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On the
Transfer of Real Resources to Developing Countries)



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NOTE ON THE G8 DEBT RELIEF PROPOSAL

ASSESSMENT OF COSTS, IMPLEMENTATION ISSUES, AND FINANCING OPTIONS

Attached for the September 25, 2005, Development Committee Meeting is a "Note on the G8 Debt Relief Proposal: Assessment of Costs, Implementation Issues, and Financing Options."

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DEVELOPMENT COMMITTEE MEETING - SEPTEMBER 25, 2005

Note on the G8 Debt Relief Proposal

Assessment of Costs, Implementation Issues, and Financing Options

I. INTRODUCTION

1. **G8 countries have proposed to augment debt relief to completion point HIPCs while preserving the financing capacity of the IFIs.**¹ The G8 proposal has two objectives: canceling debt owed by HIPCs to help achieve their Millennium Development Goals (MDGs), while safeguarding the long-term financing capacity of IDA and the AfDF; and encouraging the best use of additional donor resources for development by allocating them to low income countries on the basis of policy performance. This note summarizes the paper discussed by Bank Executive Directors on September 8, 2005,² and provides information on the views of IDA Deputies, who met in Paris on September 11, 2005.

II. KEY ELEMENTS OF THE G8 PROPOSAL AND ITS BENEFITS

2. **The G8 proposal calls for 100 percent cancellation of IDA, AfDF and IMF debt stocks for HIPCs that have reached, or will reach, completion point.** Eighteen completion point HIPCs would be immediately eligible; the remaining 10 interim and 10 pre-decision point HIPCs would become eligible once they reach completion point, as would countries that qualify for the HIPC Initiative under the sunset clause extension. Annual gross assistance flows from IDA and AfDF to a country would be reduced by the amount of relief during that year. Additional resources provided to IDA and AfDF by the donors (to compensate for the forgone debt service from the country) would be re-allocated to a larger subset of IDA and AfDF recipients than that contemplated for debt relief, based on each institution's existing performance-based allocation mechanism. Donors would provide additional contributions to IDA and AfDF to offset "dollar for dollar" the forgone principal and interest repayments due over 40 years. More specifically, donors would make additional funds available to cover the full costs for the IDA14 (\$1 billion, for FY07 and FY08) and AfDF10 periods.³ Thereafter, donors would commit to cover the full costs for the duration of the cancelled loans, by making contributions additional to regular replenishments of IDA and AfDF. The proposal seeks equivalent

¹ This proposal was initially agreed upon by the G8 Finance Ministers at their meeting in London on June 10-11, 2005, and reaffirmed by G8 Heads of State at the Gleneagles Summit on July 8, 2005. The proposal is set out in the G8 Finance Ministers' Communiqué entitled "Conclusions on Development", issued on June 11, 2005.

² *The G8 Debt Relief Proposal: Assessment of Costs, Implementation Issues and Financing Options*, SecM2005-0466, September 6, 2005.

³ The IMF is treated differently. The proposal recommends a combination of internal IMF resources to fund debt relief to 35 HIPCs, excluding countries with protracted arrears and countries that may become eligible for HIPC assistance under the extended sunset clause (through December 31, 2006).

contributions from non-G8 donors, based on agreed burden shares.⁴ The elements of the initial proposal are discussed below.

3. **Potential benefits from the G8 proposal:** First, it would facilitate long-term debt sustainability by reducing debt ratios in HIPCs. For the 18 completion point countries, the average NPV debt to export ratio would fall from 140 percent (after HIPC relief) to an estimated 52 percent after implementation of the G8 proposal. Second, additional donor contributions to replace lost credit reflows would bring timely benefits in the form of resources that could be used to achieve Millennium Development Goals (MDGs). Moral hazard and equity concerns associated with previous debt relief would be avoided since “gross assistance flows” from IDA to eligible countries would be reduced by the volume of debt relief. Re-allocating “replacement” donor contributions using IDA’s performance-based allocation system (PBA) would help strengthen the link between resource transfers and country performance. Realizing these potential benefits of debt relief would require actual additionality of donor financing, as well as adequate governance and public expenditure management standards and a prudent post-relief borrowing policy in countries receiving debt relief.

III. COSTS AND IMPACT ON IDA

4. **IDA’s core estimated cost of providing debt relief under the G8 proposal is \$42.5 billion over 40 years.** Costs of \$42.5 billion represent the cumulative debt service forgone from the 38 HIPCs, based on debt outstanding and disbursed as of December 31, 2004 (the cutoff date), and an implementation date of July 1, 2006.⁵ These costs would rise to a total of \$56.5 billion if a further 8 IDA countries qualify as HIPCs by end-2006 under the HIPC sunset clause.⁶ If debt relief is confined to disbursed credits these costs decline significantly (Table 1). Forgone credit reflows would start at \$1.0 billion during the IDA14 period (for FY07 and 08) and would increase to \$6.1 billion by IDA20 (FY24-26). Over the first decade (FY07-16), IDA’s costs of debt relief under the G8 proposal would amount to \$8.9 billion.⁷

5. **The costs of the G8 proposal have the potential, if unfinanced, to change IDA’s balance sheet significantly, lowering total assets.** Debt relief under the G8 proposal could result in the cancellation of about 27 percent of IDA’s assets, at end-June 2005. This figure would rise to

⁴ The G8 Finance Ministers’ Communiqué states in footnote 2 that “additional donor contributions would be provided on the basis of IDA13 and AfDF10 burden shares.”

⁵ IDA’s forgone SDR-denominated reflows are valued at the foreign exchange rate at end-2004 (USD/SDR 1.54899). Donors would need to select the exchange rates to be applied for converting SDR-based costs into the national currency of each donor.

⁶ The IMF and IDA Boards extended in September 2004 the sunset clause of the HIPC Initiative to end-2006. Staffs of the Fund and the Bank have started assessing information on countries that may become potentially eligible for assistance under the HIPC Initiative based on their estimated end-December 2004 debt burden indicators. New potentially-eligible countries could include Eritrea, Haiti, the Kyrgyz Republic and Nepal. For other countries, limited data availability introduces further uncertainty as to whether they would fulfill the HIPC Initiative’s indebtedness criteria, as their debt ratios fall within a “gray zone” measured by a margin of 10 percent around the applicable HIPC thresholds. The countries that were not previously listed among pre-decision point HIPCs are Bangladesh, Bhutan, Sri Lanka and Tonga.

⁷ This amount includes \$5.9 billion in principal reflows and charges that have already been committed in advance for disbursements under previous IDA replenishments, consistent with the IDA advance commitment framework which has been in place since FY89.

36 percent if additional countries became HIPC-eligible under the sunset clause. Combined with costs under the existing HIPC Initiative, IDA could cancel up to 46 percent of its assets.⁸

6. **Additionality will allow IDA to increase total assistance flows over the IDA14 period to most of the 18 post-completion point HIPCs.** However, even with additionality, new IDA commitments to most eligible HIPC countries would decrease over the IDA14 period, as new commitments are netted out to take account of forgiven debt service. The final outcome in terms of new commitments would depend on the choice of countries that would benefit from the reallocation of replacement donor resources, for example: all IDA countries; IDA-only countries; or any other subset.

7. **On the issue of costs and impact on IDA, IDA Deputies generally emphasized the need to look carefully at the structure of IDA's costs.** Three cost drivers, on which a range of views was expressed, were identified as of special interest: the choice of cut-off date; whether countries potentially qualifying for HIPC status under the sunset clause should automatically be included in the G8 scheme; and, most importantly, whether coverage should be confined to fully disbursed credits or extended to all debt outstanding and disbursed.

Table 1: G8 Proposal - Cost Estimates for IDA under Different Scenarios
(Cutoff date of December 31, 2004; implementation date of July 1, 2006;
USD billion equivalents, at end-2004 foreign exchange rates)

Credit Coverage	38 HIPCs	38 HIPCs plus Sunset Clause Countries
Disbursed and Outstanding Debt	42.5	56.5
Fully Disbursed Credits	32.4	44.4

Source: IDA staff estimates.

IV. FINANCING CONSIDERATIONS

8. **The G8 proposal makes a clear commitment to additional donor resources to fully compensate IDA for lost reflows resulting from debt cancellation.** The proposal adds to existing donor commitments under the HIPC Initiative and the recent shift to IDA grants. The combined impact would increase IDA's reliance on future donor financing.

9. **Long-term financing mechanisms are not explicitly defined in the G8 Communiqué.** Donors agreed to provide funding upfront for the IDA14 period (FY06-08). With implementation expected to start in FY07, this would result in firm financing commitments of \$1.0 billion for FY07 and FY08. Subsequent financing by donors would become available over time as reflows are forgone. At the same time, full upfront debt stock relief for the core 38 HIPC countries would lower IDA's receivables by \$42.5 billion as countries reach their completion points. The financing solution

⁸ IDA's assets in its financial statements as of June 30, 2005 are \$130.4 billion. This amount is net of the current HIPC allowance of \$11.7 billion, reflecting debt relief yet to be provided. It also excludes \$2.4 billion of principal relief already provided by IDA. Adding these two allowances result in total assets, before HIPC relief, of \$144.5 billion. This is the amount of total IDA assets against which the combined impact of the G8 proposal and the HIPC Initiative is being assessed.

therefore needs to include both long-term assurance and a baseline upon which the additionality of that financing can be assessed. The real value of donor contributions in IDA14 would seem an appropriate baseline.⁹

10. **In the IDA Deputies' discussion, many participants emphasized the important long-term role of IDA in financing of poor countries and the significance of IDA in the international development architecture.** Deputies stressed that secure and clearly additional financing was critical to the viability of the G8 proposal. The financing options put forward by management were seen as a useful starting point,¹⁰ and a range of views was expressed on the practicability of a baseline to establish the additionality of donor financing for debt relief. Overall, however, participants emphasized that more was needed to clarify the financing commitments. The IDA Deputies asked G8 countries to develop stronger and more specific commitments, consistent with national budgetary and parliamentary procedures, to provide greater financing assurance to IDA over the long term.

V. LEGAL CONSIDERATIONS

11. **Implementation of the G8 proposal would require IDA to provide 100 per cent debt cancellation for eligible countries.** IDA's Articles of Agreement authorize IDA to agree to a relaxation or other modification of financing terms. In 2000, the Executive Directors decided that interpretation of the Articles was required to provide *partial* debt forgiveness. Total debt forgiveness would thus require a further interpretation of the Articles. IDA's Executive Directors would assess such factors as the impact on IDA's financial position relative to its current position, on the rights of IDA members, and on IDA's institutional framework. In addition, if the Executive Directors recommend revisions to the IDA14 framework to address allocation of voting rights for additional contributions, or if changes are made in the resource or grant allocation mechanism, then decisions by IDA's Board of Governors, by a two-thirds majority vote, would be in order.

VI. ENSURING THE BENEFITS OF DEBT RELIEF

12. **Ensuring the benefits of debt relief requires adequate standards related to governance and public expenditure management in recipient countries.** The G8 proposal commits to ensure that governance and public expenditure management standards continue to be met in post-completion point countries. To achieve this, a two-step process could be followed. First, countries would need to continue meeting the key HIPC criteria that made them eligible for completion point.¹¹ Second, the Bank would assess governance-related aspects of the CPIA, to determine whether performance has been maintained on governance, public expenditure management and related factors since completion

⁹ Maintaining the real value of IDA14 donor contributions in SDR terms would be comparable to the 2.0 percent annual real increase in donor contributions over the past two decades, from IDA8 through IDA14.

¹⁰ In its paper of September 8, 2005, management outlined three stylized options: (i) full upfront financing commitments and debt write-offs, during IDA14; (ii) donor financing commitments and debt write-offs over four IDA replenishments (IDA14-IDA17), a period of 12 years; and (iii) progressive financing and *pari passu* debt write-offs over a period of four decades. Donors would provide their financing commitments to IDA through Instrument of Commitments (IoCs), in line with the established contribution procedures under regular IDA replenishments.

¹¹ This includes satisfactory performance under: (i) the country's PRSP; and (ii) its Fund program, if in place. If the country does not have a program with the Fund, a satisfactory review of its recent macroeconomic policy performance, as assessed by the Fund, would be required.

point.¹² Staff could present this assessment, prepared in coordination with the IMF and the AfDF for the 18 post-completion point HIPCs, to Executive Directors, who could decide on the countries that would receive relief. In the IDA Deputies' discussion, participants endorsed the emphasis of the G8 proposal on maintenance of strong performance and good governance by qualifying HIPC countries, and allocation of additional donor resources using IDA's performance-based allocations. Most participants considered that HIPC conditionality provided adequate conditions for entry, although a few noted that this would require further consideration depending on whether debt cancellation occurred upfront or, as some participants preferred, over time as financing was received.

13. **The amount and terms of post-relief borrowing by the recipient countries are also critical to ensure that the benefits of debt relief materialize.** The current joint Bank-Fund debt sustainability framework (DSF), in combination with monitoring "free riding" behavior, provides a framework to help address concerns about unsustainable post-relief borrowing. In the IDA Deputies' discussion, it was underlined that measures should be taken to prevent the re-accumulation of unsustainable debt, particularly from non-concessional sources, and that further work was needed on "free riders" and on possible future growth of multilateral debt. The IDA14 Mid-Term Review was seen as a good opportunity to assess whether the Bank-Fund Debt Sustainability Framework can be improved upon to prevent the accumulation of debt to unsustainable levels.

VII. CONCLUSION AND ISSUES FOR DISCUSSION

14. **The G8 debt relief proposal offers significant benefits for poor countries, and the potential for a substantial increase in resources towards achievement of the MDGs.** At the same time, it presents complex design issues, and potentially serious implications for the financing of IDA and its long-term developmental role. For these reasons, discussions in the Board and among the IDA Deputies have laid particular stress on the interdependence of the different elements of the proposal as an overall package, around which agreement could be reached. While a number of specific elements have been clarified in the discussions thus far, further development and consensus-building are still needed to enable the critical decisions to be made on such a package. Given the widespread expectations and the importance of the issue, this is an urgent priority in the upcoming days.

15. **Ministers may wish to discuss the following issues:**

- Do Ministers agree with the primary goal of forgiving the multilateral debt of HIPC countries, within a framework that strengthens performance and provides secure financial support for IDA and the AfDF?
- Should debt cancellation be limited to the current 38 HIPC countries, or should it be extended to countries that may qualify as HIPCs in the future under the sunset clause?
- Should debt cancellation cover fully disbursed credits only, or should it also include the disbursed portion of projects that are still under implementation as of the cutoff date?

¹² Among the 16 indices that form the CPIA (Country Policy and Institutional Assessment), five form a "cluster" related to public sector governance. This cluster includes property rights and rule-based governance, quality of budgetary and financial management, efficiency of revenue mobilization, quality of public administration, transparency, accountability and corruption in the public sector.

- What are Ministers prepared to do to ensure that the financing support set out in the G8 proposal can be strengthened to provide long-term assurance for IDA's developmental role and financial capacity, and a donor contribution baseline to establish additionality?