

Review of the Monterrey Consensus on Financing for Development

March 10-11, 2008 Review Session on External Debt

U.S. Government Submission

Goals and Commitments

The 2002 Monterrey Consensus identifies external debt as the fifth of six “leading actions” or pillars in support of financing for development (FfD). The major focus of Pillar 5 is on the shared responsibility of debtors and creditors for preventing and resolving unsustainable debt situations.

The Consensus notes that:

- National comprehensive strategies to monitor and manage external liabilities, including sound macroeconomic policies and public resource management, are key (paragraph 47).
- Debt relief measures, where appropriate, should be pursued vigorously in the appropriate fora (paragraph 48).
- The Enhanced Heavily Indebted Poor Countries (HIPC) initiative should be implemented fully in a speedy and effective manner as debtor countries take the policy measures necessary to qualify for the HIPC debt relief (paragraph 49).
- Debt sustainability analyses should be continually reviewed with respect to methodology and assumptions (paragraphs 49-50).

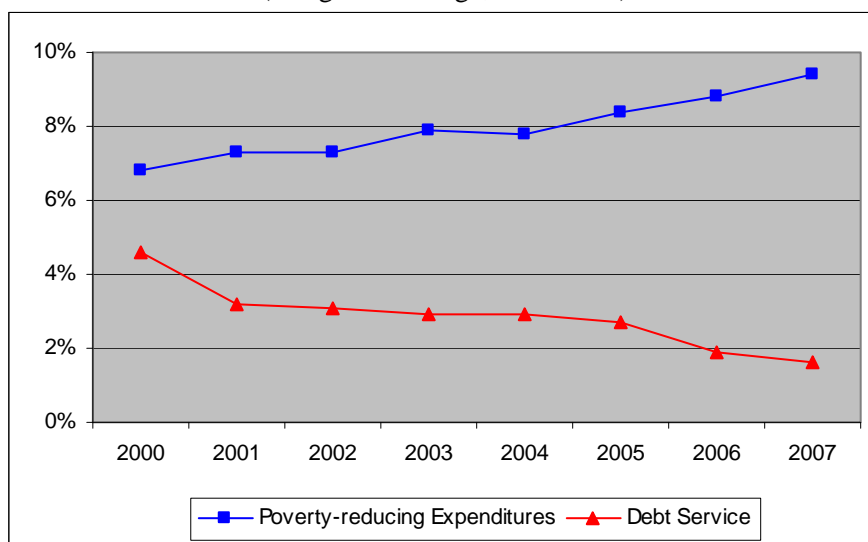
Progress since 2002

There has been substantial progress in addressing external debt issues since 2002.

Thirty-two countries have demonstrated sufficient progress on economic policies and commitment to poverty reduction to start receiving HIPC debt relief. Twenty-three have completed the HIPC process and qualified for final reduction of debt stock. Under the HIPC framework, the external debt of these thirty-two countries will be reduced by over \$63 billion in nominal terms. According to the IMF, on average the ratio of debt service to GDP for these countries declined by more than 2 percentage points between 2000 and 2006. As the graph below illustrates, at the same time that debt service has been decreasing, average poverty-reducing expenditures have been going up. By 2006, average poverty-reducing expenditures in HIPCs that had reached decision point were over five times as large as debt service payments, compared to only 1.5 times larger in 2000.

Multilateral Debt Relief Initiative (MDRI): In 2005 the G-8 countries proposed much deeper cancellation of multilateral debts for countries that reach Completion Point under the Enhanced HIPC Initiative. Under the Multilateral Debt Relief Initiative (MDRI), nearly all debts owed by eligible countries to the IMF, World Bank (IDA) and African Development Bank (AfDF) are cancelled. In addition, in 2007 the Inter-American

Figure 1: Poverty-Reducing Expenditures and External Debt Service for Post-Decision Point Countries
(Weighted average, % of GDP)



Source: IMF/World Bank, *HIPC and MDRI – Status of Implementation*, September 6, 2007. Data for 2007 are projections.

Development Bank (IDB) agreed to provide additional debt relief on the same terms. Twenty-three participants in the HIPC Initiative have benefited from MDRI and additional IDB relief to date.¹ These countries had their external debts reduced by over \$42 billion in nominal terms, above and beyond HIPC Initiative debt relief.

Evian Approach in the Paris Club: The Paris Club group of creditor nations adopted the so-called “Evian Approach” in 2003 to provide debt relief on a case-by-case basis to middle-income countries and non-HIPC low-income countries in debt distress. Under the Evian Approach, Paris Club creditors tailor a debt treatment to the financial needs of the debtor, based on an analysis of the debtor’s debt sustainability. To date, eight countries have been treated under the Evian approach.

Debt Sustainability Framework: In order to ensure that gains from major debt relief were not lost, and to institute a more forward-looking approach to debt sustainability, the World Bank and IMF developed the joint Debt Sustainability Framework (DSF) for low-income countries in 2005. The DSF is an analytic framework used to monitor the evolution of a country’s debt burden indicators, and to guide Low-Income Country (LIC) borrowing and creditor lending decisions in a way that matches needs for funds with current and *prospective* ability to service debt. The DSF assesses a country’s debt vulnerability according to its debt ratios and policy performance. Refinements to the DSF have increased the number and range of alternative scenarios and stress tests in order to provide a more complete assessment of debt sustainability.

¹ Due to internal requirements at the IMF, the IMF also provided MDRI treatment to two non-HIPC countries, Cambodia and Tajikistan.

Middle-Income Countries' Improved Debt Situation: In addition to the gains made by HIPCs, since 2002 there has been a striking improvement in the debt situations of many middle-income countries. In 2002, many middle-income countries were emerging from situations of debt distress, in many cases requiring Paris Club reschedulings and IMF support. Since then, through a combination of economic reforms, a targeted reduction of current account deficits after the East Asia debt crisis of 1997, and a favorable global environment, most of these middle-income countries have improved their debt ratios, enabling them to emerge from reschedulings and improve their credit ratings. Many middle-income countries have repaid – or prepaid – their IMF facilities. A number of middle-income countries have borrowed at competitive rates on international capital markets, a clear sign of improved credit ratings and debt management.

Lessons Learned

Grant financing is an important tool: The shift to greater use of grant financing for low-income countries at the multilateral development banks has been an important tool in helping to maintain debt sustainability. The World Bank (IDA) and the African Development Bank (AfDF) have integrated the Debt Sustainability Framework into their grant allocation and lending decisions. IDA and the AfDF increasingly use forward-looking LIC debt sustainability analyses (DSAs) prepared jointly by the IMF and the World Bank to determine the grant/loan mix for each LIC. A country with a high risk of debt distress, for instance, will receive all of its IDA allocation in grant form. Conversely, a LIC with low risk of debt distress under the DSF will receive all of its IDA allocation in loan form. More recently, the Asian Development Bank and the Inter-American Development Bank have agreed to use the DSF in their lending decisions. The individual country DSAs are updated annually, and can therefore respond to changing circumstances in the country.

Need for further improvements in debt management: Although attention has been focused for some time on the need to improve debt management capacity, increased concerns about maintaining debt sustainability following substantial HIPC and MDRI debt reduction have brought this need to the fore. Over the past year, the IMF and World Bank have worked to help build a system to improve debt management capacity in LICs. In particular, a Debt Management Performance Assessment Tool has been piloted in five LICs, and will be applied to 60 LICs over the next five years. In addition, the World Bank and IMF are increasing the focus on medium-term debt management strategies among LICs, offering technical assistance and capacity building under a targeted debt management program. The UN Conference on Trade and Development's technical assistance programs also contribute to improved debt management practices in low- and middle-income countries. Building debt management capacity is a long-term effort that can only be delivered in partnership with other institutions.

In the short term, prudent debt management is essential to avoid over-borrowing and difficulties in meeting debt service payments. In the long term, countries that pursue prudent debt management are likely to benefit from increased access to capital markets

and lower borrowing costs due to factors such as improved sovereign credit ratings. For example, with technical assistance from the U.S. Treasury Department for government debt issuance and management, countries like Ghana, Uganda, and Kenya have been able to reduce their borrowing costs, maintain debt sustainability, and better manage their risks. It will be important for developing countries that have achieved access to capital markets to follow policies and sound debt management practices that strengthen this important source of financing for growth and development.

Importance of Macroeconomic Policies: Debt relief under HIPC has not only reduced unsustainable debt burdens, it has provided a valuable process to encourage important economic reforms that support economic growth and help to reduce poverty. The experience since 2002 reinforces the view that strong macroeconomic policies are a crucial element in resolving external debt problems. Sound macroeconomic and structural policies can help countries overcome much of their debt problems through increased economic growth. In the case of low-income countries with unsustainable debt burdens, these policies may need to be supplemented with debt reduction under the HIPC, MDRI or Naples treatments. In all cases, good policies and good governance are essential elements to effective debt management and debt sustainability.

New Challenges and Emerging Issues

In addition to enhanced efforts to improve debt management capacity, further work is needed to achieve broad – both public and private sector -- creditor participation in HIPC debt relief. In this vein, helping HIPCs to avoid damaging litigation is a priority. A number of HIPCs are facing lawsuits from private creditors seeking to recover the full value of their claims. The United States believes strongly that all creditors should provide debt relief to eligible countries, and we are working intensively to find ways to encourage this, including through use of the World Bank's Debt Reduction Facility.

On the debt sustainability front, additional efforts are needed to expand active use of the Debt Sustainability Framework (DSF) as a tool to guide both creditors and borrowers. Borrowing countries need to pursue a level and composition of borrowing that is appropriate and sustainable for their individual circumstances. For some countries, the correct mix of funds may primarily be grant financing, while other countries are increasingly able to access private capital in a sustainable way.

It is important that emerging creditors, as well as traditional lenders, be aware of these country-specific needs and structure their financing accordingly. Substantial lending from emerging creditors to a number of African HIPCs, for example, puts at risk the hard-won debt sustainability that HIPC, MDRI and other initiatives have sought to achieve. In the effort to attain long-term debt sustainability, the Debt Sustainability Framework is already serving as an important tool. However, its overall effectiveness will depend on its widespread adoption as a lending and borrowing guide.