BACKGROUND BRIEFING AND FREQUENTLY ASKED QUESTIONS: DEBT CANCELLATION AND THE JUBILEE ACT FOR RESPONSIBLE LENDING AND EXPANDED DEBT CANCELLATION

Prepared for the Senate Foreign Relations Committee Hearing,
*"**Building on International Debt Relief Initiatives**" **by Jubilee USA Network***
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I. INTERNATIONAL DEBT RELIEF: WHAT HAS BEEN ACCOMPLISHED? WHAT IS THE UNFINISHED AGENDA?

Since 1996, more than 30 poor nations have received some form of debt relief under the IMF/World Bank Heavily Indebted Poor Country (HIPC) Initiative. In the United States, support for debt relief has been bi-partisan and has come from both the legislative and executive branches, with the Bush administration playing a leading role in reaching the historic 2005 agreement that led to the creation of the Multilateral Debt Relief Initiative (MDRI). Debt relief committed under the HIPC Initiative and the MDRI to date is expected to reduce the debt stock of the 31 post-decision point HIPCs by a total of $96 billion. In 2007, the 22 post-completion point counties saved $1.3 billion in debt service payments.

While relatively small compared to broader aid and investment flows, even this modest level of relief is making a vital difference in the world's most impoverished nations: Debt AIDS Trade Africa (DATA) found that for every dollar freed up from debt service, African governments have increased social spending by 2 dollars. Debt relief is an investment in the growth and stability of our trading partners, as well as an investment in our national security, as many of these countries face the kind of extreme poverty that can lead to unrest and instability. Debt relief can also help create a more attractive environment for private investment and improve the prospects for sustainable development. Recent research has found that countries that have participated in the HIPC program are seen as more creditworthy following debt relief than they were prior to receiving relief. Combined with increased and more effective foreign assistance, trade policy, and other tools, debt relief is one critical piece of a more comprehensive approach to reduce global poverty.

THE DEBT CRISIS CONTINUES: KEY POLICY CHALLENGES

Insufficient Debt Cancellation

The reality is that for too many poor countries, the debt crisis rages on unabated. Even after the debt cancellation provided to date, the world's most impoverished nations continue to send $100 million each day to the United States government, other wealthy nations, the IMF, the World Bank, and other creditors. With rising food prices threatening even greater hunger and the 2015 deadline to reach the Millennium Development Goals fast approaching, Jubilee USA argues that it is time to extend the promise of debt cancellation to additional countries that need it to achieve the Millennium Development Goals.

A majority of the world's 66 poorest countries remain mired in debt crisis. A January 2007 study of 41 poor countries that had not yet completed the HIPC Initiative found that the majority of these countries were actually paying more today on debt service than they were in 1996. Lesotho is an example of one of these countries: it does not qualify for current debt cancellation initiatives despite its high level of need. Lesotho spent $54.2 million in debt repayments in 2005, only slightly less than what it receives annually from the Millennium Challenge Corporation (MCC). Lesotho's spending on debt repayment is roughly equal to its entire education budget, while 35% of Lesotho's children are not enrolled in primary school. By extending debt relief to Lesotho, foreign assistance provided through the MCC could become more effective by ensuring that US aid stays in the country rather than flowing right back out in the form of debt repayments.

The Impact of "Vulture Funds"

Another policy challenge is the action of so-called "vulture funds," companies that seek profit by buying up developing country debt in default on the secondary market for pennies on the dollar, then try to recover up to ten times the purchase price, often by suing impoverished countries in U.S. or European courts. The most recent vulture fund case is that of Donegal International vs. the government of Zambia. In 1979, Zambia purchased agricultural equipment and services from Romania on credit. Being unable to service this debt, in 1999 Zambia and Romania agreed to liquidate it. But before Zambia could seal the deal, a hedge fund called Donegal bought Zambia's debt for $3.28 million. Donegal sued the Zambian government for $55 million seven years later, after the Zambian government had received debt cancellation. The British High Court ruled that the government of Zambia pay Donegal $15.4 million, 65 percent of what Zambia was saved in debt relief delivered through the MDRI in 2006.[1] The actions of vulture funds represent a growing problem that needs to be addressed to ensure gains from debt cancellation are preserved.

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[1] "Heavily Indebted Poor Countries (HIPC) Initiative and Multilateral Debt Relief Initiative (MDRI)—Status of Implementation," IMF Report, August 21, 2006, p. 65.

Debt Sustainability and Responsible Lending

Even in countries that have received debt cancellation, new borrowing threatens to return countries to debt crisis, undermining debt cancellation efforts over the past several years. To date, official efforts to address this problem have focused mainly on the IMF/World Bank's Debt Sustainability Framework (DSF). But this instrument has been ineffective in addressing the problem of debt re-accumulation. Moreover, the DSF sanctions *only the debtor* for breaches in the debt ceilings, even though new borrowing is in many instances the result of insufficient access to grants for poor countries. An alternative solution is needed which 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, and in the G-20, and a new framework is needed that holds debtors and creditors co-responsible for sustainable and responsible lending.

IMF/World Bank Economic Policy Conditions: Limiting the Effectiveness of Debt Relief

The current HIPC debt relief program requires nations to meet a strict series of economic policy requirements before receiving debt cancellation. While all agree that debt cancellation should be provided in ways that ensure full transparency and accountability, many of the other conditions the IMF and World Bank insist on attaching to debt relief are more controversial. A growing number of analysts including the Center for Global Development[2] have criticized the IMF in particular for being overly stringent in its requirements that poor countries have low inflation, pay down domestic debt, limit spending on public sector salaries for doctors and teachers, and maintain high currency reserves. In the case of Nicaragua, the IMF required the country to use the majority of its debt relief proceeds to bolster its foreign currency reserves and pay down its domestic debt. As a result, Nicaragua had been able to free up only a few million dollars of its debt cancellation monies for social investment as of late 2006.[3] Nicaragua was also required to privatize electricity as a condition of debt relief. Following privatization, electricity prices rose by 200%, pricing the poor out of the market, and blackouts became frequent. Conditionality for debt relief should be limited to requirements that ensure transparency, accountability and poverty reduction.

Odious Debts

Many of the debts of impoverished nations are odious, onerous, or illegal in nature – they are debts accrued by undemocratic regimes or that did not benefit the population. There is growing awareness of the problem of odious debts from civil society, academics, legal scholars, governments and international institutions. In October 2006, Norway became the first creditor to accept co-responsibility for past lending mistakes and cancelled the debts of 5 nations on the grounds that the loans reflected poor development policy. In summer 2006, the World Bank & UNCTAD published studies of the concept of odious debt.[4]

II. THE JUBILEE ACT FOR RESPONSIBLE LENDING AND EXPANDED DEBT CANCELLATION (S. 2166)

The Jubilee Act seeks to build on the historic achievements on debt relief of the past decade and to address some of the aforementioned policy challenges. The legislation:

- Calls on the U.S. Treasury Department to negotiate a multilateral agreement for debt cancellation for an initial 9, and eventually up to 24 total additional poor countries that need cancellation to meet the Millennium Development Goals (MDGs). These are all very poor countries with "IDA only" status at the World Bank and a per capita income of less than $3 per day;
- Includes strong safeguards to ensure that the money freed up by debt cancellation is used to combat extreme poverty in qualifying countries. In order to qualify, countries must meet strict criteria regarding public financial management and transparency and must report annually on how the money is used. Countries that violate human rights, have an excessive level of military expenditures, or have poor records on terrorism or narcotics control would not qualify for cancellation;
- Calls on the US Treasury Department to prevent the practice of vulture funds by designing legal remedies to curtail vulture fund activity; providing legal support to countries being sued by vulture funds; and providing technical assistance developing country governments;

[2] Goldsborough, David, "Does the IMF Constrain Health Spending in Poor Countries? Evidence and an Agenda For Action," Center for Global Development, July 2007

[3] 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.

[4] World Bank, *"The Concept of Odious Debt: Some Considerations,"* Discussion Draft, September 7, 2007. UNCTAD, "The Concept of Odious Debt in Public International Law," Discussion paper 185, September 2007.

- Urges that more World Bank resources be devoted to grants for the world's poorest countries to avoid renewed indebtedness;
- Requires greater transparency at the IFIs, including a policy of maximum disclosure in project and loan documents;
- Urges the development of a framework for more responsible future lending practices;
- Prohibits four specific harmful economic policy conditions that have been demonstrated to harm the poorest and undermine past debt relief, including user fees for primary health care and education, increased cost for the poorest for clean drinking water, measures that compromise workers' rights, and constraints on government spending for essential health care and education.
- Directs the Government Accountability Office (GAO) to undertake an audit of "odious" lending by the World Bank, IMF, and US government in specific countries.

III. FREQUENTLY ASKED QUESTIONS

Won't Debt Relief Just Go into the Pockets of Corrupt Leaders?

Debt relief now has a ten year track record of freeing up resources to fight poverty. In Ghana, the money saved is being used for basic infrastructure, including rural feeder roads, as well as increased expenditure on education and health care. In Tanzania, the government is using the money saved to import vital food supplies for those affected by drought. In Burundi, elimination of school fees in 2005 allowed an additional 300,000 children to enroll. In Honduras, debt relief is to be allocated to eliminate annual fees charged for primary education, which is expected to increase enrollment from low-income families. While debt relief advocates are encouraged by the record of the program to date, the Jubilee Act requires countries to meet specific criteria – including criteria in the areas of public financial management and budget transparency – to qualify and be eligible for debt cancellation. In addition, before they receive debt cancellation, countries must show that they are not human rights violators, that they do not spend excessively on their military, that they do not participate in narco-trafficking and that they have not provided funding for terrorism. The Act also requires nations to use the funds released by debt cancellation to fight poverty, and to provide an annual report outlining how the funds were used.

How Much Will Debt Relief Envisioned in the Jubilee Act Cost the U.S. Taxpayer?

The Congressional Budget Office concluded that the House version of the Jubilee Act (HR 2634) would have no budgetary impact because a provision was added to the House version that authorizes US Treasury to begin negotiations for a multilateral deal but requires the Administration to return to Congress for final approval. It is anticipated that international negotiations would take 2-3 years before appropriations are needed.

Bilateral Debt. Upon conclusion of international negotiations in 2-3 years, Jubilee USA estimates the costs to cancel the debts owed to the United States by the first 9 eligible countries to be $119 million, assuming, as is expected, that Vietnam does not opt into the agreement. The total potential cost for all 24 countries that could receive cancellation of their debts to the United States would be approximately $957 million. Spread over 9 years, this amounts to an average annual cost to the US of $106 million. It should be emphasized that the actual time period for all 24 countries to qualify may be longer than 9 years, so the annual average costs may be lower.

Multilateral Debt. The overwhelming majority of the debts owed by the countries made eligible for debt relief by the bill are held by the World Bank, IMF, and other multilateral lenders. In total, for all 24 countries, it would cost about $24 billion to cancel the World Bank debt and another $11 billion for debt owed to regional development banks. Jubilee USA Network has identified resources within the IMF and World Bank which are *additional* – the sale of IMF gold, the use of excess International Bank for Reconstruction and Development (IBRD) reserves, and increased allocation of IBRD/International Finance Corporation (IFC) net income to IDA – that could fund the majority of the cost of multilateral cancellation envisioned in the legislation. While we strongly believe that these additional resources of the international financial institutions can and should be used, the US may need to increase its contribution to IDA to cover the costs. Even in this worst-case scenario, the costs involved would be modest. For the 9 countries expected to initially qualify, assuming Vietnam does not opt in, we estimate that the US' fair share of additional annual contributions to IDA following an agreement would be $235 million per year for three years. To put this figure into perspective, this increase is less than the increase requested by Treasury in its FY09 budget request for IDA.

Wouldn't the Jubilee Act Expand Debt Relief to Countries Who Already Have "Sustainable" Debts?
The debts of most of the impoverished countries that would be made eligible by the Jubilee Act are not sustainable. Using a human needs-centered approach to assess indebtedness (using NPV Debt to GNI rather than debt to export ratio), 14 of the 24 countries that the Jubilee Act would make newly eligible for debt cancellation are actually poorer and more indebted than the least poor and the least indebted HIPC.[5] Moreover, 11 of the 24 countries made eligible by the bill are labeled as moderate to high risk of debt distress according to the IMF/World Bank's Debt Sustainability Framework. Most of the remaining countries that are not as highly indebted as the HIPCs are either extremely poor or small island nations facing unique development challenges such as advancing climate change and lack of access to credit, and would clearly benefit from relief.

Why Give Debt Relief to Countries that Might Not Want or Need it, as it May Endanger These Nations' Access to Capital Markets?
First, it is likely that some of the countries that could be eligible for debt relief in the Jubilee Act may "opt out." For instance, Vietnam, though poor, is increasingly able to access private capital markets and it is unlikely they would seek international debt relief. Countries have a sovereign right to decide whether to seek debt relief: if the benefits of accessing private capital markets exceed the benefits of debt service relief, a nation may choose to opt out. On the other hand, many poor nations are likely to seek relief. For those nations that opt in, debt relief can help create a more attractive environment for private investment and improve the prospects for sustainable development. While some have raised the concern that debt forgiveness could harm a country's access to credit, the reality is the reverse: recent research has shown that countries that have participated in the HIPC program are seen as more creditworthy following debt relief than they were prior.

Does the Jubilee Act Provide "Unconditional" Debt Relief?
No. The Jubilee Act outlines strict eligibility requirements and requires specific policy actions to ensure that governments that receive debt relief use funds accountably and transparently. Provisions in the act would, however, restrict the World Bank and IMF from imposing several specific controversial conditions on countries. The Jubilee Act (S.2166) prohibits four specific conditions from being attached to debt cancellation. These include user fees for primary health care and education; increased cost for the poorest for clean drinking water; measures that compromise workers' rights; and constraints on government spending for essential health care and education.

Would the Call for a Responsible Lending Framework Included in the Act Reduce Capital Flows into Developing Countries?
In fact, the opposite result is likely to occur. Investors are generally concerned about predictability in developing country investments. The current climate for lending in developing countries resembles the Wild West, with a very high risk of non-payment. Comparable evidence drawn from an examination of domestic bankruptcy systems indicates that access and interest rates for finance *improves* for borrowers in an environment where creditors have access to a predictable and orderly system for debt workouts which reduces the prospects that some creditors profit at the expense of others who carry unduly large losses.

Has Debt Cancellation Contributed to the Reduction in Aid or Resource Flows?
Jubilee USA advocates a fully additional approach to debt cancellation, meaning that countries/institutions providing debt relief must provide it in addition to expanded development assistance efforts. Some recent research has made the argument that the provision of debt cancellation has led countries to reduce their aid, leading to a net reduction in resource flows from donors to the Heavily Indebted Poor Countries. But the World Bank[6] finds the opposite. Using OECD/DAC data, the Bank finds that in the aggregate for HIPC countries, there was full additionality (meaning that aid was additional to debt cancellation, and donors did not decrease their aid contributions) through 2004. Moreover, in recent years, political will has been building around provision of aid to combat global poverty. New, large constituencies like the ONE Campaign have been keeping the issue present in the minds of politicians and will continue to hold them accountable to the funding commitments the United States has made to provide further assistance. The increase in funding for the Jubilee Act's expanded debt cancellation is small in comparison to the U.S.'s other aid efforts. It is hardly the type of increase that would threaten to divert

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[5] See Bernhard Gunter. "MDG-Consistent Debt Sustainability: How to Ease the Tension between Achieving the MDGs and Maintaining Debt Sustainability," UNDP, January 30, 2007, p. 19.

[6] "Debt Relief for the Poorest: An Evaluation Update of the HIPC Initiative." IBRD/World Bank, Independent Evaluation Group, 2006.

funding from other critical development activities. Debt relief cannot replace the benefits of increased foreign assistance; but if it is *provided with additionality*, as Jubilee USA advocates and the Jubilee Act calls for, it is vital to ensure that aid is truly effective.

Why Should We Give Debt Relief? Isn't Aid More Effective?

Center for Global Development President Nancy Birdsall and other leading development experts have long held that debt relief is an extremely effective and efficient form of aid.[7] Writes Birdsall, "the substitution of debt relief for aid disbursements can increase the efficiency of aid by increasing ownership of their development programs by poor countries, reducing transaction costs, increasing fungibility, eliminating tying, and reassuring the private sector that countries are going to be able to implement their plans."[8]

Moreover, debt cancellation is a critical component of an integrated global development strategy. As Jeffrey Sachs and his team pointed out in the 2005 United Nations Millennium Project Investing in Development report, "Dozens of heavily indebted poor and middle-income countries are forced by creditor governments to spend large proportions of their limited tax receipts on debt service, undermining their ability to finance vital investments in human capital and infrastructure. In a pointless and debilitating churning of resources, the creditors provide development assistance with one hand and then withdraw it in debt servicing with the other."[9]

IV. RESOURCES FOR MORE INFORMATION

Jubilee USA Briefing Notes. Available at http://www.jubileeusa.org/?id=111

"Expanded Debt Cancellation: A Key Tool to Fight Global Poverty." Briefing Note One, January 2008.
"Recent Development on IMF Gold Sales and Debt Cancellation." Briefing Note Two, February 2008.
"Are IMF and World Bank Economic Policy Conditions Undermining the Impact of Debt Cancellation?" Briefing Note Three, February 2008.
"Vulture Funds & Poor Country Debt: Recent Developments & Policy Responses." Briefing Note Four, April 2008.
"Recent Developments On Odious & Illegitimate Debt." Briefing Note Five, April 2008..

Congressional Testimony on the Jubilee Act (HR 2634) in the U.S. House of Representatives, November 7, 2007.
Available at: http://financialservices.house.gov/hearings.html
Testimony by Neil Watkins, National Coordinator, Jubilee USA Network; Emira Woods, Foreign Policy In Focus, Institute for Policy Studies; Gerald F. Flood, Counselor, Office of International Justice and Peace, United States Conference of Catholic Bishops; Aldo Caliari, Center of Concern.

Jubilee USA Network is an alliance of 80 development agencies, religious denominations, and human rights organizations working for debt relief and more responsible lending to fight global poverty.
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[7] Birdsall, Nancy and John Williamson. "Delivering on Debt Relief: From IMF Gold to a New Aid Architecture." Peterson Institute for International Economics, April 2002.
[8] Ibid at p. 116-117.
[9] UN Millennium Project. 2005. *Investing in Development: A Practical Plan to Achieve the Millennium Development Goals.* New York.