UN FFD Review Session on Chapter E of the Monterrey Consensus

Background Paper on "External Debt"

Many NGO networks have long campaigned on and monitored the impacts of unjust and unsustainable debt and now want to respond to new challenges that have emerged in the five years since Monterrey. It is important to put into context the scope of external debt held by developing nations. While there is no doubt that debt financing can be a critical tool for mobilizing resources for public and private investment and economic development, we remain concerned about the crushing burden that this debt continues to represent for many developing nations. Developing country debt today stands at US$2.85 trillion, up from US$2.24 trillion in 2000 and US$1.3 trillion in 1990. Developing countries paid out more than US$540 billion in debt service in 2005. Indeed, low income countries continue to pay out $100 million *each day* to creditors, diverting large sums of scare government revenue to external debt service and away from investments needed to reach the Millennium Development Goals (MDGs).

As the Monterrey Consensus points out, "External debt relief can play a key role in liberating resources that can then be directed towards activities consistent with attaining sustainable growth and development." International debt relief initiatives to date, notably the Heavily Indebted Poor Countries Initiative (HIPC) and the Multilateral Debt Relief Initiative (MDRI), have begun to address this problem. As of this writing, 23 nations have seen the majority of their debts to the IMF, World Bank, and African Development Bank canceled under the terms of the MDRI. In March 2007, the Inter-American Development Bank announced it would provide full debt cancellation to 5 Latin American countries on MDRI terms. The total amount of debts that have been canceled stands now at more than $85 billion spread over a period of 40 years. Debt relief continue to have some form of beneficial impact on the ground in countries that qualify for the initiative, with proceeds from relief being reinvested in education, health care, clean water, and infrastructure.

Debt relief initiatives to date have, however, fallen far short of the call of the Monterrey Consensus and the Millennium Declaration to "comprehensively address debt problems of developing countries." We offer the following input in the spirit of helping to live up to this vision of a comprehensive solution that has so far been lacking.

Expanded debt cancellation

First, the liberation of resources to meet the Millennium Development Goals remains a challenge, with dozens of countries still lacking the resources and falling far short of what is needed to reach the MDGs. With the international community at risk of failing to meet its MDG commitments, expanded debt cancellation to all countries with debt overhang, together with increased development assistance, can and should be part of the policy mix to achieve the MDGs by 2015.

Harmful Conditionality

Second, debt cancellation continues to be subject to onerous forms of conditionality as countries must implement hundreds of conditions as part of the IMF/World Bank HIPC Initiative. While mutual accountability and transparency should critical elements of any debt cancellation agreement, current conditionality goes well beyond these basic fiduciary standards into micro-management of the economies of impoverished countries. In a number of countries, recent studies have pointed in particular to the impacts of requirements from the IMF for tight monetary policies that have eliminated or vastly reduced the amount of money freed up by debt relief for spending on social services.[1]

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[1] On Zambia and Nicaragua, see John Weeks and Terry McKinley, "Does Debt Relief Increase Fiscal Space in Zambia? The MDG Implications," UNDP International Poverty Centre, Country Study no. 5, September 2006; and Acevedo, Adolfo "Nicaragua: The "Millennium Development Goals" (MDGs) and the IMF program," p. 9-11, 2006. Available: http://www.choike.org/documentos/ifis_odm_fmi_nicaragua.pdf

Debt Sustainability

The Monterrey Consensus urges that "Future reviews of debt sustainability should also bear in mind the impact of debt relief on progress towards the achievement of development goals contained in the Millennium Declaration." But the IMF/ World Bank have failed to live up to this call: the IMF/World Bank Debt Sustainability Framework (DSF), operational since 2005, instead of taking as a point of departure a costing of resources needed to reach the MDGs, has been based on the capacity of donor countries to provide grants. Nor has the methodology the DSF utilizes for calculating debt sustainability been suitable to consider the resources necessary to reach the MDGs. For instance, its methodology emphasizes:
1) Reliance on debt distress as defined by the pure inability of countries to repay (rather than incapacity to meet the MDGs, even when debts are being repaid);
2) Debt indicators such as debt-to-exports and debt-to-GDP with a track-record of proven failure in capturing the real needs for debt relief of countries (as opposed to debt-to-budget revenue); and
3) Reliance on a World Bank staff assessment of the degree of implementation of Bank-preferred policies as measured by the Country Policy and Institutional Assessment, which does not allow the policy space for borrowing countries to implement country-owned development strategies.

Likewise, the DSF does not leave space for participation by the borrowing country and its people in the determination of what a sustainable level of debt for the country is. This flies in the face of the Monterrey Consensus commitment to "broaden and strengthen the participation of developing countries and countries with economies in transition in international economic decision-making and norm-setting."

Responsible Lending

We are concerned that even in countries that have received debt cancellation, new borrowing threatens to return countries to debt crisis. This trend threatens to undo the hard work to reduce and cancel debts and puts the debt relief gains at risk.

This demonstrates the need for tackling the over-indebtedness problem in a forward-looking way that looks comprehensively at the process of borrowing and lending – both in terms of *quantity* and *quality*. The international community has increasingly issued calls for more "responsible lending" in the past several years, including at G-8 summits, in the G-20, and in the United Nations General Assembly.

To date, these calls have focused mainly on honoring the guidelines of the Debt Sustainability Framework. But this instrument has been ineffective in addressing the problem of debt re-accumulation, and has been completely absent from any effort to address the quality of new lending, needed to avoid the re-accumulation of odious and illegitimate debts. While the Monterrey Consensus calls for debtors and creditors "to share the responsibility for preventing and resolving unsustainable debt situations", the DSF sanctions *only the debtor* for breaches in the debt ceilings.

The International Financial Institutions (IFIs) have tried to bring lending decisions by the new creditors within the borrowing limits set under the Bank's debt sustainability analysis (DSA). These efforts do not look promising, because they aim at unilaterally exerting pressure on the borrower, without providing much of an incentive for the creditor to forego an investment opportunity, which would eventually endanger the borrower's long-term debt sustainability. In any event, the Bank does not calculate DSA guidelines for middle-income countries.

It is time for a bold, new approach. Responsible lending will only be achieved via the adoption of a binding legal framework that fairly allocates the burden of irresponsible borrowing on both creditors and debtors. Only a framework like this will change the incentives, and thereby the behavior, of lenders. This would also be more in line with the Monterrey Consensus' call for "a set of clear principles for the management and resolution of financial crises that provides for fair burden-sharing between public and private creditors and between debtors, creditors and investors." As a step towards this goal, we encourage consideration of the "Charter on Responsible Financing", developed by Eurodad, which outlines the essential components of a responsible loan (www.eurodad.org).

Odious and Illegitimate debts

A significant development after the Monterrey Consensus has been the growing legal and political interest in the concepts of odious and illegimate debts. One justification for the cancellation of Iraq's debt focused on the odiousness of the previous Iraqi government. Though ultimately the decision to provide cancellation was not made on the basis of the arguments of odiousness, the ensuing debate surely raised the profile of the issues. More recently, Norway became the first Northern government to unilaterally cancel specific debt claims on the grounds that the credit in question was an example of "failed development policy," a key element of conceptions of illegitimacy of debt. Across the developing world, civil society has been carrying out citizens' debt audits to examine the nature of debts, and in 2007, Ecuador became the first government to convene an official debt audit commission, with a mission of determining the legitimacy or illegitimacy of historical lending to Ecuador.

The debate on odious debts has further been developed with the publication of papers on the topic by UNCTAD and the World Bank. As new developments in external debt are considered, the growing global conversation on odious and illegitimate debt must surely be noted, affirmed, and supported in Doha.

Debt and trade

The Monterrey Consensus was unique insofar as it set the stage for a holistic consideration of all sources for financing development. This call is of particular relevance for debt, an area that has, like others, has suffered by being targeted with measures taken in isolation from other economic dynamics that tend to affect it and that were left untouched. An example of this was the HIPC initiative, whose debt relief gains quickly became inadequate due in large part to commodity price dynamics that the initiative failed to address, although they were well-known at the time of its design and implementation. While the Monterrey Consensus succeeded in considering all sources together, via juxtaposing one to another, we believe greater use could be made of the conference as a forum for a really holistic and intertwined consideration of these different sources.

Some issues that deserve consideration in the relation between debt and trade are: The relation between the export structure of borrowing countries and the collective debt profile (e.g., commodity-dependence or low-value-added dependence and incentives for competing production); the need to protect or replace the fiscal revenue in export and investment activities; the impact on fiscal revenues of the privatization of natural resources; the generation of foreign liabilities by foreign investment etc..

Vulture funds

Vulture funds present another challenge to developing countries that have received debt relief under the HIPC and MDRI framework and have outstanding claims that these funds buy up and try to collect thus threatening the benefits arising from debt relief. Countries are not only forced to meet the exorbitant legal fees for their defense, but also pay up debts that should been otherwise canceled. We urge member countries to take concrete steps to do away with the phenomena of Vulture Funds and give judicial and financial assistance to countries in case they are taken to court by the Vulture Funds. We also urge the United Nations to actively co-operate with other agencies to develop and strengthen the necessary Codes of Conduct that could prevent Vulture Funds from buying debt from indebted countries.

Orderly and fair debt workout mechanism

Since Monterrey, the international community failed to develop debt management as such any further. A newly over-indebted developing country would in principle face today the same problems countries had after the crisis' outbreak in 1982: there exists no comprehensive mechanism to reduce a country's exposure to all its creditors in an orderly, fair and pre-defined way. At the same time the spectrum of creditors and the variety of instruments these creditors use, has considerably widened in the past years. Transition and emerging economies have become important lenders themselves. So have private investment funds and domestic lenders. New instruments include new types of bonds, the return of the classic syndicated loan organized by international banks, as well as a new surge from Export Credit Agencies.

Individual instruments for dealing with workouts from debt crises, like Collective Action Clauses (CACs) in bond contracts or Codes of Conduct for debtor governments and creditor representatives can be useful at times. However, they generally refer to not more than one group of lending instruments or creditors when there are usually multiple types of lenders with claims on a crisis country. Additionally debt workouts continue to be hampered by increased activities by old creditors as well as vulture funds, litigating against sovereigns, often contrary to debt relief decrees by the Multilateral Institutions or the informal government creditor cartel of the Paris Club.

This lack of coherence in sovereign debt management provides new relevance for proposals for impartial and coherent debt workout procedures. Some of these have already been intensively discussed during the Financing for Development process before and after Monterrey. These proposals include the IMF's Sovereign Debt Restructuring Mechanism and also farther reaching proposals by academia, civil society and Southern official sectors. Most of these proposals share characteristics with a fair and transparent arbitration process.

Key elements of an orderly, effective and fair debt workout mechanism are:

- One single "insolvency" process needs to involve all creditors,
- Impartiality in decision making,
- Automatic stay on litigation to enforce loan contracts,
- Impartial assessment of a sovereign's sustainable debt level and income exempt from debt servicing.

Multistakeholder consultations on an orderly, effective and fair debt workout mechanism should be revived in the framework of the Doha follow-up process. Concrete proposals on next steps should be worked out and reported to the High-Level Dialogue on Financing for Development in 2009, followed by international commitment to action embodied in a resolution of the General Assembly.

To conclude, the Financing for Development Review process, culminating in Doha in late 2008, offers an important opportunity to update the international community's collective understanding of external debt and to address newly emergent issues that have come into greater prominence since the Monterrey Conference.

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