement.

21. With the increasing role of private creditors and emerging bilateral creditors, there is a need for greater creditor coordination. For example, the Paris Club has regular contacts with private sector representatives but enhanced dialogue with emerging lenders is needed.

22. Noting the limited membership of the Paris Club and the issue of representation and legitimacy, there were calls for more cooperation among all creditors. One possible avenue is to broaden the membership of the Paris Club to include non-member creditors and commercial creditors. Another is the establishment of more universal guidelines outside the Paris Club framework, covering all creditors, with developing countries playing a leading role.

23. The OECD export credit group has developed sustainable lending principles with regard to credit for low-income countries. On a global basis, there is a need for universal guidelines, with the participation of non-OECD countries, for enhanced cooperation between debtors and creditors to avoid another round of unsustainable lending.

c) Assessing debt sustainability

24. The IMF/World Bank Debt Sustainability Framework (DSF) has been used to monitor debt relief outcomes, construct the path of debt under different borrowing and macroeconomic scenarios and identify policies needed to maintain debt sustainability. A complementary framework for low-income countries that are more vulnerable to shocks and have weaker institutional settings incorporates these considerations and the need for joint creditor-debtor responsibility. Good governance is included as a key factor in sustainable public debt.

25. The DSF is effective only if used by both creditors and debtors. It is a valuable instrument to develop a medium-term strategy to meet development financing needs at a level and composition that is sustainable. It is also a tool to improve policy advice from the BWIs and regional development banks. An IMF capacity building programme in debt management has been stepped up to support debtors. Outreach to creditors by IMF has also been increased through information sharing in country debt sustainability analysis and awareness-raising on the need for enhanced cooperation.

26. The DSF needs improvement in transparency and information-sharing in the choice of scenarios and construction of indicators. Indicators should include sufficient examination of the domestic debt situation. Priority should be placed on achieving development goals in maintaining debt sustainability instead of improving debt service scenarios. In this regard, monitoring the impact of debt relief should include its development impact.

III. Policy deliberations

a) Progress and setbacks in the implementation of the Monterrey Consensus

27. A considerable number of representatives expressed their satisfaction that, as a whole, the debt indicators of developing countries had improved markedly since 2002. Most developing countries now had debt management programmes in place and had built reserves, thus reducing vulnerability. The widespread introduction of collective action clauses on debt contracts had been also a positive development.

28. Furthermore, it was pointed out that the implementation of Heavily Indebted Poor Countries (HIPC) Initiative and Multilateral Debt Relief Initiative (MDRI) had contributed to a significant reduction of the debt burden of the 23 countries reaching completion point. The debt relief granted under both initiatives had been of the order of \$ 110 billion. In the meantime, largely as a consequence of this, poverty reduction expenditures as a share of GDP had increased significantly.

29. With regard to developing countries who were not part of the HIPC initiative, it was noted that the Evian Approach of the Paris Club had also contributed to reduced debt burdens. Middle Income Countries (MICs) had seen their credit ratings improve and the interest spread on their borrowing decline markedly since 2002. However, many representatives stressed that a considerable number of countries - including LDCs and numerous low income and middle income countries - still faced very high or unsustainable debt servicing burdens.

30. Some noted that there was a considerable transfer of resources from the South to the North, partly because of debt servicing. In this regard, it was stressed that high levels of debt service hamper development. This was also true for some heavily indebted LDCs. In the view of some participants, total debt cancellation was necessary, particularly for LDCs and post-conflict countries.

31. Many representatives indicated that the pace of the HIPC initiative had been slow and that the attached conditionalities had significantly narrowed policy space in beneficiary countries. It was noted that half of HIPC countries that had reached completion point, had slipped back into unsustainability, and a number of them were facing lawsuits or litigations from commercial creditors and “vulture funds”. Moreover, in certain cases, debt relief had constrained the access to new credit.

32. Many delegates expressed that there had virtually been no progress in setting up an innovative mechanism to comprehensively address debt problems of developing countries, including MICs which, to a large extent, had been put aside. Numerous representatives stated that debt relief should not be counted as ODA or tied to political or excessive conditionalities. Some noted that debt relief has been unfair to countries with large development needs but low levels of debt.

b) Lessons learned and debt issues in the current juncture and the long-term

33. In the view of some representatives, sound macroeconomic policies and structural policies can help countries overcome debt problems through increased economic growth. In the long-term a more robust, well functioning domestic financial system was critical.

34. A large number of speakers expressed that responsible borrowing and lending was essential for maintaining debt sustainability in the long run. It was pointed out that this should be coupled with a transparent process and that it was important to pay attention to the “Principles and Guidelines to Promote Sustainable Lending in the Provision of Official Export Credit to Low Income countries” developed by OECD.

35. With respect to grants, it was noted that they were particularly important for over indebted low income countries. Indeed, IDA had increased its share of grants significantly since 2002. It was suggested that an institutional framework be designed to ensure an adequate use of resources obtained through IDA grants and other forms of concessional financing. Some representatives stated that there should be a minimum degree of conditionalities attached to any further debt relief so as to ensure that debt relief delivers poverty reduction. It was also stated that additional social expenditures as a result of debt reduction should take especially into account the gender perspective.

36. Some speakers warned that the switch from official to commercial borrowing and from external to domestic public debt is creating new vulnerabilities and risks. It was pointed out that to address this matter, there was a need to improve data collection of the composition of both the external and domestic public debt. It was also noted the need to address the issue of “free riders” in the HIPC and in the Paris Club processes.

37. With regard to the international financial system, many speakers warned of the impact and increased uncertainties derived from the sub-prime mortgage crisis and the risk of higher interest rates. Furthermore with respect to debt, it was noted that the international financial system will remain insecure and incomplete without a sovereign debt workout mechanism.

38. Related to the international financial system, it was pointed out that with more liberalized capital markets and floating exchange rates, the risk of substantial changes in the exchange rate of developing countries had increased, complicating matters because volatility of exchange rates might increase abruptly the debt burden. It was suggested that creditor nations and IFIs should pay more attention to this issue and develop a new mechanism for loans in domestic currencies. There was a need to strengthen the domestic financial system through renewed instruments like bonds in domestic currency. Also, IFIs should explore preventive mechanisms and support regional initiatives such as pooling of reserves. Another topic brought up by many speakers was the need for increased voice and participation of developing countries in institutions that set international financial policies and deal with external debt related issues.

39. Some speakers mentioned that the effective functioning of the global financial system would benefit from the establishment of an international debt commission to look for a multilateral approach to solving external debt problems. In this context, there was also a call for further consideration of the proposal to establish an independent debt arbitration mechanism to assess, adjudicate and pass judgment on debt reduction options.

40. In the view of various representatives, a debt resolution mechanism, aimed at guaranteeing fair burden sharing among debtors and creditors, whether they are dealing with official creditor debts or commercial debts, should be also considered.

41. With respect to credit rating, many speakers expressed their dissatisfaction with the present system. It was suggested that developing countries should have an input when the criteria to be used by rating agencies were being designed. Also, it was important to explore the possibilities of a multilateral approach to the credit rating process.

42. Many representatives referred to the need to build national capacities for debt management and debt sustainability analysis and a call for bilateral and multilateral support for implementation of debt management programmes, since sound financing and debt strategies are especially important. It was proposed that UNCTAD, The World Bank and the IMF should step up efforts in this area.

43. With respect to debt relief, a number of participants pointed out that additional resources were needed and that debt relief programmes should not constrain policy space. This was particularly important in the case of the SIDSs whose vulnerability makes them prone to debt servicing difficulties. It was pointed out that the BWIs should be more flexible when considering SIDSs for inclusion in debt relief programmes such as

HIPC/MDRI. It was further noted that for these countries technical assistance on debt management was critical. A similar suggestion regarding flexibility for the provision of debt relief and technical assistance was advanced for post conflict countries.

44. The case of MICs was mentioned by various participants. There was a need of effective consideration of their debt problems. One possibility mentioned was the adoption of debt swap mechanisms, i.e. swap of debt for MDG programs. These countries' income level often masked the true impact of the debt burden on their populations and their prospects of achieving the MDGs.

c) External debt sustainability frameworks (DSF)

45. A number of participants stressed that creditors should fully consider the debt sustainability of borrowers in order to prevent the occurrence of heavy indebtedness. All donors, including emerging donors should cooperate to enhance debt sustainability in borrowing countries. There was concern about emerging donors providing loans that might not be sustainable to countries that were benefiting or had benefited from debt relief.

46. It was noted that the DSF was an early warning system to be used by lenders and borrowers. Domestic debt was increasing and becoming substantial in several countries; thus, such debt should be included in the debt sustainability analysis (DSA) and debt management enhancement. Some participants pointed out that debt incurred to build physical and financial assets – particularly infrastructure and productive investments - was likely to be more sustainable than debt used to finance current expenditures, hence debt sustainability analysis should focus on both liabilities and assets. Some speakers suggested that recipient countries should participate actively in the DSA process.

47. Many participants highlighted that a review of the current debt sustainability frameworks in the IMF and World Bank was warranted. Debt sustainability frameworks should have development as an objective, including in particular, the achievement of the MDGs and other IADG.