The New World Bank/ IMF Debt Sustainability Framework: Does it Live Up to the Human Development Promise ?

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ACRONYMS

BWIs Bretton Woods Institutions
CPIA Country Policy and Institutional Assessment
DSF Debt Sustainability Framework
GDP Gross Domestic Product
HIPC Heavily Indebted Poor Countries (Initiative)
IDA International Development Association (World Bank)
IMF International Monetary Fund
LIC Low Income Country
MDGs Millennium Development Goals
MDRI Multilateral Debt Relief Initiative
MIC Middle Income Country

Executive Summary

Starting in the 1980s several schemes have increasingly recognized the need for debt relief and debt cancellation. The HIPC initiative, in 1996, was the first scheme to address the debt problem in a comprehensive manner, providing the means for reduction of two-thirds of debt for the beneficiary countries. Central to a country's inclusion in this initiative and the determination of the amount of debt relief it would receive was the concept of "debt sustainability." A stream of NGOs started to challenge the official notion of debt sustainability by promoting what they termed a "human development" approach. The central tenet of this approach was that developing countries should be able to set aside as much fiscal revenues as is needed to meet human development goals and only then pay the remnant as debt service or debt stock. Eventually, language linking debt relief and the Millennium Development Goals was adopted by the International Conference on Financing for Development, 2002.

Around 2002, though, flaws in the HIPC Initiative were starting to become more evident, leading to discussions on a new "Debt Sustainability Framework" (DSF or "the Framework"). The DSF would only address the debt problem in a forward-looking way, that is, ruling out further cancellation a-la-HIPC and, in fact, implied significant changes to the HIPC as a mechanism for debt management. Eventually, the DSF was adopted as the

[1] The author gratefully acknowledges the useful inputs from the members of the CIDSE-Caritas Internationalis Working Group on Resources for Development and, very specially, the substantial research support for the preparation of this paper contributed by Paul Martin. Responsibility for mistakes, of course, lies with the author alone.

rule for managing debt in low-income borrowing countries in April 2005. The World Bank and the IMF, which had quickly endorsed the Millennium Development Goals and the Monterrey Consensus, maintain that the debt management framework they have adopted is in consonance with the MDGs and the Monterrey Consensus.

This paper looks at the DSF using as a lens the human development approach to debt sustainability: it asks the question of whether or to what extent the DSF is consistent with it. In carrying out this analysis this paper develops and puts forward five principles that follow from the Human Development approach to debt sustainaibility and relies on a review of more than forty-three Debt Sustainability Assessments carried out under the Framework since its adoption.

In its introductory section, the paper provides a brief history of debt management initiatives, describing and contrasting the main parameters of the HIPC Initiative and the DSF. It also addresses the question of whether human development amounts to an economic heterodox framework.

Section I puts forward the main principle: developing countries should be able to set aside as much fiscal revenues as is needed to reach these goals and only then pay the remnant as debt service or debt stock. Three consequences are derived from this principle. Firstly, because the paramount nature of the human person the human development approach seeks to preserve is universal, its application admits no distinction between low-income and middle-income countries. Second, that debt relief is needed to ensure countries are not forced to pay more than they can without putting human development imperatives at risk. Third, the methodology to develop Debt Sustainability Assessments needs to be based on the ability of debtor countries to achieve human development goals and the MDGs. A combined examination of the DFS principles and DSAs already carried out is used to evaluate whether the Framework is living up to these standards.

Section II submits that, according to a human development approach to debt sustainability, those affected by debt should be able to participate in its management. The DSF proposes country-specific thresholds based on a pool of indicators and considerations. Theoretically, this approach allows taking into account the particularities of each country's debt profile and would provide space for the voice of the particular countries and their people to be incorporated in the process. However, in returning to a case-by-case assessment the DSF suffers of the same lack of transparency and accountability and misleading macroeconomic assumptions that characterized pre-HIPC debt relief schemes. A close examination of each of the pillars of the DSF and its application in actual DSAs is used to establish that the beneficiary countries and their people, have little say in the determination of debt thresholds. Moreover, that the DSF leaves so many elements to the discretion of BWIs staff that it becomes hard for outsiders, including beneficiary countries, to hold staff accountable for any future malfunctioning of the Framework.

Section III argues that a human development approach to debt sustainability requires not only that debt sustainability assessments, but also policy responses to the debt problem, give primacy to human development priorities. In looking at the DSF and its application, it becomes clear that it reinforces, rather than improve, over the HIPC initiative's use of a one-size-fits-all economic model that has failed to promote not only poverty reduction or pro-poor growth but, first of all, growth alone. In particular, the crucial part that Country Policy and Institutional Assessments ratings play in the new Framework introduce new problems in terms of assessing policy performance.

Section IV develops the principle that a human development approach implies dealing with debt in a comprehensive way. All types of debt have fiscal consequences on resources for human development, so all types of debt should be considered and receive a policy response. From this perspective, the section analyzes the performance of the DSF in dealing with three kinds of debt: debts owed to other official multilateral lenders (besides bilaterals and the BWIs), debts owed to the private sector and domestic debt. The rising attention to the "free-riding" issues in the policy agenda after debt cancellation awarded at the G8 Summit in Gleneagles are also addressed in this section.

Finally, Section V examines whether the DSF addresses the call to place human development needs not only at the center of debt sustainability, but also at the center of the joint operation of international economic policies. The HIPC Initiative lacked a holistic assessment of trade and financial policies and their interaction in the build up of unsustainable debt. It is found that the DSF is, to a large extent, liable to the same claim. It makes no mention of how to improve government's control over capital flows and it does little to take into account the close linkages between trade and debt.

The paper concludes formulating recommendations to policy-makers in governments and international organizations for implementing a human development-oriented paradigm for international debt management.

INTRODUCTION

A Human Development Approach to Debt Sustainability

Consistent with the principles of Catholic Social Teaching that guide its advocacy work, CIDSE has long advocated a human development approach to debt sustainability. This approach holds that human development imperatives should take precedence over debt payments, a principle that has been partially endorsed by the International Conference on Financing for Development and other international instruments.[2]

The premises of the Human Development Approach and the Management of Debt by the International Community

Starting in the 1980s several schemes have increasingly recognized the need for debt relief and debt cancellation. The HIPC initiative, in 1996, was the first scheme to address the debt problem in a comprehensive manner, providing the means for reduction of two-thirds of debt for the beneficiary countries.

[2] See Monterrey Consensus, para. 49 ("Future reviews of debt sustainability should also bear in mind the impact of debt relief on progress towards the achievement of the development goals contained in the Millennium Declaration.")

Central to a country's inclusion in this initiative and the determination of the amount of debt relief it would receive was the concept of "debt sustainability." In the face of the HIPC Initiative, a stream of NGOs started to challenge the official notion of debt sustainability by promoting what they termed a "human development" approach. The central tenet of this approach was that developing countries should be able to set aside as much fiscal revenue as needed to meet human development goals and only then pay the remnant as debt service or debt stock. Eventually, language linking debt relief and the Millennium Development Goals was adopted by the International Conference on Financing for Development, 2002.

Around 2002, though, flaws in the HIPC Initiative were starting to become more evident, leading to discussions on a new "Debt Sustainability Framework" (DSF or "the Framework"). The DSF would only address the debt problem in a forward-looking way, that is, ruling out further cancellation a-la-HIPC and, in fact, implied significant changes to the HIPC as a mechanism for debt management. (Box 1 contains a brief explanation of the main features of HIPC and the DSF) Eventually, the DSF was adopted as the rule for managing debt in low-income borrowing countries in April 2005. The World Bank and the IMF, which had quickly endorsed the Millennium Development Goals and the Monterrey Consensus, maintain that the debt management framework they have adopted is in consonance with the MDGs and the Monterrey Consensus.

This paper assesses the DSF using the human development approach to debt sustainability as a lens: it asks the question of whether or to what extent the DSF is consistent with it. In carrying out this analysis this paper relies on a review of forty-three Debt Sustainability Assessments carried out under the Framework since its adoption in April 2005.[3]

The question of the human development approach as a heterodox framework

This paper rests on the assumption of the human development approach as a heterodox economic theoretical framework. Therefore, before going into the exercise predicated by the introduction, this section seeks to justify the validity of this framework.

As explained above, central to this approach is the principle that developing countries should be able to set aside as much fiscal revenue as needed to meet human development goals and only then pay the remnant as debt service or debt stock. It is grounded on teachings of the Catholic Church that posit the principle that the goods of the world—

[3] The review covered DSAs for Afghanistan, Albania, Armenia, Bangladesh, Benin, Bolivia, Bosnia and Herzegovina, Burkina Faso, Burundi, Cameroon, Cape Verde, Central African Republic, Comoros, Democratic Republic of Congo, Dominica, Gambia, Grenada, Guinea, Haiti, Honduras, Indonesia, Lesotho, Liberia, Mali, Mongolia, Mozambique, Nepal, Niger, Nigeria, Pakistan, Papua New Guinea, Republic of Congo, Rwanda, Sao Tome and Principe, Serbia and Montenegro, Solomon Islands, Sri Lanka, Tanzania, Tajikistan, Uganda, Vietnam, Zambia, Zimbabwe. With the exception of the Mali DSA, all the DSAs included in the review were made public after April 2005 when the new Debt Sustainability Framework was officially approved by the Board of Governors of the Bank and the IMF. In spite of using as a cut-off date that of the decision to formally endorse the DSF, for several of the DSAs in the pool it is not entirely clear that the LIC DSF is in fact what has been used.

which includes finance—are originally meant for all. Pope John Paul II, for instance, while always recognizing in principle the ethical obligation to repay debts, qualifies this by stressing that in practice such repayment must never be demanded at the price of unbearable sacrifice. [4]

Although Catholic Social Teaching references constitute the basic paradigm adopted in this paper, however, it is worth noting that basic references to the human development approach do not only belong into this doctrine. The Human Development Report, produced by UNDP since 1990, represents an effort to capture the human development dimension in economic policies. [5]

In the realm of economic theory, the main challenge for the human development paradigm is to justify its relevance in explaining economic phenomena. In this regard, it is important to stress human development is, admittedly, a normative framework. As such, it does not purport, nor should it be expected, to provide an explanation for economic phenomena, but to provide normative guidance for human behavior in relation to economic issues, on the basis of a moral or ethical imperative.

It should also be recalled that, while not usual –even in the realm of heterodox economics-- the use of normative frameworks is not new. Normative approaches to economic issues were, for example, prevailing in antic and medieval times. These frameworks had “as an objective, to find rules of moral conduct, not to understand the functioning of the economy.”[6] Their methodology was also different from positivist theories. The method “was based on the principle of authority, namely on the deduction of rules of conduct from first principles that amounted to articles of faith.”[7]

However, it is important to highlight that, like any normative framework, human development can be relevant as an explanatory factor for phenomena to the extent that its principles are internalized and incorporated into human behavior, whether individual or collective. It is well-known the inspiration that ethical concepts about the relationship between debt relief and cancellation and human development provided to the civil society and the public, resulted in active promotion and support of successive rounds of debt relief and cancellation. Eventually these factors had to be incorporated by policy-makers and even economists in their assessments of debt sustainability.

To the extent that human development principles become the basis of human action they may acquire supreme relevance, even from the more positivists of the viewpoints, and provide adequate complement to them. On the other hand, a purely positivist approach

[4] John Paul II 1991, 35.

[5] For an account by the intellectual author of the concept of such report see, in general, Ul Haq 1995. He also argues that the idea that social arrangements must be judged by the extent to which they promote “human good” dates at least to Aristotle, and can be also found in Kant, Adam Smith, among others. (See p. 13)

[6] Roncaglia 2006, 31.

[7] Ib. See also Ib., 19 (“philosophers… of the Middle Ages considered it their task not so much to describe and interpret the way the economy works, but rather to provide advice on morally acceptable behaviour in the field of economic relations.”)

would inexorably run into difficulties in explaining the successive rounds of debt relief and cancellation in the last decade, without resorting to some normative elements.

Moreover, it could be argued that normative elements underpin any framework, only sometimes less explicitly than others. In this regard, any attempt to justify an economic theoretical framework that is different from the human development approach will, most likely, be associated to the recognition of a different ethical framework—e.g., an utilitarian one—rather than the absence of ethics at all.

Paradoxically, another challenge to the human development approach as a heterodox economic framework relates not to its value as a theoretical framework, but to its value as a heterodox one. In fact, the attempt to come up with the so-called "Washington Consensus plus" or augmented Washington Consensus, can be seen as an attempt by orthodox schools to claim an equal right to be considered a human development-oriented paradigm. As put by Gore:

"An important strand of development research in the 1990s has sought to refute its challenge by showing that Washington Consensus policies in fact serve to reduce poverty, increase employment and can, in themselves, deliver growth with equity, and that therefore social concerns are already adequately addressed by mainstream approach." [8]

Certainly, a human development approach is susceptible of capture by orthodox perspectives. But this is not unique to this heterodox framework, as proved by the appearance of elements of several heterodox frameworks cast in orthodox schools, such as versions of the Washington consensus that have been branded as concerned with gender issues, or institutions, even though they are far from representing an embracement of the respective heterodox frameworks of gender economics or institutional economics.
Suffice to say that this paper takes the stance that human development belongs into the realm of heterodox frameworks. In seeking to define the scope of the framework with regards to the treatment of debt policy issues, it emphasizes it seeks to define elements that make it incompatible with the orthodoxy.

I. THE DSF DOES NOT SEEK TO ENSURE DEVELOPING COUNTRIES WILL BE ABLE TO FULFILL THE FINANCING REQUIREMENTS TO MEET HUMAN DEVELOPMENT GOALS AND THE MDGS

A human development approach to debt sustainability requires that developing countries be able to set aside as much as they need as public revenues needed to achieve human development goals and the MDGs, and only then pay the remnant as debt service or principal. Three conditions follow from this:

1. ***Because the paramount nature of the human person the human development approach seeks to preserve is universal, its application admits no distinction between low-income and middle-income countries.***

[8] Gore 2000, 795

The HIPC initiative addressed only a selected number of countries amounting to a small percentage of the debts of developing countries which also hosted only a small percentage of the world's poor. The criteria on which this selection was made have been criticized as "arbitrary, lacking in objectivity, and based on debt relief costs to creditors instead of the debt relief needs of HIPCs for their sustainable development."[9]

While the Debt Sustainability Framework is applicable to all low-income countries, by virtue of doing so it makes a distinction between low-income and middle-income countries. This paper argues that a human development approach should equally guide the treatment of debts of all developing countries, and therefore the distinction between low and middle-income countries for this purpose is an artificial one. Under this approach, the existence of natural variations among the different levels of human development in different countries certainly warrants different debt thresholds. However, the framework for carrying out DSAs and its application of the principles of human development should remain the same.

While the BWIs have sought to justify the distinction on the basis of some purportedly objective factors that make LIC debt different from MIC debt, a closer look at these justifications reveals the distinction stands on shaky grounds. It has been argued that:

"A framework for assessing sustainability in low income countries can build on the approach the Fund has adopted for countries with significant access to international financial markets. . . While the key features of this framework are also relevant to low income countries, these countries share a number of characteristics that warrant some important modifications in the analysis of debt sustainability: notably, their dependence on (unreliable) aid flows, the importance of concessional and official debt; the nature of the shocks to which they are subject; and constraints on their ability to generate the resources necessary to repay their debts."

In this view, therefore, the alleged differences in features are due to the alleged access (lack of access) to private financial markets by middle-income (low-income) countries. However, this division is a rather fallacious one that stretches reality.
Low-income countries, as defined by the Framework, can show surprisingly high levels of debt in the hands of private creditors.[10] Moreover, bonds issued by some of the countries covered by the Framework are in high demand as confirmed in the press, Pakistan and India being two such cases.[11]

On the other hand, to downplay the impact of official creditor debt in middle-income countries is also rather dubious. Middle-income countries can show surprisingly high levels

[9] UNCTAD 2004, 29.
[10] For instance, Serbia and Montenegro, near 30 percent; Liberia and Grenada, over 30 percent, D.R. of Congo, over 40 percent.
[11] Financial Times 2006; 2006a

of dependence on official creditors. For instance, nearly all the debt of Gabon, a country classified as middle-income, is owed to official creditors.[12]

Even for countries far above the IDA cut-off line and objectively enjoying high access to private capital markets, the impact of official creditors should not be downplayed. In the last two years, a number of middle-income countries have repaid their whole outstanding debt to the IMF, and Turkey is reportedly considering a similar move. Earlier on, Argentina, in the wake of its negotiation with private creditors, decided to restart paying debt service to the institution (instead of seeking rollover agreements) so as to be able to suspend the agreement. In these cases, revenues that could have been put to social and economic development goals or to repay debt to private creditors were applied to pay official debt. This signals that this debt, while proportionally smaller, can have quite a meaningful impact on the finances of the debtor.

Realizing the deceiving nature of a purely income-based approach, the BWIs have sought to nuance the applicability of the Framework to allow for the inclusion of countries that share many of the features typical to low-income countries, or the exclusion of some that do not.[13] Our review, in fact, found 11 DSAs under the DSF for countries above the current income cut-off line for IDA-only countries.[14] The fact that the BWIs themselves cannot stick to this distinction, besides showing its lack of rigor, creates great confusion.

Furthermore the idea that apparently (but not consistently) underpins the distinction in treatment is that different types of creditors warrant different treatment. As shown in Part IV, this idea is incompatible with a human development approach.

2. Debt relief is needed in order to ensure countries are not forced to pay more than they can without putting human development imperatives at risk.

A significant issue with the new framework is its policy consequence. The "forward-looking" nature of the Framework means that a lower debt threshold does not lead, in any case, to increased debt relief. In fact, a premise of the Framework mentioned in the discussions leading to its adoption was that debt relief was a one-off event that had "run its course."[15]

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[12] Gabon's debt to multilateral and bilateral creditors stands at an astonishing 98.8 percent. See also Djibouti (97 percent), Paraguay (60 percent), Fiji (64 percent) and Tunisia (57 percent). The phenomenon is also noted in Sachs 2005, 39.

[13] See IMF/IDA 2003, 5 ("… this paper leaves open the precise definition of low-income countries, to allow for the inclusion (exclusion) of countries that share many (few) of the features typical for this group.")

[14] Not all of these DSAs showed indication that country policy-dependent thresholds (a clear distinguishing feature of the Low-Income Countries DSF as opposed to the MICs DSF) were being used. Therefore it is ambiguous whether these DSAs were being carried out under the DSF for Low Income Countries. However, it is confusing that the absence of mention of the CPIA-derived threshold was also found in what are undoubtedly low-income country cases, such as Cameroon, Rwanda, Zimbabwe, etc.

[15] IMF/IDA 2003, 5

Some analysts have pointed out the fallacy of trying to establish a separation between "old" and "new" debt from the perspective of the impact a country's debt stock level has on its ability to finance the MDGs.[16]

In follow-up to this Framework, it is foreseen that debt burdens will go down because indebted countries would take more grants and less loans in their mix of instrument to fulfill financing needs. However, these countries are competing for grant resources in an environment where these resources tend to become more scarce. This means that the DSF does nothing to guarantee that the amount of grants identified as requisite become available for use towards achieving the MDGs. This is the case for all countries eligible for grant resources under IDA but it is even more so for countries above their debt thresholds and not eligible for grants, such as the IDA blend countries.[17] For this reason, the absence of a debt relief component does not meet the requirements for a framework to help achieve the MDGs.

In assessing the suitability of the DSF to support efforts towards the MDGs the decision reached by the Gleneagles G8 Summit in 2005 should not be overlooked. Here the G8 agreed to cancel 100 % of the debts owed to IDA and the African Development Bank by a number of, in principle, HIPC countries.[18] The G8 decision amounted to a recognition that previous responses by the international community to the debt problem in developing countries, including the HIPC initiative, were insufficient. More importantly, coming after discussions on the DSF that were trying to call off future debt relief initiatives it vindicated debt relief as a measure still necessary in many cases for countries to reach the MDGs.

In a later assessment of the DSF the World Bank staff somehow acknowledges that lower thresholds of debt sustainability would be more consistent with the MDRI (Multilateral Debt Relief Initiative), but yet suggests the Board should reject this option. One of the arguments advanced for this was that "lowering thresholds could risk depriving countries of financing (...). Non-MDRI countries in particular would need additional grant to avoid a sharp reduction in aid flows. This would be costly for donors, including IDA"[19]. That is, the Bank assumes that donors will not provide enough funding in the form of grants.

Unfortunately, the most recent aid trends do point to a materialization of those risks. Aid from OECD countries, in spite of pledges to increase, reports an overall drop of 1.8 percent between 2005 and 2006, even excluding from the calculation figures that admittedly inflated the 2005 figure by counting one-off debt relief to Iraq and Nigeria as aid.[20]

The fact that the grant resources that are necessary to complement the Framework are not forthcoming has a negative impact on the DSF's effectiveness to even achieve its proclaimed goal of keeping debts at a sustainable level in a forward-looking fashion. The

[16] CAFOD et al, 2004
[17] IDA 2005, 26
[18] Group of Eight 2005
[19] IMF/IDA 2006, 15
[20] Financial Times 2007

scarcity of grant or concessional financing makes debtor countries highly vulnerable to offers of financing in non-concessional terms by private actors, or even official ones charging market or otherwise high rates, such as Export Credit Agencies or others. Devoid of any enforceability besides the World Bank and the IMF, the Framework is quite ineffective as a tool to achieve its modest goal of keeping debts at a sustainable level towards the future.

3. The methodology to develop Debt Sustainability Assessments needs to be based on the ability of debtor countries to achieve human development goals and the MDGs.

The DSF's methodology does not contemplate the fulfillment of human development needs over debt repayment as a primary concern or, in most of the cases, as a concern whatsoever. Of the forty three DSAs included in the review, only six mentioned the MDGs, while only in one of them (that of Nigeria) did this mention actually include some costing of what it would take, financially, to achieve the MDGs. This is all the more regrettable given the methodological progress that has been made since the human development approach was first coined in terms of spelling out what the approach actually means in terms of costing.[21]

More to the point, an analysis of the complex method designed to arrive at the definition of the level of debt considered to be sustainable yields several findings that show it as unlikely to lead to an outcome consistent with the human development approach or the financing of the MDGs. In light of this, the BWIs' mention of the MDGs as justification for the DSF can be classed as simply a cosmetic disguise for an evaluation purely centered on addressing debt repayability.

This can be seen in each step of the methodology. As explained[22], the very first step of the process consists of assigning debt thresholds to given levels of quality of policy. The debt thresholds that were decided come from an exercise that looked into episodes of debt distress in low-income countries and the frequency and debt levels at which they tend to be experienced by those countries. The choice of the debt distress indicators that correlate with the policy performance ratings is derived from studies that made rather arbitrary assumptions about what is considered a "debt distress episode" and what the probability is of debt distress considered "tolerable" for a country. For instance, debt distress was defined as debt-servicing difficulties, e.g. arrears or Paris Club rescheduling, or the impact of debt burdens on growth.[23] It is worth noting that, compared with other potential definitions of debt distress, such as countries being so classified when unable to spend as much as they need in order to remain on track to achieve the MDGs, this approach would tend to underestimate the debt ratio at which countries run into situations of unsustainability.[24]

[21] See e.g., Mandell 2006 and Sachs 2005.
[22] See Box 1
[23] IMF/IDA 2004, 17
[24] Staff papers also acknowledge that the issue of "how much probability of debt one is willing to tolerate" is a policy choice. Consequent conclusions in the paper as to the debt caps that are appropriate are informed by the assumption that one would accept a 25% probability of debt distress as, in principle, reasonable. As put by the IMF "a crucial decision is which probability of debt distress one is willing to tolerate. .... the implicit choice of debt distress probabilities remains a policy decision." (IMF/IDA 2004, 19-20)

The next step consists of assigning a debt threshold to the country depending on its quality of policy as measured in the CPIA. A first issue here has to do with the indicators used to establish the debt thresholds, as they are poor proxies of how an economy is faring and, particularly, how well a government is meeting its revenue needs to achieve human development goals. The HIPC Initiative had been heavily criticized for relying mainly on debt-to-export and debt-service-to-export ratios as indicators to measure sustainability. Export revenue, indeed, does not necessarily correlate with growth, poverty reduction rates or, more importantly, fiscal revenue. In addition, the chosen thresholds, being fixed numerical thresholds, were said to be unable to capture the possible variations in country situations. A further criticism related to the fact that the thresholds adopted were too high.

The DSF takes a country-by-country approach by relying, for each country, on a menu of indicators. In addition to those used by HIPC, these indicators also include debt-to-GDP, debt-to-revenue and debt-service-to-revenue. The assignment of a role to the latter two is a positive step towards the MDGs, as it is seen to more closely reflect the budgetary resources available to meet them. In practice, however, the export-based indicators still prevail. Moreover, IDA has announced that it will directly prescind of revenue-based indicators because of “problems of data availability /comparability as well as risks of moral hazard”[25]

With regards to the threshold values, a look at the indicative debt threshold ranges confirms they continue to be potentially very high for many countries, especially if they are medium or high performers. The debt-to-exports indicator could now get as high as 200[26], even though several studies have shown that the 150 % mark used in the HIPC Initiative is just barely sustainable.[27] The debt-service-to-exports indicator could, in high performers, be allowed to rise up to 25%, which is far above the 12% at which independent studies have found it to be already unsustainable.[28] Quite strikingly such a ratio was not deemed sustainable beyond 3.5% for Germany in 1953.[29]

In interpreting whether these thresholds are suitable to reach the MDGs, the decision made by the G8 in Gleneagles in 2005 is, again, quite a meaningful benchmark. Concern about the MDGs justified, for the limited number of countries benefiting from that decision, debt thresholds of an average 40 percent debt-to-exports ratio by 2010.[30] IDA Staff, however,

[25] IDA 2004, 2
[26] This is after the downwards revision requested by the Board (see IMF 2005).
[27] Martin 2004, 17, quoting studies by Cohen, Elbadawi et al., Johnson, Pattillo et al, and Vaugeois.
[28] See Martin 2004, 18. Additionally see IDA 2004, 6-7, engaging in the interesting exercise of comparing the application of the DSF (IDA’s interpretation) to IDA countries with a hypothetical range that caps debt ratios at 150% debt-to-export for medium and high performers. Not surprisingly, the application renders, depending on the hypothetical scenario used for the comparison, between 8 and 18 more countries with unsustainable debt levels.
[29] Germany then obtained 51% debt relief.
[30] IMF/IDA 2006, 13

argues that "lowering thresholds for all countries could reopen the question of HIPC eligibility (...), which could substantially increase the cost of the HIPC Initiative"[31] It is quite clear with this rationale that the Bank's main concern is not poor countries reaching the MDGs, but the interests of donors (including IDA's allegedly scarce resources).

A second issue with this step of the DSA process concerns the use of the CPIA system to determine the debt thresholds for each country. The problems presented by the peculiar implementation of this country-by-country approach in the DSF are addressed in next section (see Part III). Here it is only noted that CPIA ratings are totally unsuitable to arrive at a determination of a country's financial needs to meet human development goals. The rationale behind the use of the CPIA rating system is entirely another: that a country with better policies would be more able to repay and, therefore, can carry higher levels of debt. However, even under this rationale, the CPIA has proved to be woefully ineffective to provide this measurement.[32]

The third step of the DSF approach is meant to bring an element of conservatism into the debt sustainability assessment: an assessment of projected debt burdens in the face of plausible shocks is part of the measurement of debt sustainability under the DSF. At first sight, this provision seems to address one of the criticisms of the HIPC initiative, namely, its overoptimistic projections and lack of attention to external shocks. A closer analysis, though, reveals this is far from being the case.

The charge against HIPC in the past was that the very optimistic projections embedded in the DSAs underestimated the magnitude of the problems in debtor countries and, hence, debt relief needs. The DSF hardly safeguards against this possibility and the increased discretion awarded to staff does not help. It is unclear whether the old models that tended to overestimate countries' export growth prospects will be replaced by new ones. 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 are not dispelled by a framework that continues to leave the exercise in the hands of the same actors and does not require any further disclosure from them. On top of this, IDA has announced that, at least for some time, it will base its assessments only on the first pillar, which rules out the inclusion of a vulnerability assessment altogether.[33]

This review 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.[34] In addition, in six cases the countries breaching thresholds were found to be at moderate risk. 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

[31] Ib.
[32] An exhaustive analysis of the different arguments that have been leveled is beyond the scope of this paper. For a summary see Caliari, 2005.
[33] IDA 2004a, 8
[34] The countries are Zambia, Vietnam, Sri Lanka, Papua New Guinea, Mozambique, Mali, Cape Verde, Armenia and Albania.

the difference in treatment between these countries and those where breaches of thresholds led to a determination of "high" risk. Perhaps more troubling is the review's finding that, in fifteen cases[35], the policy-dependent threshold categorization that is 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 comes from.[36]

From a human development perspective, some positive results could have been expected from an approach that sought to safeguard against overoptimistic manipulation of models and data. But the lack of transparency and accountability in the implementation of these safeguards neutralizes these potentially positive aspects of the DSF.

II. THE DSF AND PRINCIPLES OF PARTICIPATION AND ACCOUNTABILITY

A human development approach to debt sustainability entails ensuring that those affected by debt are able to participate in its management.

HIPC countries have called more than once for indebted countries to be placed in a leading role in the development of the DSAs.[37] This should follow naturally from the principles of ownership and participation that the World Bank and the IMF repeatedly endorse in their rhetoric. It would also be warranted in the light of international commitments to "broaden and strengthen the participation of developing countries . . . in international economic decision-making and norm-setting."[38]

However, the DSF does not improve over the situation existing under the HIPC Initiative. It has failed to increase the participation rates of developing countries in decisions about management of their debt and, in fact, the very actors for whom the evaluation of debt sustainability is most relevant are those most alienated and sidelined by the current approach.

While HIPC was criticized for setting fixed quantitative debt sustainability thresholds for all beneficiary countries, it should be stated that HIPC brought a welcome element of certainty about debt relief needs missing in previous schemes, based on ad hoc political arrangements agreed on by the creditors on a case-by-case basis. It was also this element of certainty what allowed the international NGO community to hold donors accountable when countries having gone through the Initiative had debt levels still above the set numerical thresholds. Indeed, the introduction of an accountability element should be seen as the crucial factor that led eventually to the recognition that HIPC had failed to meet its targets, which eventually evolved into the 2006 G8 decision at Gleneagles to expand debt relief.

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[35] Bangladesh, Bolivia, Bosnia, Cameroon, Comoros, Democratic Republic of Congo, Dominica, Grenada, Liberia, Pakistan, Republic of Congo, Rwanda, Sao Tome and Principe, Serbia and Zimbabwe.
[36] In six of these cases, the vulnerability assessment is also missing altogether (Bangladesh, Bolivia, Bosnia, Cameroon, DRC, Dominica).
[37] HIPC Finance Ministers 2004.
[38] See Monterrey Consensus, para. 62 ("We stress the need to broaden and strengthen the participation of developing countries and countries with economies in transition in international economic decision-making and norm-setting.")

The DSF proposes country-specific thresholds based on a pool of indicators and considerations. Conceptually, this approach is better than the one embodied by HIPC inasmuch as it recognizes the reality that a similar debt burden might impact different countries in different ways. Such an approach also allows taking into account the particularities of each country's debt profile and would provide space for the voice of the particular countries and their people to be incorporated in the process.

However, in returning to a case-by-case assessment the DSF is also open to the lack of transparency and accountability and to the misleading macroeconomic assumptions[39] that characterized pre-HIPC debt relief schemes. Indeed, in the process of setting debt thresholds the DSF leaves so many elements to the discretion of BWIs staff that it is hard to see any way that it will be possible for outsiders, including beneficiary countries, to hold staff accountable for the malfunctioning of the Framework. As such, the very usefulness of the concept of debt sustainability thresholds has become doubtful. Under the new approach, the BWIs would be able to pass as sustainable a debt level that would have hitherto been considered extremely high, by invoking the debt profile and circumstances of the country involved.

Each of the three main pillars of the DSF (debt distress, policy-dependent threshold ranges and vulnerability to shocks assessment) is ultimately subject to discretionary and subjective decisions by the staff, based on country-by-country circumstances.

The policy dependent thresholds are formulated based on the CPIA rating of the country. The indicators used to arrive at this rating are based on a matrix of policies relating to economic management and structure, public sector and institutional management, and social inclusion and equity. The governments rated have no input into the rating itself, or the development of the criteria, regardless of how democratic or participatory the processes by which these governments make their policy choices are.

The process for developing CPIA ratings is a very secretive one. DSAs are still being done on the basis of CPIA ratings that until last year were not disclosed. Although they are now released by individual country and by criterion[40], staff questionnaires and documentation on which they are based remain classified, depriving debtor countries of due process and civil society and outside experts from any basis for outside and independent scrutiny.[41]

The vulnerability to external shocks as addressed in the second pillar of the DSF also leaves a lot of space for discrete and non-transparent decisions. For each country five indicators are to be evaluated against the threshold level in a baseline scenario and in a stress scenario. But there is no rule established as to what happens in the diverse number of possible scenarios where some indicators are above and below thresholds. Judgment in these cases

[39] The IMF itself recognized having shown "a systematic tendency to excessive optimism" (IMF/IDA 2004, fn. 10)
[40] IDA 2004
[41] See Caliari, 2005, summarizing different criticisms to the process.

would need to take into account several additional, country-specific variables, such as the type and size of the deviation between the indicator and the threshold and historical circumstances of the export structure.

Finally, as discussed in the previous section, the debt threshold ranges associated with each rating have been determined on the basis of controversial judgments about what types of situations constitute “debt distress.” Moreover, the affected countries have had no say in this decision.

The DSF not only leaves no role to the country concerned in the determination of debt sustainability, but it contradicts basic principles about accountability and transparency by shielding staff from attempts by outside experts to scrutinize decisions on the categorization as sustainable or unsustainable of the debt profiles of specific countries.

This process also represents a continuation of the troubling pattern whereby the international financial institutions, creditors themselves, decide on what a sustainable debt level is. This is especially troubling given that creditors tend to be biased towards receiving payment on their credits. Different considerations on the debt cost to growth and human development in the country concerned are only likely to come into the process if the government and people of the affected country have a say in it.

III. THE DSF CONTINUES TO PROMOTE A ONE-SIZE-FITS-ALL, FLAWED ECONOMIC MODEL

A human development approach to debt sustainability requires not only that debt sustainability assessments, but also policy responses to the debt problem, give primacy to human development priorities.

The HIPC Initiative conditioned debt reduction upon the adoption of a one-size-fits-all economic model that resembled the structural adjustment programs that began to be promoted in widespread fashion by the Bretton Woods Institutions in the 1980s. Structural adjustment programs have failed to promote not only poverty reduction or pro-poor growth but, first of all, growth alone. Their main rationale was that they would improve the trade performance of countries undergoing them and thereby improve the level of foreign exchange earnings needed to repay debts. More than two decades of implementation of the programs reveal that not even in this have they succeeded, with the developing countries that were able to apply different, non-orthodox models, being the only ones that have seen lasting improvements in trade performance and growth in value-added products trade.

This realization has been eventually accepted in international fora, materializing in calls for policy space[42] and adaptability to national realities.[43]

[42] São Paulo Consensus, para 8. ‘The increasing interdependence of national economies in a globalizing world and the emergence of rule-based regimes for international economic relations have meant that the space for national economic policy, i.e. the scope for domestic policies, especially in the areas of trade, investment and industrial development, is now often framed by international disciplines, commitments and global market considerations. It is for each government to evaluate the trade-off between the benefits of accepting

In this regard, it needs to be remembered that the DSF does not call for debt relief, so it would not condition debt relief on the implementation of a specific program. At the same time, however, it does not call for changes to the overall policy conditionality attached to the receipt of concessional or non-concessional financing by indebted countries.

On top of the ongoing restrictions on policy space coming from grants and loans, the DSF's methodology for judging policy performance encourages the adoption of a flawed economic model as can be seen from the fact that CPIA ratings are taken as a proxy for economic success, an approach that has been critiqued by the World Bank itself in 2001. The CPIA methodology, indeed, was originally designed to measure policies rather than outcomes, but several of the indicators used in the DSF assess outcomes, rather than policy.[44] As such, a self-fulfilling cyclical framework can result in which poor countries are punished for being poor.

Being a one-size-fits-all measurement of what a "good policy" is, the CPIA in itself contradicts the intention of the DSF to bring about country-by-country analyses. Some of the indicators are evidently subjective: different types of trade policies can be good or bad to different groups of people with divergent interests, but there is in no case agreement among economists or policy makers about what constitutes good trade policy.

Besides, the CPIA was in the first place developed to help allocating IDA resources. Although the BWIs found some correlations between what they view as debt sustainability and the CPIA, it is technically unsound to use the same indicator to assess both debt sustainability and aid allocation. The latter aims at measuring the capacity of a country to reduce poverty, while the former measures the repayment capacity of a country. For instance concerning rural institutional settlements, one would expect the specialization on export products to be highly graded if one seeks better debt repayment capacity, but anticipate agrarian reform and the protection of poor farmers if poverty reduction is at stake.

The application of such a device as CPIA ratings in a mechanical, unthinking fashion, overshadows progress made in other areas of the DSF towards a tailored approach. But it also shows that judgments about the policies followed by the country, far from being based

international rules and commitments and the constraints posed by the loss of policy space. It is particularly important for developing countries, bearing in mind development goals and objectives, that all countries take into account the need for appropriate balance between national policy space and international disciplines and commitments.'

[43] Monterrey Consensus, para. 54. This notion has been endorsed by some fairly mainstream economists, see e.g. Rodrik, Birdsall and Subramanian 2005, 9/10 ("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."); Rajan 2004 ("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.")

[44] World Bank OED 2001, 23-24. See also Herman 2004.

on their overall ability to address human development concerns, are based on a dogmatic assessment of whether they adhere to a model of questionable effectiveness to foster growth and the reduction of poverty.

IV. THE DSF DOES NOT PAY ADEQUATE REGARD TO PRIVATE SECTOR AND DOMESTIC DEBT

A human development approach to debt sustainability implies dealing with debt in a comprehensive and binding way. All types of debt have fiscal consequences on resources for human development, so all types of debt should be considered and receive a policy response.

The HIPC Initiative was an improvement over previous attempts to deal with debt problems in a piecemeal way. It was the first time that bilateral, multilateral and private sector debt was addressed in a comprehensive manner. However, it had drawbacks. It lacked a legal framework for dealing with credits held by the private sector and did not consider domestic debt issues.

The DSF has failed to improve the situation regarding private sector debt. The DSF is predicated for LICs and presumes issues of private sector debt are largely alien to these countries, on the basis of their general lack of access to private financial markets. This contrasts with the verifiable finding that the existence of private sector debt is neither actually nor potentially confined to countries above a certain income threshold. Several examples of low-income countries with high levels of private sector debt have been already mentioned in this paper.[45] The lack of a legal regime to deal with these debts can be a significant problem undermining the impacts of the goodwill of official creditors.

This might happen not only when creditors hold large proportions of the debt, but also when they hold relatively small ones.[46] This problem has come to the surface in several HIPC countries where the action of commercial creditors, in some cases ”vulture fund” creditors[47], that put pressure on the debtors to maximize recovery, undermines or threatens to undermine the gains in debt relief conceded by other creditors.[48]

Besides, the DSF has no binding effect on future non-concessional creditors willing to lend to poor countries beyond their debt sustainability thresholds (see Part I.3). It is, indeed, a concern of IDA that after the Multilateral Debt Relief Agreement (MDRI), the fiscal space created by debt cancellation may be rapidly filled in by such free-riders.[49]

[45] See Part I.1, above.
[46] IMF/IDA 2002, 18 (“While small in NPV terms, commercial creditors can create pressure for settling claims because debtors may fear the impact of litigation and/or impairment of creditor-debtor relationships.”)
[47] Vulture fund creditors profit by buying cheap sovereign debt in secondary markets and then maximize recovery via litigation and other pressure mechanisms.
[48] E.g. Guyana, Uganda, Nicaragua, Sierra Leone, Niger, Mozambique, and others.
[49] IMF/IDA 2006, 21

A human development approach to debt sustainability should bind all creditors, which would mean a party lending to a country beyond its debt sustainability threshold would be at serious risk of not being repaid. This should be made legally clear in all major creditor countries.[50]

But, far from this, the response that major creditor countries have given to the “free-riding” issue has been through an ineffective tinkering with the Debt Sustainability Framework. On the one hand, they placed emphasis on fostering “creditor coordination” around the DSF, with the expectation that such coordination will grow out of mere outreach and communication efforts towards creditors not providing debt relief.[51] On the other hand, they placed incentives for debtors to stop them from borrowing beyond sustainable levels. These incentives come in the form of reduced nominal allocations to the affected borrowers and harder terms of assistance.[52] In the case of Fund-supported countries they are subject to conditionalities related to the level of borrowing.[53]

A striking feature of this response is that it squarely places responsibility on the borrower, while neglecting to address the responsibility of the donors and creditors. The risks that in an environment of declining grants countries seeing their debt reduced might need to borrow again was clearly seen in advance by the creditors. The failure of donors to meet their aid commitments, that translates in less availability of concessional finance to meet development targets by borrowers, is, at least, one part of the reason why borrowers are getting re-indebted.[54] In addition, the responsibility for lending beyond prudent limits is, arguably, a shared one between debtor and creditor. All this seems lost on the policy response, even though creditors are apparently well-aware of the need and superiority of a response based on binding coordination of creditors. According to IDA:

“Part of the complexity of the free-rider issue stems from the fact that there is no institutional framework either for a formal creditor coordination process of for the prevention of serious breaches of concessionality benchmarks by opportunistic commercial lenders. The DSF . . . could not be expected to solve the free-riding problem associated with the provision of grants by IDA and other official creditors.”[55]

Thus, te effort will not only unfairly punish debtor countries, but also prove ineffective to stop unsustainable lending and a re-creation of the debt overhang. Since the punishment is a reduction of access to concessional lending, it is likely that the borrower in question will have to just ramp up its non-concessional financing, thus worsening the problem. IDA’s warning of this outcome could not be clearer:

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[50] Such a legal framework could for instance have prevented the massive indebtedness of Congo, where Sassou Nguesso mortgaged future oil revenues in 1998-99 to finance the civil war.
[51] IDA 2006, IV.A
[52] IDA 2006, para. 47
[53] IMF 2006, paras. 25/26. See also IDA 2006, para. 55.
[54] See Part I.2.
[55] IDA 2006, paras. 34/35.

"The key risk [involved with a volumes-based response to free-riding] is that affected countries may attempt to compensate for their reduced IDA allocations by seeking further non-concessional financing from other creditors."[56]

On the other hand, creditors, knowing that they are certain not to face any consequence for lending to borrowers above sustainable levels, have certainly no real incentive to respect debt ceilings in countries whose reduced debt ceilings turn them into attractive profit-making opportunities.

As for domestic debt, the DSF does take one step forward by recognizing the importance it may have; it has yet, however, to incorporate such an insight into its methodology.[57] Domestic debt offers significant challenges due to the usual scarcity of data and the difficult policy consequences. However, in terms of ensuring the availability of financing for the MDGs its fiscal effects are the same as those of external debt.

Moreover, there are reasons where in a framework such as this, heightened attention to domestic debt is warranted. As examined earlier in this paper,[58] one flaw of the DSF as a debt management framework is its failure to ensure the availability of enough grant financing to cover the budgetary gaps generated by lack of access to borrowing and its a priori dismissal of debt reduction as a mechanism to cover that gap. This puts pressure on governments not only to borrow from other, more expensive, sources, but also to borrow internally. Our review found that a public debt DSA (as opposed to a purely external debt DSA) had been carried out in 16 cases, which represents some progress versus the pre-DSF methodology. While it might be assumed that the remaining countries did not have large domestic debt problems, it is impossible to subject the decision to leave domestic debt out of the assessment to outside scrutiny. It is worrisome that in some punctual cases examined in this review where a public debt DSA had not being provided, domestic debt was cited as existing in problematic levels.[59]

While the policy consequences attaching to domestic debt might not be as clear-cut, at least a systematic assessment of domestic debt, regardless of its size, would be desirable at least in order to begin to estimate its impact on financing needs to achieve the MDGs and the challenges its treatment entails in each case.

V. THE DSF CONTINUES TO DODGE AN INTEGRAL, HOLISTIC CONSIDERATION OF TRADE AND FINANCE DYNAMICS

A human development approach calls for human development needs to be placed not only at the center of debt sustainability, but also at the center of the design and implementation of all international economic policies.

[56] IDA 2006, para .55.
[57] IMF/IDA, 2006. UNCTAD has also insisted on the importance of taking domestic debt into consideration in order to assess debt sustainability (UNCTAD 2004, 40)
[58] See Part I.2
[59] This is the case for, e.g. Bosnia and Herzegovina and Central African Republic.

The need for coherence between trade, financial and monetary policies has also been a matter of commitments made in important political documents, such as the Monterrey Consensus and the UNCTAD XI Declaration.[60] Indeed, a human development approach to debt would be of little service if it could be undermined by the simultaneous neglect of trade and finance dynamics affecting the beneficiary countries.

However, this was very often the case with the HIPC initiative. Its design emphasized only narrow financial aspects of the debt equation while assuming improvements in trade performance and underestimating well-known features of the trade profile of the countries involved. Against this backdrop, it is not surprising that several beneficiaries of the Initiative saw their debt reduction undermined due to their export profiles' weaknesses.

First, the financial picture considered in the HIPC framework was rather not complete. External indebtedness and capacity to repay are to be assessed against the access of a country both to domestic and external financing.

According to conservative estimates, capital flight would cost $500bn to Southern countries, notwithstanding the misuse of public resources entailed by grand corruption. This detracts often already insufficient domestic savings from domestic use and increases the cost of domestic credit, either for domestic entrepreneurs or for government, thereby providing an incentive to borrow abroad. This huge capital flight is due partly to the complete liberalization of capital flows imposed by the IMF over more than two decades of structural adjustment. In the DSF no mention is made of how to improve government's control over capital flows.

Besides its partial consideration of the financial dimensions of debt sustainability, the DSF does little to take into account the close linkages between trade and debt. Although it comes at a time when there seems to be consensus in the international community as regards achieving coherence and consistency among financial and trade policies, the DSF is susceptible of the same critique. In contrast to what this consensus would require, the policy-dependent thresholds chosen to shape debt sustainability assessments are totally unfit to gauge whether the policies being implemented by the beneficiary countries, and the policy environment in which they work, will lead to improved trade performance on a sustained basis and increase government revenues.[61]

An approach that links debt and trade on ethical grounds would ensure that resources from both debt relief and enhanced trade are first applied to the fulfillment of human

[60] See Monterrey Consensus, para. 52. See also Sao Paulo Consensus, para. 17 ("In order to enable developing countries to reap greater benefits from globalization and to achieve the international development goals, including those contained in the Millennium Declaration, there is a need to enhance the coherence and consistency of the international monetary, financial and trading systems . . . development should be at the centre of the international economic agenda.")

[61] For instance, severe losses in tax collection have resulted both from trade and investment liberalization encouraged by the international financial institutions. Tax and other fiscal losses incurred by the liberalization of investment regimes under a new wave of free trade and investment agreements are paramount among these.

development goals. But through its application of thresholds mainly set based on export ratios, the DSF repeats a tradition of prioritizing use of resources from exports in debt repayment.

One aspect where the DSF timidly tries to improve over its predecessor is the various stress tests included as one step of the methodology to carry out DSAs. However, as already mentioned, they are applied in addition to the country's baseline scenario, hence being only incidental to core projections and not a central aspect of focus. In fact, this review found sixteen cases where vulnerability assessments and stress tests are missing altogether. In seven of these cases the countries under assessment were still given a "green light."

An added problem is that, assuming that the assessments really changed significantly in the light of trade projections, it is hard to see whether these changes would project into downward revisions of the debt sustainability thresholds. Part I.3 has examined situations found by this review where the way exogenous shocks considerations bear upon the initial thresholds is very unclear.

This is especially problematic given that the HIPC's two main criteria are now replaced by country-by-country thresholds based on several debt burden indicators. These thresholds could be lower, but in many cases they will be higher than those of the HIPC Initiative. The indicative threshold ranges leave ample room for higher debt burden indicators to become, in the end, acceptable.

The DSF also fails to consider a large array of 'non-shocks'[62], classified as such on account of their apparent predictability or permanent nature. An example of these is the change in textile markets posited owing to the phase-out of the Multi-Fiber Agreement. While these events will generate visible setbacks to the debt sustainability of the countries concerned, the DSF is not suitable to devise a compensatory financing solution for them, either.

Here it is worth noting, again, the importance of an analysis not only of the methodology, but also of the policy consequences of the DFS. HIPC governments have been asking for a long time that exposure to shocks be built into the baseline scenarios of programs. This measure would have helped them if its purpose had been that contingency financing be committed up-front by donors and creditors to automatically offset such shocks, should they materialize.[63]

The DSF provision is hardly functional to this request. The purpose of the debt sustainability assessment under the new framework is only to inform a borrowing strategy and set prudential limits on non-concessional and concessional financing. If the calculations on vulnerability are adequately reflected by the debt sustainability assessment, all this would mean that the country can only undertake debt up to a certain level and the rest needs

[62] It has been argued that the distinction between shocks and 'non-shocks' is spurious – both affect balance of payments, budget revenue and export growth. This is further the case from a human development approach, implying that both types of events require a policy response when it comes to debt sustainability assessment and management.

[63] HIPC Finance Ministers 2003 and 2004

to be financed through grants. Nothing in the DSF ensures that the needed amount of grants (or needed reduction of debt stock) will be awarded.[64] As a consequence, the indebted country does not benefit from any certainty regarding its access to funding in case the projected shocks materialize. This hardly accords with an approach that tries to prioritize the availability of resources for human development.

RECOMMENDATIONS

A human development approach to debt sustainability holds that human development imperatives should take precedence over debt payments.

1. Debt sustainability assessments should be geared to ensure that debtor countries are able to fulfill the financing requirements to meet human development goals and the MDGs. The faithful implementation of this principle requires that:

a) **it be equally applied to all countries, without distinctions, including distinctions based on income,**
b) **debt relief and cancellation be actively promoted as a means to reduce the debts of countries when they are above sustainable levels, and**
c) **the methodology for performing Debt Sustainability Assessments deliberately seeks to measure the cost of achieving the MDGs and places it against the public revenue available to meet them.**

2. Debt Sustainability Assessments transparent, accountable and independent. This could only be achieved through a process that balances the voice of the creditor and that of the debtor government, acting in consultation with the internal venues for democratic and civil society participation.

3. As part of their debt management strategies, debtor countries should not be asked to adopt policies that are inconsistent with human development priorities. This calls for an immediate withdrawal of economic policy conditions and of any role for CPIA economic policy criteria in the design of the DSF.

4. Debt sustainability assessments should address debt in a comprehensive way domestic and external, owed to public and to private creditors. A debt management scheme should incorporate a legal framework for private creditors, as well as for multilateral creditors. It should also provide for the systematic and ongoing assessment of domestic debt levels and include them in evaluations of pressure on budgetary resources that can be directed to finance human development.

[64] Interesting proposals have been put forward by such economists as Cohen and Jacquet, to transform loans totally or partly into grants under specific circumstances, especially in the case of an external shock. (See Cohen et al., 2005)

5. Debt management strategies should include mechanisms that ensure their benefits will not be undermined by the simultaneous design and implementation of other international economic policies, especially on trade.

END OF PAPER

Box 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.[65] 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.

[65] 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."

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 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'.[66] 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.

[66] IMF/IDA 2004, 24

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.

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