

# CRACKING THE



SHELL

# GAME

IMPLEMENTING DEBT RELIEF FOR THE HIPCs

by Jeffrey Sachs

What is the capacity of the highly indebted poor countries (HIPC) to repay their debts while addressing urgent human needs? In general, most have no debt-servicing capacity whatsoever. Indeed, most of the HIPCs receive more in grants and new loans than they paid in debt servicing. In other words, the world has implicitly or explicitly recognized that these countries cannot service their debts now or in the foreseeable future. We just hide that fundamental reality in a complex shell game, in which large-scale debt servicing is very imperfectly offset by debt postponements, arrears, new loans, and grants from donor government. The shell game, however, is exhausting and debilitating. Virtually every HIPC government spends an enormous amount of time simply staying one step ahead of outright default, and many fail to do even that. In the meantime, there is little long-term thinking, and less long-term planning to solve critical problems.



At the Cologne Summit in June, the G 7 instructed the Bretton Woods institutions and other parts of the international community to consider new ways of incorporating social priorities into their programs. The first step should be to assess the real budgetary costs of meeting urgent social needs – particularly in health and education – and assessing the extent to which debt servicing jeopardizes the budgetary capacity to meet those needs. Without such an analysis, the HIPC Initiative will remain moribund, and impoverished governments will continue to make debt service payments at the expense of the very lives of their citizens.

When the HIPC initiative was launched in 1996, there was some hope that social criteria would be incorporated into the heart of the initiative. Such was not the case. Finance ministries and the IMF/World Bank decided instead that debt-servicing capacity would be judged mainly by comparing the net present value (NPV) of debt with the level of exports. These criteria neglected the obvious fact that the debts were owed by governments, not exporters, and that ratio of debt to exports could not conceivably measure the tradeoffs of debt servicing and meeting basic human needs. The result has been a statistical standard bereft of economic and social logic.

The Cologne Initiative (CI) reopens the international official discussion about HIPC debt crisis. The HIPCs are a group of countries

designated by the IMF and World Bank to be poor and highly indebted. There were 41 countries on the original HIPC list; my list includes 42 countries (the original list plus Malawi); 34 of the 42 countries, including 548 million of the 712 million HIPC population (or 77%) are in Sub-Saharan Africa.

Unfortunately, the CI leaves in place many of the serious flaws of the original HIPC initiative. Neither the HIPC initiative, nor the CI, have come to grips with three basic problems:

- ▶ The debt is owed by impoverished governments, and therefore should be based on the HIPC governments' capacity to pay, not on arbitrary numerical guidelines related to exports, which have little if anything to do with the countries' fiscal position or ability to pay;
- ▶ Most HIPC governments have no capacity to repay debts in view of the urgent social crises that they must confront. These governments are in fact in need of large net resource transfers from the rest of the world;
- ▶ Under current arrangements, debt service burdens are imperfectly offset via new loans, grants, rescheduling and outright arrears. The instability, unpredictability, and time-consuming nature of these rollover mechanisms contribute to the incapacity of HIPC governments and the international community to formulate long-term solutions to the pressing social crises in the HIPCs.

While the new CI aims at more "ambitious" debt reduction targets, the basic problem remains that the

new standards are as arbitrary as the old ones. Both initiatives focused mainly on the relationship of debt to exports, even though debt-to-export ratios have little, if anything, to do with the real ability of governments to meet urgent social needs while servicing debts. An effective process of HIPC debt relief should be grounded on the following principles:

- ▶ For most HIPCs, the unmet social needs are so vast and urgent that these countries will require significant net resource inflows for many years, larger than the net inflows that they are now receiving.
- ▶ To achieve these increased inflows, it will be necessary to cancel most or all old debts – with much greater relief than is envisioned in the CI – and to sustain or increase the inflows of new grants and loans.
- ▶ To the extent possible, new inflows should be highly concessional, to avoid a repeat of the current situation in which non-creditworthy countries were financed through commercial loans rather than foreign assistance.
- ▶ Debt relief should be guided by a process that helps to ensure that the increased resource transfers will be channeled into areas of urgent human need, especially in public health and primary education. Such a process requires the leadership of key international organizations with responsibility in these areas of urgent social need – especially the World Health Organization (WHO), UNICEF, the United Nations Development Program (UNDP), and the World Bank – and

with a diminished role of the International Monetary Fund (IMF).

### The Capacity to Pay

Many of the HIPC's currently service their debts at the cost of widespread malnutrition, premature death, excessive morbidity, and reduced prospects for economic growth. If the resources were freed up *and successfully redirected towards basic human needs*, there could be significant improvements in human welfare.

Looking first at the basic nutrition levels, we see evidence of outright declines in caloric consumption in ten HIPC's in recent years. In nine Sub-Saharan African HIPC's, average caloric intake does not even reach 2,000 calories per day (compared to 3,300 calories per day of the average resident in the G7 countries). Average life expectancy at birth for G-7 countries is 78 years; and 51 years for HIPC's, with 13 Sub-Saharan HIPC's showing declines in life expectancy during the 1990s, partly due to the AIDS epidemic, which is ravaging the continent.

The enormity of the AIDS epidemic in Africa could approach the scale of the Bubonic Plague of 14th century Europe. In parts of Southern and East Africa, HIV infection rates are now over 20% of the total population, including over a third of the sexually active adult population. AIDS claimed an estimated 2 million deaths in Sub-Saharan Africa in 1998, a rate of 5,500 people per day, and has left millions of children orphaned. Enterprises in many of the worst affected countries have had to institute policies prohibiting employees from attending more than one funeral per week. Firms are training three people for each job in

anticipation of AIDS deaths, and are often forced to cut health care benefits entirely as costs have spiraled due to the epidemic.

Money matters. Vaccination, drug therapies, doctors' salaries, teachers' salaries, basic sanitation systems, and other underpinnings of basic human welfare cost real dollars. While the average Frenchman or German has approximately US\$2,500 devoted by the government to public health, the astounding figures in Sub-Saharan Africa include: Kenya, US\$8; Uganda, US\$9; Cote D'Ivoire, US\$25; Burkina Faso, US\$54; and Ethiopia, US\$3. The same vast gap is evident in education spending.

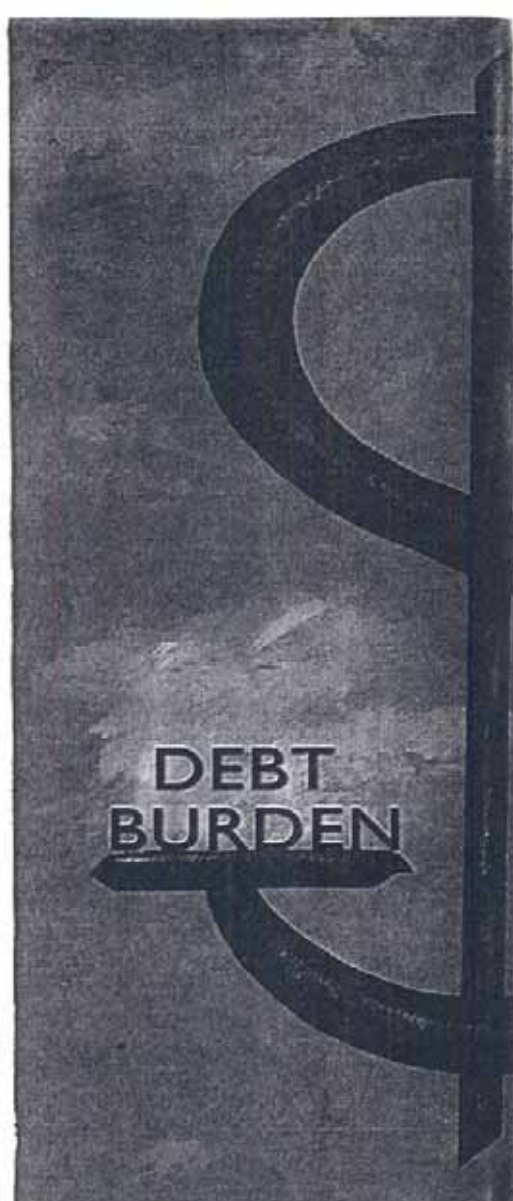
### The Current Debt Quagmire

The current debt servicing "system" works as follows. Part of the debt service that is due is postponed, formally or *de facto* as arrears. Of the substantial debt service that is actually paid, some is covered through new loans and the rest through grants from bilateral donors. In the end, the HIPC's generally receive more than they pay but the amounts of net resource transfers are small (less than US\$10 per person in 1997), grossly insufficient in the face of the social crises hitting these countries. The net resource transfers are also unstable and unpredictable. As a general rule, the HIPC's make net resource transfers (i.e., they pay more in interest and amortization on old loans than they receive in new loans) to their bilateral creditors, the IBRD (International Bank for Reconstruction and Development), the IMF, and private creditors.

Even though the net resource transfers tend to be positive, the debt

servicing "system" is fundamentally flawed. First, and most urgently, the net resource transfers are not large enough to enable the HIPC governments to meet basic health and education needs of the population. The negative net transfers on existing debt have gotten substantially larger in recent years, while the grants extended to the HIPC's have remained roughly unchanged.

Second, and crucially, *the bilateral grants to do not neatly offset the heavy burden of debt servicing*, even if they appear to do so in formal accounting. The debt burden falls heavily on the budget, and therefore on line ministries while grants frequently finance extra-budgetary activities established by the donors. In fact, since the governments are bankrupt, donors often attempt to establish these extra-budgetary programs precisely so that they will not be drawn into the fiscal insolvency





## SOCIAL NEEDS

of the government. The result is profound de-institutionalization of public activities, with a government that remains insolvent and illiquid, and a bilateral donor process that supports non-governmental activities in lieu of an effective state.

Third, the process of offsetting heavy debt payments with grants and new loans is highly unstable and erratic. Indeed, sometimes there is a self-fulfilling collapse of fiscal resources. A "financing gap" opens up, causing the IMF to delay payments to a HIPC country. The IMF decision in turn blocks the disbursement of funds by other major creditors, including the World Bank and bilateral donors. The absence of such funds then dramatically worsens the budget situation, "proving" that the IMF was right to suspend the program. A long period of default, followed by difficult negotiations to restart lending, transpires.

“The result of constantly trying to cover up fiscal bankruptcy through new loans and grants, therefore, results in the system promoting long-term institutional degradation of the HIPC governments.”

The result of constantly trying to cover up fiscal bankruptcy through new loans and grants, therefore, results in the system promoting long-term institutional degradation of the HIPC governments.

### Financing the Debt Relief Program

One of the peculiar arguments concerning the HIPC initiative is that rich countries and multilateral institutions cannot "afford" to forgive the HIPC debt. For most of the bilateral creditors, a high proportion of the debt is already deemed to be uncollectable. In the United States, for example, the roughly US\$6 billion owed by the HIPCs is already held on official accounts at around 10% of face value, or US\$600 million. Under current procedures, the US Congress would have to appropriate only US\$600 million to enable a complete write-off and forgiveness of all of the HIPC debt owed it.

In the case of the World Bank, we must consider mainly the IBRD claims which totaled around US\$4 billion in 1998, but are falling fast as a result of net repayments. Outstanding IBRD claims may amount to no more than US\$2 billion as of 1999. These loans could be forgiven by the Bank with losses easily absorbed by loan loss reserves at the Bank. The IBRD has already provisioned for some US\$3.24 billion of loan losses. In addition the World Bank has capital of at least US\$27 billion.

In the case of the IMF, several methods could be used to reduce IMF claims, which amount to roughly US\$3.5 billion in NPV of ESAF (enhanced structural adjustment fund) loans, and another US\$2.8

billion of standby loans. First, the IMF is sitting on massive unrealized capital gains on its gold reserves, which could also be used to back debt write-offs on the IMF balance sheet. Even without gold sales, these gold holdings could be revalued to market prices, and the capital gain could be allocated partly to finance debt cancellation and partly to augment the IMF various reserve accounts. In addition, the IMF maintains various special accounts to absorb losses. Thus, some combination of gold revaluation (and/or gold sales at market value) together with the use of various reserve funds available for adverse contingencies, could easily fund a complete write-off of IMF claims on HIPCs.

The more difficult case involves the African Development Bank. It is probably true that a deep write-off of debts owed to the AfDB would impair the bank, and require some recapitalization. Informal estimates by US Government officials suggest that the overall recapitalization could amount to a few billion dollars, to be shared among a large number of donor governments.

### The Need for Social Audits

The current international assistance strategy is based on a series of negotiations between the indebted country and its major creditors: the bilateral donors, the IMF, the World Bank, and the regional development banks. The IMF operates as *primus inter pares* among the international institutions and donors. It alone judges whether a country's budget is in macroeconomic balance. When the IMF declares that a HIPC budget is out of balance, its verdict generally stops much or all of the resource

# DEBT DEBT DEBT DEBT DEBT

transfers to the country coming from bilateral and other multilateral sources.

Under current aid arrangements, aid decisions – and decisions about how much debt should be serviced – are taken with little attention to social needs. The IMF has no expertise to deal with issues of public health, nutrition, immediate food security, the HIV-AIDS epidemic, and other critical social issues in need of budgetary expenditure. When the IMF renders a decision on whether a government can or cannot service a debt, it gives little attention to whether the health care system has collapsed, whether children are being vaccinated, or whether the HIV-AIDS epidemic is being attended to. This would be fine if the IMF were limited to its own immediate brief – monetary stability – but, in fact, the IMF has a major, if not decisive, influence on the implementation of the entire HIPC process although its net transfers to the HIPCs are relatively small.

In the future, decisions over the extent of debt relief should be made in view of a detailed assessment of real social needs. UN agencies that specialize in critical social areas should play a decisive role in the process of assisting the HIPCs, working under the leadership of the HIPC governments to prepare “social audits” that can be the basis for a revised and revived strategy on meeting urgent social needs. NGOs involved in social services should also be encouraged to provide inputs to the deliberative process. The key UN agencies would include the WHO, UNICEF, the Joint United Nations Program on HIV-AIDS, the World Food Program, and the Food and Agricultural Organization.

“The UNDP should work with the World Bank and the IMF to ensure that the social audits form the basis for actual debt relief.”

The UNDP — which is both the UN's producer of key social indicators in the *Human Development Report* (and national human development reports), as well as the agency charged with *coordination* of UN development activities at the country level — should play a leading role in coordinating the UN efforts in preparing the social audits. The UNDP should work with the World Bank and the IMF to ensure that the social audits form the basis for actual debt relief implementation and monitoring.

The debt reduction process itself could be based on a formal debt reduction-cum-human needs program presented by each HIPC government to a creditor committee, which would formally approve a timetable for debt cancellation in conjunction with enhanced efforts on the social programs. The creditors, sitting as a committee, could formally vote on the proposed program, so that no single institution or creditors would be the arbiter of the relief process. One of the key aspects of such a program should be a *multi-year commitment to meet quantitative targets on basic human needs*, such as immunization coverage, population access to mother-and-child care, HIV incidence and prevalence, and primary school enrolment rates. These quantified targets would not only be a guide to long-term budgeting and funding of social programs, but would also provide a kind of conditionality for the international community as well as the HIPCs.

It is often asked whether debt relief will simply release countries from necessary conditionality on future loans. In the case of the HIPCs, conditionality will be easily

maintained even after comprehensive debt relief. These countries need not only a cancellation of old debts, but also a continued inflow of new resource flows. For that reason, bilateral and multilateral donors will be in a position to insist upon real government performance in using international funds, and will be in a continuing position to monitor the use of those funds – even to the point of cutting them off if governments abusively misuse the international resources put at their disposal.

Social policy is but one aspect of overall development policy. Considerable research and country case studies show that the single best long-term solution to crises of basic human needs is long-term economic growth. Thus, we should not put aside the goals of long-term growth as we turn our attention to enhanced social programs. A greatly enhanced social strategy and an improved long-term growth strategy are complementary components of an overall revision of development policies for the HIPCs. 

Jeffrey Sachs is Director of the Center for International Development at Harvard University. Sachs serves as an economic advisor to governments in Latin America, Eastern Europe, the Former Soviet Union, Asia and Africa. He has been a consultant to the IMF, World Bank, OECD and UNDP. This article has been abridged, with permission, from “Implementing Debt Relief for the HIPCs”, by Jeffrey Sachs et al, August 1999. The full text is available on the CID website at: [www.cid.harvard.edu](http://www.cid.harvard.edu)