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Interactions between Debt Relief, Trade, and Aid

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1. Introduction

Coherence and consistency among the financial, monetary, and trading systems was a key aspiration of the Monterrey Consensus. The logic of interaction between these different spheres is easily argued. Commodities account for an average of 84 per cent of the export earnings of beneficiary countries of HIPC (“Heavily Indebted Poor Countries”). While HIPC preceded the Consensus, it is trumpeted by participants in the Monterrey process as a key indicator of progress under Chapter 5 entitled External Debt. Coherence would suggest that the commodity price dynamics would have to be considered at least in the chapter on trade, and, given the existence of the Compensatory Financing Facility (CFF) since 1963, in order “to help countries cope with temporary exogenous shocks affecting export earnings without resorting to undue and unnecessary adjustment,”² might also be considered in the chapter on systemic issues where the operations of the IMF fall.

Policy interventions, including those which concern debt, aid, and trade, in one of these sectors, impact other areas of development concern. There are implicit, or explicit, compromises or trade-offs that are undertaken when trade liberalization, for example, is pursued under the (analytically consistent) presumption that the policy is neutral in regard to total public revenues. It is the position of this paper, however, that logic, grounded in development debates, can be applied to these thickets of interactions in order to understand the net impact of policy.

While debt, aid and trade dynamics are all inextricably interrelated in the development strategies and efforts to reduce poverty, the international community has, for the most part, a paradigm based on a functional division of responsibilities that tends to conspire against holistic policy-making (Caliari 2007, p. 1). Any and all trade-related issues have been assigned to the World Trade Organization (WTO). This permit the WTO to define its focus as trade expansion, independent of developmental considerations, even though the majority of its members are developing countries and the current round of trade negotiations are undertaken under the Doha Development Agenda. In principle, the agendas of organizations are defined by collective decisions among its members and are not limited by its constitutional purpose. For example, the WTO agenda has expanded to a

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² IMF (2000) “Review of the Compensatory and Contingency Financing Facility (CCFF) and Buffer Stock Financing Facility (BSFF)--Preliminary Considerations” p.1, see <http://www.imf.org/external/np/ccffbsff/review/index.htm#i>, accessed 22 March 2008

variety of “trade-related” issues (not uncontroversially). The WTO launched a Working Group on Debt, Trade and Finance in 2002, even though development and development finance are not explicitly in the WTO agenda.

When institutions attempt to stretch themselves to cover related issues, constitutional arguments often become decisive limitations as to what they can do and cannot do. A manifestation of this is that, when it comes to the relationship among the three areas this paper addresses, there are issues that “fall between the cracks.” This is the argument in favor of a venue where linkages between trade, debt and finance can be identified, debated, and addressed at least initially or perhaps permanently.

The Monterrey Consensus sought a holistic consideration of all sources of finance, but this is a call that has been partially honored. While the Monterrey Consensus addressed all sources of finance, they were still addressed in separate chapters, thereby giving an incentive to reproduce the compartmentalized nature of deliberations followed in other institutions. This has reduced the capacity of the process to add value to the other processes. Better use could be made of the mandate and follow-up process to ensure the Monterrey process’ unique position is used to enable a structured discussion that integrates different sources of finance and more deliberately explores their interrelations. An argument can be posed that global and regional institutions with limited mandates would welcome the outcomes emerging from such deliberations that they are structurally disabled to hold.

This paper is meant to initiate an exploration of the interactions between the different chapters of the Monterrey Consensus, which include domestic resource mobilization, international private capital flows, trade, aid, external debt and systemic issues. Because it may be overly ambitious to try to cover all those interrelations, it has chosen the dynamics between debt relief (one aspect of debt policy), market access (one aspect of trade policy) and aid. It attempts to illustrate the manner in which holistic and integrated consideration of different issues may lead to superior policy outcomes for each specialized (debt, trade, aid) policy-making area.

There is a growing realization of instances of interactions between the Monterrey chapters. Among a few examples are:

1. A recent IMF staff study indicates that on the average LDCs have only recovered one-third of the tariff revenues they lose in trade liberalization through other taxes (Baumsgard and Keene, 2005). This implies that trade liberalization has an impact on domestic resource mobilization. It also means that trade liberalization could have a significant impact on the ability of the public sector to service its external (and domestic) debt.
2. The Monterrey chapter on external debt encourages donor countries to ensure “that resources provided for debt relief do not detract from ODA resources intended to be available for developing countries.” From a purely accounting point of view, most DAC countries have included their debt relief contributions in their ODA. Total DAC ODA has recently increased mostly because of debt relief (humanitarian support) and has declined after debt relief contributions. Logic suggests that donor countries will be unable to meet their intentions to meet the target enunciated in the aid chapter through debt relief.

3. The mandate of WTO Working Group on Trade, Debt, and Finance (WGTDF) involves the interaction between debt and trade by including the examination of:
 - any possible recommendation on steps that might be taken within the mandate and competence of the WTO to enhance the capacity of multilateral trading system to contribute to a durable solution to the problem of external indebtedness of developing and least-developed countries (WTO, 2001)
4. The liberalization of the domestic financial sector (domestic resource mobilization chapter) and the capital account (private capital flows chapter) has provided many emerging economies access to international capital markets. This permits investors, both foreign and domestic, to borrow, both in the external markets, to fund their operations, which has implications for the external debt chapter. This paradisiacal access to debt generation ironically places an additional burden on many national governments to maintain their countries' credit-worthiness in external private financial markets. In many instances (i.e. in actual practice), this has involved the public sector sustaining the combination of a not-insignificant primary fiscal surplus, an appreciating currency, and high domestic interest rates, all distinct from the confines of an IMF program.

There are a number of axes for analyzing the interactions among debt relief, aid and market access. This paper will take the following two axes for analysis: compensatory financing for trade-related losses (including Aid for Trade) and domestic capital accumulation for development.

2. Compensatory financing for trade-related losses (including Aid for Trade)

The discussion on compensatory financing for trade-related losses began with the recognition of the possibility of smoothing out commodity price swings. The financial basis for the idea appeared to be sound: countries could borrow when export earnings and financial reserves were low and repay when they are high.

There is the second category of trade-related losses, that of policy induced losses in conjunction with trade liberalization-inspired reform efforts. In the traditional neoclassical view, these losses are temporary and would be recovered subsequently after reallocation of investment to competitive sectors. This has justified the recent international discussion on Aid for Trade, which we discuss in the next section; compensatory financing for trade-related shocks are discussed in the section after that.

A. Aid for Trade

The appearance on the international scene of "Aid for Trade," (along with the associated acronyms, such as "A4T") overturns the adage from the 1980s of "trade, not aid." It signals a willingness on the part of the donors to undertake international cooperation in the nexus between trade and development not only through providing market access but also in assisting developing countries being able to take advantage of

market access. This willingness was elicited in the launch of the current round of WTO of negotiations.

As in previous development fashions, Aid for Trade is not new. Paragraph 57 of the WTO Hong Kong Ministerial declarations defines the area as assistance to “developing countries, particularly LDCs, to build the supply-side capacity and trade-related infrastructure that they need to assist them to implement and benefit from WTO Agreements and more broadly to expand their trade.” According to the OECD, which utilizes a definition of Aid for Trade which excludes infrastructure financing that some donors include, 20-30 per cent of total ODA are already flowing to trade-related capacity issues, a proportion that is increasing.

Conceptualizing “Aid for Trade” is therefore critical as the international community grapples with erecting an Aid for Trade agenda. The first question that can be raised about Aid for Trade is: Is the objective trade expansion or is it development? The trade expansion objective is associated with “tough love” (Everett 2005); this aid will help to overcome developing countries’ objections³ to faster multilateral trade liberalization, consistent with the framework that the losses from such liberalization are by nature temporary. How much resources would be required to attain a policy decision facilitation objective? Resources would be needed only up the point where these address the most critical obstacles to political decision-making in each developing country.

If Aid for Trade is developmental, then it should be shaped by the ongoing advances in development cooperation thinking. For example, Aid for Trade programs should be operationalized consistent with the principles of the Paris Declaration on aid effectiveness. Therefore, Aid for Trade projects should not distort domestic spending priorities and the developing country should be able to determine how much of its total aid receipts will be devoted to trade-related projects. In establishing priorities and evaluating Aid for Trade projects, the objectives of employment generation and gender equality (and not necessarily trade expansion) should be decisive benchmarks.

Beyond the more modern ideas on donor-recipient relations and in the context of previous donor commitments to development finance, Aid for Trade should generate additional resources for development. It should not represent only a reclassification of previous ODA flows. Unless justified by analysis that indicates that trade is the critical constraint to other development objectives, it should not be limited to a redeployment/repositioning of ODA away from other sectors to the trade-related sector.

The most difficult conceptual issue has to do with the role of trade in development, or of trade policy in development policy. The various proposed categories of Aid for Trade have varying and uncertain degrees of developmental content:

1. Trade negotiating capacity and support for costs in engaging in the legal activities of the multilateral trading system to enforce their rights – Developing countries are clearly at a disadvantage in this area, but it needs to be asked

³ It is a generally presumed principle in the Doha trade negotiations that while Aid for Trade has been recognized by negotiators, it is not part of the single undertaking. A November 2007 statement from a number of NGOs issued in connection with the Global Aid for Trade Review demanded Aid for Trade not be given as a *quid pro quo* in trade negotiations.

whether building permanent capacity in developing countries can be avoided with a less asymmetrical enforcement mechanisms and less byzantine trading rules.

2. Adjustment costs of liberalization – These would be temporary, time-bound adjustments involved in adjusting the domestic legal regime to meet international commitments and programs to recover revenues lost due to liberalization. This kind of financing, if provided through loans, could prove onerous in the future if it proves to be the case that reforming the domestic legal system proves to be a long-term agenda. Loans to cover fiscal shortfalls are not justified unless there is a reasonable expectation that tax reform will succeed.
3. Infrastructure and other non-trade sector-specific investment – This kind of aid and/or lending would tend to count among the more traditional development-oriented assistance. It can be justified as improving supply capacity (number 4 below), but it raises the redeployment of aid issue.
4. Improving the “supply capacity” for international trade – This formulation is the most general and common formulation for Aid for Trade. It can be restricted to those sectors for which market access exists but the domestic supply capacity is wanting. The question is – would this be a limitation that donors would like to impose? If it is not restricted to these, the Aid for Trade raises all the development issues associated with trade. Would policy reform conditionality accompany Aid for Trade? Can Aid for Trade resources be applied toward developing infant industries or at least toward increasing domestic value-added in selected manufacturing sectors?

There are vast differences in conception among countries in what should be included in the Aid for Trade agenda. Moreover, it is likely that the World Bank will have a key role to play in shaping the Aid for Trade and will be an important conduit for such resources. This will tend to bias the evolution of the facility more towards donor interests, as long as the weight of voting influence in the bank remain with the developed countries. If policy conditionality accompanies Aid for Trade, will it represent another new channel for reshaping the development policy space of developing countries?

The final important consideration is that there is no presumption that Aid for Trade will be restricted to grants. The Japanese government’s announcement of resources for Aid for Trade during the December 2005 WTO ministerial meeting in Hong Kong implied that its support would be available as concessional loans. To what extent will Aid for Trade provide a new channel for debt accumulation by developing countries?

In 2004, the IMF introduced the Trade Integration Mechanism (TIM) to address the negative balance of payments impacts of WTO commitments. A country can apply for financing under TIM if it can demonstrate an expected balance of payments shortfall due to measures undertaken by other countries in pursuit of a more open and non-discriminatory market access.

This discussion highlights the fact that Aid for Trade is a multi-chapter issue in terms of the Monterrey framework. A desirable goal is that their implementations fulfill the standards enunciated in each of the chapters on Aid, Trade, and External Debt. Should it

be the case that Aid for Trade will generate significant resources for its objectives and become an important source of financing for development, Aid for Trade has the potential of being a pilot process in exploring the interactions between these Monterrey chapters.

B. Compensatory financing for trade-related shocks

A high dependence on commodity exports is strongly connected with the external debt problem of developing countries. Commodity-dependent exporters have borrowed to pay for needed imports and to help finance sustain domestic investment in the context of a small domestic private sector and in the face of declining commodity prices. Despite the jump in commodity prices of the last few years, the prices of commodities have been declining in the last four decades. The recent increases have not yet caught up with the previous decline. Between the years 1977 and 2001, prices for 41 out of 46 leading commodities declined (after adjustment for general inflation). The average decline in dollars was 2.8 percent. World Bank estimates point to similar trend. For instance, the Bank estimates that the cumulative loss resulting from adverse terms of trade over a period of three decades, for African non-oil-exporting countries, amounted to 119% of their combined GDP.

External borrowing has also been resorted in response sharp fluctuations in the prices of commodities. The variability of commodity prices makes countries that are highly dependent on commodities unable to plan on the basis of a predictable stream of income. It also makes them susceptible to terms of trade shocks that introduce high levels of uncertainty to their balance of payments, and (indirectly) also impact negatively their fiscal positions, rates of growth and poverty. Some studies have, for instance, found the average standard deviation of export prices for 27 HIPCs to be around 20 percent. So, in spite of rising commodity prices, considerations around the predictability of income do not support commodity production as a strategy to assure debt servicing capacity in the long term. Research studies have noted that fluctuations tend also to be asymmetric in the sense that price busts tend to be larger than the booms. Price busts tend also to be larger and happen at a faster rate of change than price booms. Additionally, IMF research has demonstrated that lower income countries tend to suffer larger damage in comparison to other developing countries when commodity price shocks occur and that commodity price shocks tend to happen more frequently in those countries.

Protecting economic growth from commodity price changes in a manner which does not introduce debt vulnerabilities has long been an identified financing for development need. In the long run, diversifying out of commodity export dependence into manufactured exports would be the solution. In the short-run, the build-up of reserves to during periods of high prices to ride out the periods of price slumps is necessary. When there are insufficient reserves to address price declines, financing responses have to be consistent with the nature of the shock (Griffith-Jones and Gottschalk 2005).

For temporary shocks, timely finance through official liquidity for a large proportion of the shock could help the country avoid a negative impact on growth. Liquidity provision would permit the country to maintain levels of imports and government spending (Griffith-Jones and Ocampo 2008, p. 2). If the shock subsequently proves to be more longer-lasting, the repayment of the liquidity provision could be automatically extended; this is an original feature of the IMF's Compensatory Financing Facility (CFF). If the shock is on the export side and is of a permanent nature, financing for export diversification would be

appropriate. Such an effort should be supported by the consistent policies, such as exchange rate management to maintain competitive exchange rates. If the shock is on the import side, financing to reduce dependence, such as greater energy efficiency would be appropriate.

There is general agreement on the list of principles in the design of compensatory financing, and the controversies have more to do with feasibility and practicality. It is important to measure the shock precisely. Financing should be made available in a timely manner, with low or no conditionality (since the shock is by definition exogenous) and the size of the financing available should be a significant proportion of the shock). For low income countries, the financing should be made available at concessional rates.

The Compensatory Financing Facility had been a major facility of the IMF until 2000 when the program was reviewed and amended. Griffith-Jones and Ocampo (2008, p. 10) suggest that the very high conditionality attached to the program combined with the recent run-up in commodity prices is the reason for the sudden stop in the use of CFF. Countries have preferred to tighten fiscal and monetary policy than to undertake the high conditionality required by the CFF. The CFF is non-concessional lending, which makes it an expensive proposition for low income countries.

The IMF has provided liquidity for trade shocks for countries under the Poverty Reduction and Growth Facility (PRGF). Even though it is concessional financing, it is not available to non-PRGF countries and its financing is accessed under high conditionality of a PRGF. The size of the financing has been found to be small in comparison to the shock. The IMF created a new window, called at External Shocks Facility (ESF) at concessional rates for low-income countries facing exogenous shocks. It applies only to export price shocks, not imports. So it would not be available to countries facing higher import payments due to higher food imports. It can be regarded as a high conditionality financing since it requires agreement on a program (called the Policy Support Instrument or PSI) which is effectively conditionality without financing. When a shock occurs, adjustments to the PSI can be negotiated to trigger the ESF financing. In fact, the PSI is suspended the moment an ESF is approved. ESF financing is limited to 25 per cent of quota. No country has used the ESF.

The EU provides an export shock facility under the program called FLEX for “ACP” (Africa, Caribbean, Pacific) partners, which has its own flexibilities and limitations.

The inadequacy of existing compensatory mechanisms for trade can be interpreted as a generator of debt vulnerabilities. To be adequate, it will be necessary to reconsider the conditionality requirements to provide financing for shocks that are outside the control of affected countries. For countries with programs with the IMF, it will not create additional work to identify the price assumptions behind the existing programs and provide for automatic increases in financing when these assumptions are violated. It will create new facilities and scale up existing ones. In the current situation of higher food and energy prices, the absence of adequate import financing facilities is particularly critical.

A French instrument for countercyclical intervention sets a precedent that could be considered in relating debt servicing to trade shocks. The facility permits countries to suspend debt service in response to an export shortfall to a maximum of five years.

3. Domestic Capital Accumulation

A. Debt relief, and aid, in relation to market access opportunities

Developing countries require significant levels of investment in infrastructure, physical and human resources in order to take advantage of trading opportunities and move into the export of products whose weights in world trade are increasing. The potential benefits of market access are severely constricted by “supply-side constraints,” which has less to do with high domestic labor costs and more to do with low productivity and poor technological capability. For many countries, the incidence of high debt servicing costs diverts funding that could have been to undertake these types of investments (UNCTAD 2002, p. 152). Moreover, the uncertainty associated with the costs of high debt service debts to deter private investment.

One interpretation of the key ingredient underlying the success of East Asian countries is their ability to translate export earnings into investment and vice-versa (Akyuz *et al.*, 1999, p. 9), the so-called investment-export nexus. While export earnings as a proportion of GDP have increased in many developing countries since the 1980s, investment rates have actually stayed stagnant or declined slightly, with only a few countries such as Korea and Malaysia showing an opposite pattern (Memis and Montes 2008).

Ugarteche (2007) demonstrates this in the case of Latin America. High debt service levels, which in many countries also translate into high domestic interest rates, have represented a key factor in breaking the investment-export nexus. In the case of Latin America, particularly, there has been a clear substitution of domestic debt for external debt. While the external debt problem appears to have subsided, domestic investment in conjunction with higher export earnings is constricted by high domestic interest rates. Higher export earnings have therefore not translated into increased domestic value-added.

In spite of the emphasis by international financial institutions on the importance of trade-led growth in order to strengthen debt servicing capability, the actual impact of debt service on the ability of the country to establish this key condition for trade-led growth is not a consideration in determining eligibility and amounts of debt relief. The effectiveness of Aid for trade will also be affected if such aid is used to finance debt payments instead. Moreover, evidence shows that in the past donors, who are also major creditors, have tended to direct aid to countries heavily indebted in order to ensure these countries would be able to service their debts (UNCTAD 2002, p. 153).

B. Debt relief and the expansion of “policy space”

In order to take advantage of market access opportunities, the capacity to design trade within a development strategy tailored to the reality of the specific country is critical. Without that, the contribution of both debt relief and market access to domestic capital accumulation would be negligible or may well be negative. The ability experiment to find the appropriate mix of policies is therefore indispensable but this is an approach that requires sufficient policy space to advance or roll back certain components in their policy mix. Since the 1980s debt crisis, countries that have undertaken debt restructuring have undertaken these under the auspices of the Bretton Woods institutions. In fact, even aid

programs of bilateral donors began to be condition on the operation of such programs. This has constrained policy experimentation by debt-vulnerable countries. Recent thinking has emphasized the importance of such experimentation, as in:

“All successful cases of development in the last fifty years have been based on creative and often heterodox policy approaches. . . . If we want to assist developing countries in their quest for development, the way to move forward is not through more onerous conditionality, further international harmonization, better dissemination of ‘best practices’ or greater international discipline. It is through greater policy space.” (Rodrik, Birdsall and Subramanian 2005, 9/10)

Others thinkers have made reference to the potential ineffectiveness of *a priori* conceptions being applied to developing country realities.⁴ Internationally-agreed documents such as the Monterrey Consensus have recognized the logical notion that policy advice from multilateral financial institutions should take into account local conditions.⁵ A significant constraint on the successful participation of developing countries in the trade system that debt relief is supposed to alleviate —though the least easy to quantify - is the restriction on domestic policy space.

These restrictions result in the deepening of asymmetries and imbalances between these debt-distressed developing countries and their developed country trading partners. The kinds of reforms undertaken by countries benefiting the from HIPC initiative and the Multilateral Debt Relief Initiative (MDRI) affect these countries’ trade and investment policies and stances in international trade and investment negotiations. Their capacity to negotiate for market access terms are compromised by the multilateral and bilateral actors on whom the provision of such external financing (or rescheduling of debt obligations) is contingent. These programs, by requiring unilateral trade liberalization and deregulation of key service sectors, have also affected the bargaining power of the affected countries in undertaking other trade and investment agreements.

The debt sustainability framework (DSF) is the new venue of policy interaction in the area of debt, trade, and aid. Because of the inherent uncertainty on what constitutes the capacity of a developing country to absorb external debt, the framework has turned to an indicator World Bank staff had been relying on internally to assess the various aspects of a country’s policy regime called the Country Policy and Institutional Assessment (CPIA). A debt sustainability calculation for a developing country must contend with the reality that it being applied to a developing country, for which it will be difficult to characterize a

⁴ “But while some abstraction is important, gross abstraction can make a model irrelevant. And for many situations, at least in the developing world, the complete markets model is too far distanced from reality to be useful.” (Rajan 2004)

⁵ Para. 56 of the Monterrey Consensus states “We stress the need for multilateral financial institutions, in providing policy advice and financial support, to work on the basis of sound, nationally owned paths of reform that take into account the needs of the poor and efforts to reduce poverty, and to pay due regard to the special needs and implementing capacities of developing countries and countries with economies in transition, aiming at economic growth and sustainable development.”

'heterodox' policy. While the HIPC initiative made debt relief conditional on a track record of structural adjustment-type reforms, the DSF basically determines the amount of debt a country can borrow on the basis of CPIA ratings. The rationale for the use of the CPIA would be that countries with better policies are expected to be more able to repay and, therefore, capable of sustaining higher levels of debt.

It can be said that the CPIA, an internal staff tool meant to be 'road-tested' for many years before public use, has been prematurely released⁶ as a result of their application to DSF. A 2001 World Bank review cast doubt on the accuracy of the CPIA ratings to predict higher rates of growth. The review found that good CPIA ratings tended to be preceded by, rather than to precede, high rates of growth in the countries under evaluation. There has been a spate of criticisms of the adequacy of the CPIA as a proxy of borrowing countries' performance. The CPIA criteria, especially those in the area of economic management and structural policies, replicate the approach to the debt-trade connection at the core of HIPC and its shortcomings. CPIA indicators are explicitly based on a country's trade and investment policies.

For instance, under the criteria on "Trade" a country gets the highest rating when

"Average tariff (weighted by global trade flows) is low (10% or less), with low dispersion and insignificant or no quantitative restrictions or export taxes. Trading monopolies absent or unimportant. Indirect taxes (e.g. sales, excise, surcharges) do not discriminate against imports or exports. Efficient and rule-bound customs administration. IMF Article 8 status. Minimal or no foreign exchange restrictions on long-term investment capital inflows."

Under the criteria on "Financial Stability" a country gets the highest rating when, inter alia, "Good competition policies (e.g., no barriers to entry, equal treatment of foreign and domestic investors, integrated financial system, virtually complete capital account convertibility). . . "

The Directors of the IMF complemented the DSF thus: "In view of the heterogeneity of low-income countries, Directors saw the ability of the framework to incorporate country-specific information and judgments as one of its key merits."⁷ The CPIA is not really a "one size fits all" approach because it permits country-specific information to be inputted. However, it is a one-scale-fits-all or a one-metric-fits-all approach to policy evaluation. For example, its metric would conflict with the historical pattern that successful countries have liberalized and protected different sectors at various stages of development in order to build their international competitiveness. More to the point, CPIA ratings as currently conceived tell nothing about the progress of a country in moving towards the adoption of a trade and investment regime suitable to help the country find a sustainable exit to its debt situation. In several aspects the underlying policy model is contradictory with the policies that countries historically used in order to make the move into more dynamic and higher value added production.

⁶ In line with international calls for greater transparency as part of good governance, its premature release nevertheless can be considered a positive development.

⁷ IMF 2004a.

The same 2001 World Bank review stated that the range of policies included in the CPIA is “extremely difficult to do well, given countries’ different natural endowments and levels of development.”⁸ It can be argued that even developed countries will have a difficult time “to do well” on many of the policies included in the CPIA.

Through successive innovations, the governance elements of the CPIA have progressively been given increased weight relative to the other clusters of criteria.⁹ Even if one agreed with the basic premise of the critical role of governance, given the shaky links between the particular areas measured by the indicators in this cluster and the large margins of error associated with their measurement, it is hard to justify the large relative weight assigned to this cluster. The CPIA rating process itself is fraught with inadequately good governance or inadequate good governance, as the case may be (see below).

The CPIA was originally designed to measure policies rather than outcomes. However, several of the indicators tend to measure outcomes rather than policy. When this is the case, they are sensitive to the levels of development of the countries being rated, and would disadvantage certain countries for being poorer and less-resourced than others, regardless of their efforts to implement the required policies.¹⁰ Furthermore, ratings focused on outcomes evaluate countries, at least implicitly, for factors outside their control. Usually, when ratings measure outcomes they do not differentiate to what extent certain outcomes are the responsibility of the rated country itself and to what extent they might be the result of a) economic policies that are regarded as good by the rater itself; or b) exogenous shocks (either terms of trade shocks, exchange rate movements, disasters, etc.) outside the control of the country. Staff of BWIs do not have a framework to disaggregate their own responsibility for policy advice to borrowing countries and the policy decisions of borrowing countries themselves.

Lastly, concerns have been raised about the process for arriving at the ratings. The ratings are made by World Bank staff in absolute secrecy and are completed without the rated country being able to have any say on the matter. Only recently the Bank has started the disclosure of ratings country-by-country and criterion-by-criterion, but only for low-income countries. Records of the staff questionnaires that back up the ratings, however, are not accessible, so the initial non-transparent situation whereby an outside researcher could not scrutinize the ratings or how they were arrived at, remains. The changes also include broader consultation with country authorities. In spite of this, it was made clear that the authorities should have no expectation of being able to influence the final rating at all.¹¹

⁸ Id., 45

⁹ See UN SG 2007, para. 33 (“The concept of good governance and institutions is inherently subjective... the index may reflect how well countries are implementing the Bank’s policy advice.”)

¹⁰ Id. 23-24. The confusion between policy performance and outcomes has also led to confusion in the sense that CPIA indicators tend to be mistakenly used as a variable to justify econometric results. As explained by Herman (2004, 5), a particular example is the Nehru-Kraay study that has been used as a basis for the conclusions reached in the DSF paper.

¹¹ IDA 2004d, 7: “In its guidance to staff Management ... will make clear that country discussions should be seen as consultations not negotiations.”

C. Market access, capital accumulation and the indicators of debt sustainability

The indicators of debt sustainability have traditionally been the net present value (NPV) of debt to exports and NPV of debt to budget revenue ratios. Both of these indicators generate an important connection with trade. Countries became eligible if, at the time of the Decision Point, and after traditional debt relief arrangements, their debts were above a threshold of 150% debt to exports.¹² The subsequent debt reduction is aimed at reducing the debt of recipient countries by an amount sufficient to bring it to, or below, those thresholds. (See Annex 1 for a synopsis of debt relief initiatives.)

Because trade dynamics have a direct impact on exports and budget revenue, they were to weigh heavily on the eligibility and level of debt reduction of a given country. However, the initiative was not designed to take into account favorable trade dynamics that could lead to *underestimating* debt relief needs at the time of the Decision Point.¹³ Neither was it to take into account unfavorable trade dynamics that could affect the debt burden after this point. The capacity of a country to accumulate capital and its market access opportunities are taken exogenous to the indicators in debt sustainability.

The sustainability of the debt of countries completing the initiative over the long term depends on the accuracy of assumptions about their export growth and the levels and terms of new financing being provided to them. These assumptions are reflected by projections the Bretton Woods Institutions make as part of the debt sustainability assessments. The assumptions under about export growth and the consequent growth of GDP have been, under the HIPC initiative, the subject of widespread criticism by many sources, generally for being too optimistic.¹⁴ As early as 2000, the US General Accounting Office (GAO) was pointing out that, even if export growth projections seemed to be consistent with the recent past, since the recipient countries were dependent on primary commodities these projections were subject to the vagaries of prices typical to those commodities.¹⁵

The critique was eventually taken up by the staff of the BWIs. According to a HIPC Status of Implementation report dated September 2002, "Staffs' review of the export projections embodied in decision point documents suggests that earlier projections turned out to be optimistic in two-thirds of the countries reviewed. . . " It also confirms that projected future growth for decision point HIPCs was significantly higher than may be expected on the basis of past export performance alone."¹⁶

¹² The debt to exports was the primary indicator. Debt to budget revenue was only applicable exceptionally, when debt to GDP and debt to exports surpassed a certain ratio.

¹³ Change in multi-year average of exports (Martin and Alami, 2001:

¹⁴ GAO 2000 and 2004; World Bank, 2003:28 and Annexes G and H documenting criticism by creditors and debtors.

¹⁵ GAO, 2000: 52. Reproduce

¹⁶ IMF/IDA, 2002: 28 reproduce

A later review by the US General Accounting Office of the 27 HIPCs that passed Decision Point found that projected export growth rates continued to be overly optimistic.¹⁷ While according to the IMF/World Bank the 27 HIPCs would become debt sustainable if they had an average export growth of 7.7 percent, “export earnings are more likely to grow”, says the GAO, “at the historical annual average of 3.1 percent.”¹⁸

In addition to the accuracy of the assumptions, concerns raised by the Operations Evaluation Department of the World Bank relate to the models by which debt projections are conceived, the consistency with which they are applied and their sensitivity to selected assumptions. The Operations Evaluation Department claims in its report it was prevented from making a judgment on these matters because the methodological basis for these projections was not made available. Its concerns, it revealed, were strengthened by consultations with World Bank and IMF staff and analysis in the HIPC documents.¹⁹

The HIPC approach did not integrate trade dynamics impinging on the debt of its intended beneficiaries and their likely capacity to raise levels of domestic capital, in any significant way. The DSF remedies this situation by requiring an assessment of projected debt burdens in the face of plausible shocks as part of the measurement of debt sustainability.²⁰ However, there are still serious flaws in the DSF approach of incorporating exogenous shocks.

First, the assessment continues in the hands of the staff of the BWIs. The DSF has no safeguard against the charge that very optimistic projections underestimated the magnitude of the problems in debtor countries. The increased discretion awarded to staff does not help. While the assessments of vulnerability have been elevated to the category of an explicit element in the new framework, holding the institutions accountable for implementation of this guideline is going to be extremely difficult. There are no guarantees that the old models that tended to overestimate countries' export growth prospects will suddenly be replaced by new ones. Nor are the concerns about the models used for integrating assumptions about export and GDP growth into debt burden projections that were raised by analysts of the HIPC initiative dispelled by a framework that continues to leave the exercise in the hands of the same actors without requiring from them further disclosure.

¹⁷ GAO (2004, 15). The report estimates the potential export shortfall (assuming that countries fulfill their policy conditions) at \$ 215 billion for 23 of the HIPCs (compared with World Bank / IMF estimates).

¹⁸ GAO (2004:15).

¹⁹ World Bank (2003:22). “In particular, it is unclear how the initiative itself is incorporated into projections of imports and net resource transfers, or how the debt projections are integrated with the macroeconomic framework. It would be useful for the World Bank and IMF to provide an explicit statement of how the debt projections, including their balance of payments and fiscal components, are arrived at.”

²⁰ As previously noted, IDA has announced it does not plan to include this element in its assessment, at least for some time.

Second, assuming that the assessments really changed significantly, it is hard to see whether these changes would project into downward revisions of the debt sustainability thresholds. The two main criteria of the E-HIPC are now replaced by country-by-country thresholds based on several debt burden indicators. These thresholds could be lower, but in some cases they will be higher than those of the HIPC initiative. The indicative threshold ranges, as explained above, leave ample room for higher debt burden indicators to become, in the end, acceptable. A review of more than forty debt sustainability assessments found nine countries that had a breach of the respective threshold indicators and were, nonetheless, considered to be at a low risk of debt distress.²¹ In addition, in six cases the countries breaching thresholds were found to be at moderate risk. As asserted by the review, given the continuation of an obscure and highly discretionary approach to reach conclusions from the performance of stress and vulnerability tests, it is very difficult to know what amounts for the difference in treatment between these countries and those where breaches of thresholds led to a determination of “high” risk. Perhaps more troubling was the review’s finding that, in fifteen cases²², the policy-dependent threshold categorization that was supposed to act as point of departure for application of stress testing is not listed, making it impossible to know with any certainty where the final assessment came from.²³

Thirdly, a more important concern has to do with the specific consequence assigned to the risk of external shocks. For a long time HIPC governments have been requesting that exposure to shocks be built into the baseline scenarios of programs, and that contingency financing be committed up-front by donors and creditors to offset such shocks automatically, should they materialize.²⁴

The DSF is meant to inform a borrowing strategy and set prudential limits on non-concessional and concessional financing and has no provisions for the financing impact of external shocks (see Annex 1). Thus, under the DSF, if the calculations on vulnerability are adequately reflected by the debt sustainability assessment, all this would mean is that the country only can undertake debt up to a certain level and the rest needs to be financed through grants, which may or may not be available. The concept of building a contingency fund for situations of shocks remains absent, hence leaving the indebted country with the same uncertainty. Not only a trade strategy is seriously handicapped, but investment that may be oriented to exports is very unlikely in the light of these uncertainties.

²¹ Caliarì 2006. The countries are Zambia, Vietnam, Sri Lanka, Papua New Guinea, Mozambique, Mali, Cape Verde, Armenia and Albania.

²² Ibid. Bangladesh, Bolivia, Bosnia, Cameroon, Comoros, Democratic Republic of Congo, Dominica, Grenada, Liberia, Pakistan, Republic of Congo, Rwanda, Sao Tome and Principe, Serbia and Zimbabwe.

²³ Ibid. In six of these cases, the vulnerability assessment is also missing altogether (Bangladesh, Bolivia, Bosnia, Cameroon, DRC, Dominica).

²⁴ DRI 2004:3.

3. Concluding Section

External debt is potentially an important source of development finance. That it has taken on the image of being an obstacle to development reflects the inability of the international system to address weaknesses in its provision and in the resolution of problems which periodically emerge in loan relationships. While debt is one of the chapters in the Monterrey process, its accumulation by developing countries is often explained by events in the other chapters. Inadequate mechanisms for compensatory financing for trade shocks are important drivers of debt accumulation by developing countries. Responses to developing country debt crises also have significant implications both to the role of debt in subsequent development efforts and to capital accumulation. This paper sought to identify the processes through which investment and policy experimentation are often overly constrained by current international approaches to debt distress.

Aid is also a potentially an indispensable source of development finance. The current discussion on Aid for Trade is an important example of the interaction between market access, aid, and policy conditionality and raises many questions about the impact of this kind of financing on development efforts.

This paper sought to shed light on the types of issues that tend “to fall through the cracks” between the Monterrey chapters. Sustaining capital accumulation toward upgrading and diversifying economic activities should be the purpose of financing which takes the objective of development seriously. At the present time, there are no standing international venues in which these interactions can be brought up and debated in a considered manner, except possibly through the Monterrey process itself.

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Annex 1 - Debt relief initiatives: a brief synopsis

The Enhanced HIPC Initiative had as a goal turning the debt levels of 42 countries, representing 8% of total debt of developing countries, to a sustainable level.²⁵ Seen against this backdrop, the HIPC goals seem rather modest. Nonetheless, the HIPC Initiative represented the first attempt to deal with all debt (bilateral, multilateral and private) in a comprehensive manner, and it is the first one to include reduction of debt owed to multilaterals. HIPC consists of two stages. At first, the potentially eligible country builds a track record of implementing World Bank–IMF programs for three years. At that point, called the Decision Point, the BWIs determine whether, after all traditional debt reduction mechanisms have been tried, the country's debt would still be above a numerically pre-determined threshold. If this is the case, a package of debt relief is designed. In order to obtain full debt relief the country needs to continue a series of reforms for three or more years. When this is achieved, the country reaches what is called Completion Point and the promised debt stock is written off. Between Decision and Completion Point, however, debt service relief already happens on an interim basis. In total, when completed, the Initiative would provide up to two-thirds debt reduction to the eligible countries.

The Debt Sustainability Framework (DSF) was adopted by the IMF/World Bank as the new framework for managing the debt of Low Income Countries (LICs) early in 2005. The DSF applies only to LICs in account of the argument that Middle Income Countries' general capacity to access to capital markets militates in favor of different rules than those applicable to countries that are mostly dependent on official creditors. Among LICs, the DSF applies to those that have either never entered, or already graduated, from the HIPC Initiative. Countries in between would have both types of assessments carried out.

An important characteristic of the DSF is that, unlike the HIPC Initiative, it is not used as a basis to calculate debt relief. The policy consequence of lower debt thresholds under the HIPC Initiative was to flag the need for greater debt relief. Instead, the policy consequence of a lower debt threshold under the DSF is decreased access to lending in non-concessional terms and the need to finance remaining development and poverty reduction goals via grants, with the option of debt relief (or further debt relief, depending on the case) being ruled out.

Also unlike HIPC, the DSF does not rely on pre-set numerical indicators but rather on country-specific debt thresholds.

The establishment of thresholds is arrived at through a method based on three pillars. The definition of debt thresholds is dependent on the quality of policy of the indebted country, assessment of actual and projected debt burden indicators based both on baseline and stress test scenarios, and a comparison of the country's debt burden against these indicators, leading to an overall assessment of the country's risk of 'debt

²⁵ The figure is taken from World Bank, 2003, 5 and the goal from id.,11. More recent documents from the Bretton Woods Institutions have become increasingly cautious in describing the goal of the initiative. See e.g. IMF/IDA 2003, 5, "[The Enhanced HIPC Initiative] charted a course toward restoring debt sustainability by providing resources for substantial debt relief. However, the Initiative, ... can only support but not guarantee sustainability going forward."

distress'. It is on this final conclusion that subsequent financing decisions are meant to be based.

Country-specific debt thresholds are generated on the basis of the quality of their policy and institutional environments, measured using the Country Policy and Institutional Assessment (CPIA) methodology. The CPIA system compares a country's institutional and policy framework against a set of pre-established criteria, receiving a score based on a standard, pre-set view of what is considered a good performance. Depending on their CPIA ratings, countries are placed into three groups (poor, medium and strong), and for each of the five fiscal measures used, assigned a threshold debt level range.

The second step in the DSF process is 'assessing and interpreting a country's current and prospective debt-burden indicators under [a] baseline [scenario] and in the event of plausible shocks'.²⁶ The baseline scenario centers on macroeconomic and fiscal forecasts about the conditions likely to confront the country over the next twenty years, according to the IMF, while the exogenous shock scenarios or stress tests are circumstances such as diminished GDP or export growth, or a depreciation in the value of the national currency, that the country subject to analysis may face.

Finally, these indicators are compared to the thresholds previously established, and on the basis of whether they are under or over the established limits, a rating of low, medium or high risk of debt distress is made. Taken literally, this framework would leave little room for discretion, but in fact a more nuanced approach is encouraged in reaching the ultimate conclusion, meaning, for example, that countries breaching one or more of the thresholds can theoretically be determined to still only be at low risk of debt distress.

Such a rating is then meant to inform the longer-term financing strategies of the IFIs and other lenders and donors as regards the level of the grant element in new financial flows to such countries. Those at a lower risk of debt distress and better prepared to handle the fall-out from external shocks are assumed to be able to take on higher levels of (concessional) financing, while for countries with high levels of debt distress, an increase in the amount of funding received as grants is deemed preferable. Concretely, a "traffic light" system has been established. Countries at a low risk of debt distress receive a "green light" (so are able to finance their requirements through loans). Those at a medium risk of debt distress receive a "yellow light" (can be financed through a 50-50 mix of grants and loans). Those at a high risk of debt distress can only be financed through grants.

Debt, in this framework, is supposed to be brought under the country's allowed threshold through the persistence, over time, of a particular level of grants and loans to fulfill financing requirements.

²⁶ IMF/IDA 2004, 24