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BUILDING ON INTERNATIONAL DEBT RELIEF INITIATIVES

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BUILDING ON INTERNATIONAL DEBT RELIEF INITIATIVES

THURSDAY, APRIL 24, 2008

U.S. SENATE,
COMMITTEE ON FOREIGN RELATIONS,
Washington, DC.

The committee met, pursuant to notice, at 1:59 p.m., in room SD–419, Dirksen Senate Office Building, Hon. Robert P. Casey, Jr., presiding.

Present: Senator Casey.

OPENING STATEMENT OF HON. ROBERT P. CASEY, JR., U.S. SENATOR FROM PENNSYLVANIA

Senator CASEY. The hearing of the Committee on Foreign Relations will now come to order.

We are starting as close to exactly on time as possible. There is a vote at 2:15. So I do not know what that will do to our proceedings here, but I wanted to get started so we could move forward.

Today the committee meets to assess the utility provided by international debt relief initiatives in alleviating poverty and promoting development in the world's poorest nations. A primary purpose of this hearing is to assess the lessons learned from recent debt relief initiatives, including the heavily indebted poor countries known as HIPC and multilateral debt relief initiative known as MDRI. Both of those initiatives have been undertaken in the past dozen years.

These two broad debt relief initiatives, when combined and completed, are expected to reduce the debt stock of those 32 nations that are eligible under these initiatives by a total of $96 billion. In 2007 alone, these nations included in the MDRI initiative benefited from $1.3 billion of annual reductions in debt service payments or approximately 1 percent of their overall gross domestic product. The Bush administration should be congratulated for having provided strong leadership in initiating the MDRI effort and promoting a greater awareness of the real benefits afforded by comprehensive debt relief.

I recognize the numbers that I just provided are abstract, but it is essential to recognize the real savings for impoverished nations that can now use scarce resources for the benefit of their people. The Government of Zambia, for example, benefited from the forgiveness of almost $24 million in outstanding debt in 2006 under the MDRI initiative. Using proceeds from that debt relief, the Zambian Government ended user fees for rural health clinics, ensuring that medical care and prescription drugs were free and available for all.

Another example. Just listen to the former President of Tanzania who wrote in 2004, "In 2001, Tanzania was granted significant debt relief. We have already witnessed tremendous successes. The primary school population has increased by 66 percent, the greater part of an extra 2 million children, and the shortfall in the enrollment of girls has been eliminated. We have built 45,000 classrooms, 1,925 new primary schools, and over 7,500 homes for teachers in partnership with their communities." So that is another example of the success of these initiatives.

The purpose of this retrospective look is to establish whether additional international debt relief today makes sense for nations not already included in the HIPC and MDRI initiatives.

Last week, the House of Representatives passed on a bipartisan basis H.R. 2634, the Jubilee Act for Responsible Lending and Expanded Debt Relief.

Last October, I introduced S. 2166, the Senate version of this legislation, which differs in some respects from its House counterpart but retains the overall goal of expanding debt cancellation to an additional 24 nations. These new nations, which range from Georgia to Moldova in the former Soviet Union to Kenya and Lesotho in Africa, qualify on the basis of their low per capita income levels and their subsequent eligibility to receive special assistance from the World Bank. I am proud to be joined by 25 other Senators who have agreed to cosponsor the legislation, including a majority of Senators who sit on the Foreign Relations Committee.

In recent years, the world has witnessed a coming together of a diverse coalition of groups on behalf of the cause of forgiving the debts of those nations at the lowest rungs of the world's economic ladder. A grassroots religious coalition has organized itself under the Jubilee Network to provide for greater debt relief and has been joined by academics, entertainers, and world leaders.

Jeffrey Sachs of Columbia University and a former adviser to the U.N. Secretary General has declared, "No civilized nation should try to collect the debts of people who are dying of hunger and disease and poverty."

The late Pope John Paul II, whose successor, Pope Benedict, visited the United States last week, made international debt relief a key priority for his papacy, calling on the international community to "reduce substantially, if not cancel outright, the international debt which seriously threatens the future of many nations." So said the Pope.

Finally, we have seen the United Kingdom, under the leadership of Prime Minister Gordon Brown, maintain a sustained focus on expanding the benefits of debt relief for all worthy recipients.

I recognize that the Jubilee Act bill before the committee is not perfect and can be improved. One of my purposes in calling this hearing was to solicit the views of the administration and outside experts for just that purpose.

However, I do want to take this opportunity to briefly address some of the critiques of expanded debt relief, and I look forward to a fuller exchange on these issues with our witnesses on both panels during the time for questions.

Critique No. 1. Debt relief has already been made available to these nations with "unsustainable debt levels" and we should not squander scarce resources on those nations that are able to manage their debt flows. That is the critique.

Just a little bit of rebuttal here. A recent analysis undertaken for the United Nations Development Programme demonstrated that of the 24 nations that would be made newly eligible for debt relief under the Jubilee Act, 14 of those nations are actually poorer in terms of human poverty levels and carry more debt as a percentage of gross national income than nations already eligible for debt relief under the HIPC initiative. The 24 new nations that would receive debt relief under the Jubilee Act are designated only because they are eligible to receive special assistance from the World Bank on account of their deep poverty levels.

More to the point, nations judged to have "sustainable debt levels" means that those nations have borrowed responsibly and have not been in danger of defaulting on their debt. Yet, these nations, which remain poor and economically struggling, may also be sending valuable payments every year to foreign creditors that can be spent more effectively at home for the benefit of their people. It is a curious approach to cite moral hazard in arguing that nations that have borrowed heavily and irresponsibly should be eligible for debt relief, but not those nations with more responsible debt burdens.

Critique No. 2. Expanded debt relief will only serve to crowd out other valuable development assistance.

Some observers have expressed concern that the resources required to fund expanded debt relief initiatives for as many as 24 new nations will put at risk existing development assistance programs. That is the attack—the critique I should say. In other words, there is a fixed pool for development assistance, and a new debt relief initiative will only take funds away from other good programs.

I do not believe this is a valid concern. Indeed, we in the Congress have been guilty at times of not fully funding the U.S. share of debt forgiveness initiatives approved by the United States. We must commit to ensure that debt relief initiatives are additive to existing programs and provide a real benefit to struggling nations and not simply substitute for other efforts.

That said, continuing debt payments by nations that in turn receive grants and other assistance from the international community is also a form of "robbing Peter to pay Paul." It is strange common sense to send foreign assistance to impoverished nations on the one hand and on the other hand see an exodus of valuable foreign exchange reserves from those very same nations in the form of debt payments.

Critique No. 3. Debt relief by itself is meaningless without accompanying policy reforms.

First of all, let me make clear that I do not believe debt relief alone is a complete panacea for the ills that beset the world's poorest nations. Instead, only when combined with other effective policy instruments can debt relief succeed. Greater transparency and accountability in national budgets, investments in the rule of law, strengthening educational systems, and other measures are often necessary prerequisites if debt relief initiatives are to promote real economic growth and alleviate poverty in developing nations. Debt relief is an important piece of the puzzle, but only one piece of the puzzle.

That is why the Jubilee Act legislation is so promising. It imposes rigorous requirements on recipient states before they are granted complete relief. Those nations eligible for debt relief under the Jubilee Act provisions must allocate all savings from debt cancellation toward poverty-reducing expenditures. Next, they must commit to future borrowing in a responsible fashion. They must develop transparent and effective budget mechanisms and refrain from excessive military expenditures. In other words, these nations must undertake the type of policy initiatives that will help ensure that debt relief proceeds are used in the most effective fashion and are not wasted or diverted to other purposes. This legislation ensures there is no free ride—no free ride—for those governments benefiting from a new debt relief initiative.

Today we are honored to be joined by an illustrious group of witnesses. On our first panel, the Honorable Clay Lowery, the Assistant Secretary for International Affairs at the Department of the Treasury, will testify on behalf of the executive branch. Mr. Lowery will offer the administration's overall perspective on the utility of debt relief initiatives and provide specific views on the provisions of the Jubilee Act.

On our second panel, we will have a group of three nongovernmental witnesses, all of whom have devoted much of their careers to better understanding the role of debt relief in promoting international development. I will make their introductions when we are ready for their testimony in the second panel.

For now, I think we might move to testimony unless and until one of my colleagues shows up. I know that we may have at least several who might want to offer opening remarks or comments. So I think, Mr. Lowery, if we could just skip ahead a little bit and allow you to present your testimony.

Thank you very much.

STATEMENT OF HON. CLAY LOWERY, ASSISTANT SECRETARY FOR INTERNATIONAL AFFAIRS, DEPARTMENT OF THE TREASURY, WASHINGTON, DC

Mr. LOWERY. Thank you, Senator Casey, and thank you very much for the opportunity to discuss the administration's views of international debt relief and the new proposals contained in the Jubilee bill.

I also want to personally thank you for your very thoughtful statement. I think you are right about the critiques and you will hear some of them in my statement. And I thought you made some very good points as to how to take them on.

We are in full agreement that debt relief can be a valuable tool to help the poorest, most heavily indebted countries. It helps them reestablish a sound economic footing and can support their efforts to lift people out of poverty. Debt relief can remove a significant barrier to economic growth when external debt levels become so high that they interfere with the country's basic economic sustainability.

This administration, as you pointed out, as well as the previous administration and the Congress, have been ardent advocates and critical leaders in major international initiatives to maximize the potential of debt relief as a responsible and effective tool of development. In fact, the two major international debt relief initiatives that you mentioned have, over the last 10 years, provided over $100 billion in debt relief to 33 heavily indebted countries. It is slightly different than the number you used mainly because Liberia just became eligible.

Given this track record, it is not surprising that we find many of the goals that you have proposed in your act to be laudable. The administration shares the goals of increasing economic growth, reducing poverty, and obtaining greater financial stability in these poor countries. However, we cannot support this bill, and I will try to make clear by positing three different questions.

First, is this bill sound policy? In countries where debts are sustainable, other development tools should take precedence over debt relief. The aim of the HIPC initiative was to remove unsustainable debt levels for the most heavily indebted poor countries so that these countries could stabilize their economies and focus on growth and poverty reduction. It included requirements for sound economic policies so that debt relief was not simply throwing good money after bad. For countries that are already able to successfully manage and service their debts, sound debt management can help them to transition gradually toward access to private capital markets. In short, debt relief makes the most sense when debt itself is a major barrier to development.

However, of the eight countries that some supporters of this bill have suggested would be immediately eligible, none face a high risk of debt distress. This means that the immediate impact of the bill, if agreed to internationally and if funded by the Congress, would be to forgive the debts of the countries that are able to service their debts, countries for which debt is a minor issue compared to the challenges they face in tackling issues such as promoting growth.

My second question is how will expanded debt relief be financed? Debt relief has a U.S. budgetary cost, just as new development assistance has a U.S. budgetary cost. While it is difficult to estimate, the potential U.S. share of the cost of the Jubilee bill could easily be in the range of $7–$10 billion over time. One could argue that the international financial institutes should finance this type of debt reduction with internal resources. However, as we learned during the financing of the MDRI initiative, it is unlikely that we could garner the necessary support for use of the institutions' resources, meaning the United States would need to be prepared to make a significant contribution.

Moreover, the United States is not meeting its commitments on current debt relief initiatives, and is far behind on financing the multilateral development banks, which are the institutions that finance most of the world's development assistance. When every other country has basically paid all of its bills to the MDBs and the United States is the only country—the only country—with substantial arrears, over $800 million, including almost $400 million to the IDA alone, it leaves our credibility somewhat in question.

Third, and maybe most importantly, is the expansion of debt relief really the right priority? Secretary Paulson and other senior Treasury officials meet regularly with the finance ministers, central bank governors, private sector and civil society leaders from many of these countries. The priority they most often highlight is the need to spur long-term growth and reduce poverty by attracting investment, building core infrastructure, and strengthening their financial sectors. Debt relief is hardly ever mentioned, if at all.

Less than 2 weeks ago, Secretary Paulson had a meeting with officials from six African countries. One minister stressed his priority was for assistance to increase electricity generation, while another was worried about the costs of transportation in his country.

There has been significant success over the last few years in many of these countries in establishing sounder economic policies, achieving greater headline growth, and reducing poverty. What we think that we should be trying to now shine a light on is their attractiveness as investment destinations to help spur greater productivity and greater economic growth.

Mr. Chairman, in our opinion, rather than embark on expanded debt relief, the United States should focus on three things. First, it should fulfill its commitments to current debt relief initiatives and meet our other multilateral commitments. Second, it should continue to provide direct development assistance to poor countries through bilateral and multilateral mechanisms aimed at increasing economic growth and reducing poverty. And third, we need to find ways to work with countries to build their capacity so they can handle more open trade and investment.

Thanks for your consideration of these issues, and I welcome your questions.

[The prepared statement of Mr. Lowery follows:]

PREPARED STATEMENT OF HON. CLAY LOWERY, ASSISTANT SECRETARY FOR INTERNATIONAL AFFAIRS, DEPARTMENT OF THE TREASURY, WASHINGTON, DC

Thank you for the opportunity to discuss the administration's strong leadership on international debt relief and the new proposals contained in the Jubilee bill (S. 2166).

Debt relief can be a valuable tool to help the poorest, most heavily indebted countries. It helps them reestablish a sound economic footing and reengage with the international community, supporting their efforts to lift people out of poverty. Debt relief can remove a significant barrier to economic growth when external debt levels become so high that they interfere with a country's basic economic sustainability. This is something that plagued many poor countries throughout the 1980s and 1990s. Recognizing the need for strong action, this administration has been an ardent advocate of and critical leader in international initiatives to maximize the potential of debt relief as a responsible and effective tool of development. The two major debt relief initiatives that this administration has supported, the Heavily Indebted Poor Country (HIPC) Initiative and the Multilateral Debt Relief Initiative (MDRI), are expected to provide over $110 billion in debt relief to 33 heavily indebted poor countries. Further, we anticipate that seven additional countries could still qualify under these initiatives.

Many of the goals of the proposed Jubilee Act (S. 2166) are laudable. It is clear that all of the countries which are potentially eligible under this bill, the so called "IDA-only countries," face significant development challenges. The administration shares the goal of increasing economic growth and obtaining greater financial stability in these countries. However, we cannot support this bill based on the answers to the following three key questions.

Is this bill sound policy? In countries where debts are sustainable, other development tools should take precedence over debt relief. We believe that debt relief is not the best development tool for the countries targeted in this bill. The aim of the HIPC initiative was to remove unsustainable debt levels for the most heavily indebted poor countries, so that these countries could stabilize their economies and focus on growth and poverty reduction. It included requirements for sound economic policies so that debt relief was not simply "throwing good money after bad." For countries that are already able to successfully manage and service their debts, sound debt management can help them to transition gradually toward access to private capital markets. Furthermore, increased private investment and targeted development assistance are more focused ways to address the challenges these low-income countries face.

How will expanded debt relief be financed? Debt relief has a U.S. budgetary cost, just as new development assistance has a U.S. budgetary cost. We continue to face challenges in financing our commitments to existing debt relief initiatives, including in the multilateral development banks, which is why it is so important that Congress enact the President's full request for these programs. The Jubilee bill represents an unfunded international mandate to fully cancel roughly 75 billion dollars' worth of debts owed by the potentially eligible countries to official bilateral and multilateral creditors. As we learned during the financing of MDRI, it is unlikely that we could garner the necessary international support to finance multilateral debt relief with the internal resources of the international financial institutions (IFIs), meaning the U.S. would need to be prepared to make a significant contribution.

Is expansion of debt relief the right priority? Secretary Paulson and other senior Treasury officials meet regularly with the Finance Ministers, central bank governors, and private sector and civil society leaders from many of these countries. The priority they most often highlight is the need to spur long-term growth and reduce poverty by attracting investment, building core infrastructure, and strengthening their financial sectors. I would welcome closer collaboration with the Congress on ways in which the United States can support these countries' private sector development agendas.

CURRENT DEBT RELIEF EFFORTS

This administration has led international debt relief efforts for the world's most heavily indebted poor countries. Building on the work of the previous administration and with strong congressional support, we have deepened and broadened the Heavily Indebted Poor Countries (HIPC) debt reduction initiative.

In 2005, the administration, with bipartisan congressional support, initiated and negotiated the landmark Multilateral Debt Relief Initiative (MDRI). MDRI provides 100 percent cancellation of eligible debt obligations owed to the World Bank's International Development Association (IDA), the African Development Bank's African Development Fund, and the IMF, for poor, heavily indebted countries that complete the HIPC initiative. We have also continued this work, designing an initiative and leading negotiations in cooperation with Brazil to forgive 100 percent of HIPC debts to the Inter-American Development Bank.

As I mentioned earlier, these debt relief initiatives are expected to provide over $110 billion in debt reduction to 33 countries that have already qualified under the HIPC initiative. Further, we anticipate another seven countries could qualify under these initiatives. These two initiatives continue to provide benefits to countries such as Afghanistan, Liberia, and Haiti. In 2007, Afghanistan became the 31st country to qualify for debt relief under the HIPC initiative. After years of conflict, Liberia is now rejoining the international community. Debt relief for Liberia under HIPC and MDRI, with eventual cancellation of over $4 billion in debts, is an important part of this transition. However, even under these well-established initiatives, the process is not always easy and international support is not always firm. In the case of Liberia—a country whose debts were clearly unsustainable and for which the U.S. provided strong leadership and intense engagement—the international effort to clear its $1.4 billion in arrears to the international financial institutions took over 18 months and almost failed on a number of occasions.

DEBT SUSTAINABILITY

To help ensure that gains from debt relief are not wasted, the administration has worked through the international financial institutions, such as the World Bank and IMF, to put in place an internationally agreed debt sustainability framework to help guide future lending and borrowing. We are also working through the OECD to operationalize that framework with a set of principles and guidelines that commit export credit agencies to follow sustainable lending practices and consider IMF and World Bank recommendations when extending new export credits to low-income countries. This administration also led efforts in the multilateral development banks to increase the level of grants for the poorest countries. In 2001, IDA provided less than 1 percent of its financing for the poorest countries in the form of grants. Today, as a result of U.S.-led efforts, over 40 percent of funds from IDA to these countries are in grants. For instance, the World Bank is providing $82 million in grants to Haiti through the first half of this year. These efforts will help ensure that poor countries will not reaccumulate unsustainable debts in the future.

MISMATCH OF TOOLS AND OBJECTIVES

Debt relief is a valuable tool, but it must be balanced against other policy instruments, such as direct development assistance. It is not always the right response to address a country's development needs. The Jubilee bill (S. 2166) targets a group of countries that face tremendous development challenges. However, debt relief is most appropriate when the debt itself is a barrier to development, as is the case with the countries eligible for the HIPC initiative. This is not the case for the countries targeted in this bill, many of which are experiencing robust growth and reductions in poverty levels. In fact, many of these countries have such manageable debt positions that they are either seeking access to private capital markets—as in the case of Vietnam—or are repaying their debts early—as with Angola and Nigeria.

Of the eight countries that some supporters of the bill have suggested would be immediately eligible, none faces a high risk of debt distress. This means that the immediate impact of the bill, if agreed to internationally and if funded by the U.S. Congress, would be to forgive the debts of countries that are able to service their debts—countries for which debt is a minor issue compared to the challenges they face in tackling issues such as promoting growth. For such countries, targeted development aid and our support for efforts to attract investment are more immediate.

Our experience with HIPC and MDRI has shown that debt relief alone is not enough to address these countries' long-term challenges. For example, Rwanda benefited from $1.8 billion in debt relief under these initiatives, but it is still considered to be at high risk of financial distress. The reason is not that it has borrowed irresponsibly—its debt levels are still low. The reason is that it has a small and vulnerable export base that cannot provide a consistent source of government revenue. The key to supporting a sustainable path for countries such as Rwanda is assistance to directly improve their economic growth potential, not more debt relief.

Countries must also develop and implement effective policy reforms to ensure that savings from debt cancellation—and in fact all development assistance—can be used effectively for poverty reduction efforts. This is why international debt relief initiatives have been conditioned on the adoption of sound macroeconomic policies. Debt relief simply will not have the intended benefits if it is delivered in an environment of macroeconomic instability. Placing blanket restrictions on the types of economic reforms that are appropriate can make it difficult to implement policies tailored to a given country's situation.

POTENTIAL COSTS OF EXPANDED DEBT RELIEF

There is also the issue of cost. Debt relief must be financed, just as development assistance must be financed, and we should not enter into negotiations without a sense of the costs that could be incurred. The budget impact of pursuing the program described in the bill (S. 2166) would be substantial. Expanded debt relief would be a commitment to replace costs over 30 to 40 years, and we need to consider the total, long-term U.S. Government exposure to such an initiative.

The Treasury Department estimates that the budget cost to forgive the nominal debt owed to the United States alone, including loan guarantees, by all of the IDA-only countries that do not currently qualify under the HIPC Initiative would be approximately $1 billion. This cost estimate assumes that all IDA countries qualify in FY 2008 and would change depending on the year each country qualified for debt relief. These countries also owe approximately $32 billion in nominal debt to the World Bank and IMF and roughly $15 billion to the major regional development banks. While the bill is not explicit about whether negotiations on expanded debt relief should include comparable debt relief from other bilateral creditors, I note that the total official bilateral debt owed by potentially eligible countries under this bill is approximately $30 billion.

While the bill calls for international financial institutions to fund debt relief from internal resources to the extent possible, the availability of such resources is very likely to be limited. Our recent experience with funding for debt relief under MDRI is a good example of what we are likely to encounter. We began those negotiations in 2004 with a similar goal of seeking no additional donor resources, while providing increased debt relief to HIPC initiative countries from finances of the international financial institutions. However, there was no international support for this proposal. In the end, donors were required to compensate, dollar for dollar, for MDRI debt relief at the World Bank and African Development Bank. The U.S. is bearing about

20 percent of the costs of MDRI at the World Bank and about 12 percent at the African Development Bank.

It is uncertain, at best, whether other creditor governments would be willing to agree to additional debt relief of this magnitude, particularly if we are unwilling to provide additional funds. If negotiations for expanded debt relief were to follow our experience with MDRI, the U.S. would need to be prepared to make a significant contribution, likely at the expense of other development assistance priorities.

CONTINUED FINANCING NEEDS FOR CURRENT INITIATIVES

The United States is far from making good on its commitments to the current debt reduction initiatives—which seek to help the poorest, most heavily indebted countries. The administration has continued to request, but has still not received, sufficient appropriations to fully fund U.S. bilateral HIPC debt relief to the Democratic Republic of the Congo. The U.S. also has an outstanding pledge of $75 million to the HIPC Trust Fund, which is needed to support HIPC debt relief at the regional development banks. U.S. support for debt relief under MDRI is funded through our contributions to the IDA and African Development Fund replenishments. However, we have consistently received less than our full request for these replenishments. The result is that, in fiscal year 2008, we anticipate the U.S. Government will have over $870 million in arrears to the multilateral development banks, including $385 million to IDA alone. In fact, our arrears request this year is specifically targeted at fulfilling our commitment to MDRI.

TARGETING THE CORRECT PRIORITIES

When we meet with developing countries, debt relief appears to be far down the list of their priorities. Indeed many of these countries see strengthening the environment in which the private sector can flourish and drive economic growth as their primary development challenge. This means improving the business climate, meeting infrastructure needs, integrating into the global economy, and strengthening financial sectors.

To underscore what we at Treasury hear from our counterparts in many low-income countries, let me share with you a recent discussion that Secretary Paulson had with the Finance Ministers from six African countries. One minister noted that his President's top priority was increasing electricity generation. Another spoke eloquently about the costs that poor energy and transport infrastructure impose upon his country's ability to grow and create jobs. And all of the ministers and central bank governors asked Secretary Paulson to work with them to find additional ways to attract foreign investment to their countries. Secretary Paulson wants to find ways to shine a light on this core challenge in these countries. We believe that these issues, rather than debt relief, are the real priorities for spurring growth and poverty reduction in these countries.

CONCLUSION

Rather than embark on expanded debt relief, the United States should focus on three things. First, it should fulfill its commitments to current debt relief initiatives and meet our other multilateral commitments. Second, it should continue to provide direct development assistance to poor countries through bilateral and multilateral mechanisms aimed at increasing economic growth and reducing poverty. Finally, we need to find ways to work with countries to build their capacity to handle more open trade and investment.

Thank you for your consideration of these issues. I look forward to working with you further to support our current debt relief efforts and to develop the best possible policies in this area. I welcome your questions.

Senator CASEY. Thank you very much. I know you will submit your whole statement for the record. I appreciate the summary you gave us.

At this time, my problem is we have a vote that just started. What we will do is we will just adjourn. I will run over and vote. It should not take more than 8 to 10 minutes at the most I hope. So we will come back very shortly.

Thank you.

[Recess.]

Senator CASEY. Well, thank you very much. We are back. I was moving pretty quickly.

First of all, Mr. Assistant Secretary, I wanted to review some of what you just spoke to us about. Could you just recite again what you think the three U.S. priorities should be? There were three. Fulfilling our commitments was the first one. If you can just walk through those again, I wanted to ask you about that in terms of this discussion.

Mr. LOWERY. Well, they were basically, first, to fulfill the commitments that we have already made in, frankly, the bills that we need to pay. Second is to focus our attention on other types of development assistance programs that we have, both bilateral and multilateral ones, to help spur economic growth. And third is basically work with countries to find better ways to build capacity so that they can actually attract more investment and open up greater trade routes.

Senator CASEY. And in terms of our current commitments, give me that number again.

Mr. LOWERY. To the multilateral development banks—the biggest one is the World Bank, but it is also the Inter-American Development Bank, the African Development Bank—the number is roughly—by the end of this year, it will probably be about $870 million. And we also do have some requests in for other debt—part of that goes toward debt relief and part of that goes toward new assistance, new financial flows.

Senator CASEY. One of the arguments that is made in support of this legislation and, obviously, in support of the concept of further debt relief is that the so-called HIPC qualification criteria are unfair to a lot of countries. Would you respond to that?

Mr. LOWERY. When HIPC was begun, which was actually around 1995 or 1996, there had been a number of debt relief initiatives over time that had been tried to try to get rid of this problem, and they frankly had failed. HIPC was a way to expand on that. The idea was to try to actually take the indebtedness of countries and take it down to a level that was considered sustainable by economists and so forth. No one is exactly sure, but it was based on a number of criteria about indebtedness levels. And the idea was that the debt was so high that you could do almost anything, if you were these countries—you could have great economic policies—you will never get out of it because you have this huge debt overhang. So HIPC basically reduced this down to a level which became a much more sustainable level.

The MDRI initiative took it down even further to basically get rid of the debt for good, so to speak, and try to get the countries back on a path where they can get new assistance through grants and they would not get back into this kind of lend-and-forgive cycle. That is kind of what had happened for the HIPCs.

The poor countries that were not HIPCs, which this bill is trying to address, basically had not gotten into these indebtedness problems, maybe from good policies on their part. Maybe nobody wanted to lend to them. I am not sure. But indebtedness is not their problem. That is not creating the overhang for them. What is their problem is they just have other areas that they need to address, and that is where we think that more direct development assistance—if you want to provide them money, give them a grant or work with them on building a better investment capacity.

So a country like Bangladesh, which is a very poor country—the World Bank is going to provide Bangladesh something like $1 billion this year in new financial assistance, some in grants, some in very low concessional debt. But the idea is to give it financial flows so that they can address some of the problems that they have in that country.

Senator CASEY. I am going to speak kind of generally about this and get your reaction. As you look at the legislation as it is currently drafted, is it your position on behalf of the administration that the administration is unalterably opposed to it?

For the sake of argument, let us just say the administration would support a new debt relief initiative. How would you construct it or how would you change what we have or what recommendations would you make? Or is it just the position that you do not think this initiative is worthy of legislation?

Mr. LOWERY. I guess with all due respect, in general we do not think that this is the right way to go. And we have thought about this a lot. Could we make some changes or tweaks or what have you? We think if Congress wants to focus on some of these countries, then let us focus on them and let us look at it through the different types of assistance vehicles that are out there that we could utilize. But the debt relief does not seem, to us, to be the best way to approach it.

There are debt relief issues that we can work on and work with the Congress together that we can get at. Part of it is financing what we have already agreed to, as I have stated, but part of it is also there are ways that we can help with—there are facilities out there to help countries that have indebtedness problems to private creditors instead of to official creditors. There is something called the IDA buy-back program that we could actually get involved in, and I am happy to explain that program.

Basically I think "unalterable" is probably a little bit strong, but I think that our view is that this bill is not the way that we should be going.

Senator CASEY. Now, if you look at—this is playing devil's advocate on my side. Even if you use the World Bank's debt sustainability framework, from what I know, 11 of the 24 potential recipients of this aid under the Jubilee Act would have unsustainable debts even at the World Bank rather limited terms. I do not understand why those countries should not be eligible for some kind of debt cancellation.

Mr. LOWERY. Well, I guess a couple things. One is that we are actually kind of proud of the debt sustainability framework. At the start of this administration, when we started at that time candidate Bush or Governor Bush had supported President Clinton's initiative on doing debt relief for the poorest and most indebted countries. When he came into office, he said we should go beyond even what the Clinton administration did, and we did that through a couple means: One, deepen the debt relief, which we have seen, but also establishing a grants program. If you go back to 2001, the World Bank provided almost none of its assistance—actually it is less than 1 percent of all of its assistance was provided in grants form. Today it is around 40 percent. So that was something that really was a Bush administration lead.

The other thing we did was actually set up the debt sustainability framework. How do you avoid this problem from happening again? We do not want to continue to do this every 10 years. And so the debt sustainability framework is based on basically stress-testing. How do you stress-test an economy so you can see if it is going to get into indebtedness problems?

If you look at the countries that are in the Jubilee bill, they basically, in some respects, have a green light, yellow light, red light system. The red light is like you could have some indebtedness problems. Of the countries that we have seen, if you dismiss the small island nations, there are four countries that are actually heavily indebted: Kyrgyz, Tajikistan, Burma, and Zimbabwe. Our view is look, how indebted are they really? The only one of them in "debt distress" through the debt sustainability is Burma. We are obviously not going to be giving debt relief to Burma, or at least to this government. So is this really what we want to be doing?

So our view is that given the scarce resources that are there, basically we should be doing this through new assistance, making sure that countries do not get into indebtedness problems—that is for debt sustainability—and really working on how do you diversify and work on these economies so that they do not have these problems in the future.

And let me just give one example. I have gone on too long, but let me give one example.

The country of Rwanda actually has gotten debt relief, significant debt relief. It is possible that they are going to get back into indebtedness problems if people are not very careful. It is not because they are taking on a lot more new debt. It is because their economy is so undiversified that their export base is tiny. So they do not have any revenues. So basically they are not going to be able to pay off even the small amount of debt that they do have. So basically debt relief can be helpful, but it is usually helpful when countries have real indebtedness problems.

Senator CASEY. And if you look at this issue from the perspective of the United States, one of your concerns is that we are going to be shouldering too much of the burden.

Mr. LOWERY. It is not that we will be shouldering too much of the burden. I mean, we should shoulder a lot of the burden. We are the wealthiest country in the world. We are the biggest country in the world. And we do shoulder a lot of the burden in the indebtedness issues.

What my worry is that we are not doing it. We have stepped up and put these policies in place, but we are continuing to run arrears and they have grown over a long period of time. So it is not something that is recent. And if we do not address that, we are not going to make good on our commitments in debt relief, let alone on providing development assistance to the poorest.

Senator CASEY. From my point of view, I think that in terms of the concern about countries falling back into a cycle of indebtedness or kind of returning to where they were, I think the provisions of the Jubilee Act try to address that concern by requiring—in terms of basic requirements, we require the country to allocate the savings from debt cancellation toward poverty-reducing expenditures. We require that policy reforms be developed to ensure that the savings from debt cancellation are redirected to poverty reduction initiatives. We also require that an annual report is produced. So I think that a lot of the concerns about a country kind of turning back around in the wrong direction, so to speak, as it pertains to debt, are contemplated.

But what is your sense of that?

Mr. LOWERY. No. I think that those parts of the bill we have general support for. One of the really sound things of the debt relief initiatives has basically been to work on making sure that there is sound economic policy, so a macroeconomic framework, and then that they use the resources largely for poverty reduction programs. And if you look at 2000 to 2006, I think, on the countries that receive debt relief, their poverty reduction expenditures have gone from roughly 6.5 percent of GDP to about 9.5 percent GDP, so about a 3-percent increase. At the same time, debt service has gone from about 4.5 percent of GDP down to a little less than 2 percent of GDP. So it is not 1 for 1, but it has actually been a little bit better than that, which is a good thing. So I think that that part of the bill we basically roughly agree with.

The issue, again, is can you do the same thing by just providing it through a grant as opposed to getting into debt reduction problems for some countries that are actually trying to actually be good payors and be good debtors so that they can get other types of credit. I mean, that is kind of our issue.

But I think that part of the bill is probably a very sound part of the bill.

Senator CASEY. Would it be unfair to say that your—not you, but the administration's—perspective or approach to this challenge would be grow your way out of the problem as opposed to dedicating dollars to debt reduction? Is that an unfair characterization?

Mr. LOWERY. I think that is a little unfair. I think that this administration has stood up not only for debt relief for the countries that are poorest and most indebted, but we have also stood up and put in place good programs to help fight against HIV/AIDS, to help fight against malaria, to help fight against hunger. And actually the Millennium Challenge Corporation, which I know probably the most about, is to help fight for economic growth and development. And those are programs to provide grant assistance to sometimes specific activities and sometimes to help increase economic growth. So we are not against aid as a catalyst. We are saying that debt relief does not necessarily have to be the only catalyst out there. And that is one of our worries about the bill.

Senator CASEY. I would not ask you to walk through all 24 of these countries in terms of our support or help for them. And this is I guess more along the lines of amplifying the written record, which I hope you would do on this question. But tell me what the administration is currently doing as it pertains to these 24 identified countries and tell me also what the administration plans to do. In other words, if you are saying that this particular strategy for debt relief or any kind of support is not the way to go, what do we say to these countries as it pertains to what this administration is doing, or what do we say to the world in terms of why a debt relief initiative does not make sense for these 24 countries? And some of that I know you have to amplify the record.

Mr. LOWERY. Sure. Well, in terms of the countries—by our calculations, from 2001 to 2006, the United States has provided this group of countries nearly $5 billion in official development assistance. Some of that comes from the MCC. Some of that comes from USAID. Just real quick just looking, five of these countries are eligible for MCC and are scheduled to get over $1 billion of new financial assistance.

So it is not that we have anything against these countries. I mean, we want to work with these countries. The MCC is, obviously, about working with the countries that are putting in place the best policies and rewarding them for that. Some of the USAID money goes toward countries because they have big pockets of poverty, big problems of poverty, and so how do you help work with those countries.

So we are not against working with these countries. I mean, in fact, the United States is the biggest supporter of the World Bank. The World Bank is providing these countries—I have a figure here—basically about $4 billion this year to these countries. So it is not that there are not development assistance flows going to them, and the United States is one of the big supporters of those flows.

Senator CASEY. What were the years you cited?

Mr. LOWERY. 2001 to 2006.

Senator CASEY. So you are saying from 2001 to 2006, the United States gave $5 billion to these 24 countries in total and that 5 of the 24 are currently eligible for MCC?

Mr. LOWERY. That is correct. In other words, MCC money really has not started being disbursed. It is just starting now. So that money would not be counted in what we were talking about.

Senator CASEY. I wanted to move to another aspect of this using the United Kingdom as an example. I mentioned this before about Prime Minister Gordon Brown. Prime Minister Brown and his government have, obviously, long supported debt relief. He stated that in 2006 that all 67 of the world's poorest nations should secure debt relief. The U.K. has already begun to deliver debt service relief for the U.K.'s share of the debt payments made by nine qualifying, non-HIPC poor nations in the World Bank.

Here is the question. How does Treasury view the U.K. initiative to expand debt relief beyond HIPC to well-governed countries that need it to meet the U.N. Millennium Development goals? What is your sense of that?

Mr. LOWERY. I do not know a lot about their initiative, but I think that it is just a different way of providing financial flows. I mean, there are two ways you could look at it. One is you could say, OK, we are going to forgive these debts that are coming due to us and so is that in addition or are you going to provide them new financial assistance or what? Because it is just basically just reversing the cash flow effect. You just do not pay. So instead of getting a grant, you basically just do not pay. So that is one way of looking at it, and that is, I think, a good way of looking at it.

A bad way of looking at it is basically they provided that debt relief and now that country pays a different creditor. I mean, one of the reasons you try to do debt relief together is because you are all taking the pain together. Right? You are all the creditors, and everybody takes the pain of not being paid back. But that is so one creditor is not in a better position than another creditor. So that is why you do it together. But it is obviously difficult to do that when countries do not have indebtedness problems.

Senator CASEY. To go back to the U.K. example—and I really may not have the opportunity to fully address it today, but for the purposes of this record, if you can go back and analyze the U.K. strategy on this as it contrasts with the administration's, I think that would help the record.

Mr. LOWERY. OK.

Senator CASEY. Just a couple more because I know we want to keep moving. This relates to conditionality in debt relief.

The current debt relief program requires nations to meet a strict series of economic policy requirements before receiving debt cancellation. Now, everyone agrees that debt cancellation should be provided in ways that ensure that funds released get to the poorest people with full transparency and accountability. But many of the other conditions the IMF and the World Bank insist on attaching to debt relief are more controversial, as you know.

A growing number of analysts, including a recent study by the Center for Global Development, have criticized the IMF in particular for being overly stringent in the requirements that poor countries have low inflation; No. 2, that they pay down domestic debt; No. 3, that they limit public spending, including public sector salaries for doctors and teachers; and finally, that they maintain high currency reserves.

The impact of these policies in several countries meant that countries have been unable to spend aid or debt relief money on poverty reduction. In nations where robust public sector spending is needed to ramp up investments in schools, hospitals, and clinics, these policies are obviously of great concern.

A question about Treasury. Does Treasury have concern about the impact of overly restrictive IMF policies on indebted nations' ability to allocate aid and debt relief for poverty reduction?

Mr. LOWERY. I mean, this is an important question and debate that has been going on for a while I think.

I do not know the Center for Global Development's study. So I cannot comment on that.

I will comment on if they are saying that inflation is a good thing, then they are wrong. Inflation is one of the worst taxes on poor people that there is in the world. I assume they are not saying that, but inflation is a bad problem for poor people because they have no way to address it.

What economic conditionality gets into is a couple different things. One is trying to establish a sound macroeconomic framework, which is basically about putting in place decent monetary policies and good fiscal policies. Now, there are times where the IMF or the countries in question or maybe even the United States sometimes go too far, and they are being too restrictive. But most of the time, I think the idea is establish a good macroeconomic framework. This will help provide the basis for greater economic growth so that you have a sound fiscal position and you are able to spend your money where you need to spend it.

So the IMF is worried about the fiscal envelope, the overall envelope of what you can spend your money on. And the IMF needs to be careful. It cannot get too down in the details and the weeds about where countries should be spending their money. The countries need to make some of those decisions themselves. But the IMF has to be worried about the overall envelope because it has to be financed, and finance will come through a variety of different means for poor countries, usually from a development assistance perspective. So I think that that is what the IMF tries to get at.

So it is probably important to have good economic conditionality and sound macroeconomic frameworks. There are criticisms and I think that the IMF and others that do this need to pay attention to those criticisms. But that does not mean that they are wrong to try to work with countries on those types of frameworks.

Senator CASEY. We are having a philosophical difference here. I am trying to see it from both vantage points.

When you said before that inflation is not good for poor people, I would agree that inflation is not good for anyone, but I do not think debt is either. I just do not see how an initiative that helps almost 25 countries deal with the burden of debt—I just do not understand how the administration does not think that is a good idea. But we have a basic difference I guess.

Mr. LOWERY. Well, let me just say that, first of all, I will respectfully disagree with you on one thing. Debt is not evil. We all have to find ways of financing things, whether it is an individual getting a mortgage or you are in a poor country and you are trying to finance an infrastructure project or what have you. So debt can be a good thing. It is a way of getting finance. Where debt becomes a problem is when countries have bad debt management from a borrower's perspective or people are overlending.

So those are things that we have been trying to address through a variety of means. Besides getting rid of the debt, also let us make sure that countries do put in place good economic policies, they actually have debt management programs. The Treasury Department works in 11 or 12 of these countries basically on debt management capacity-building. We have worked with the export credit agencies to try to basically put guidelines down so that they do not continue to lend riskily, so to speak, or frankly, ridiculously to these countries so that they get back into these indebtedness problems.

But debt itself is not a bad thing. It is just that it has to be handled correctly and managed correctly, and that is why it is very important to have debt management shops in most countries. We have one, obviously, in the United States. Most countries have them. Unfortunately, a lot of them got into trouble and we have tried to get rid of that problem. And I think largely we have gotten rid of that problem.

Senator CASEY. I do not think anyone would make the case that debt is intrinsically evil, but it can lead to other problems.

Let me ask you this. This is more of a comparative question. You may have an example; you may not. If you can summarize one for the record, it would help.

Do you have an example of a poor country with heavy indebtedness, say, in the last decade or maybe more than that? Let us say the last 25 years where kind of both strategies were tried or something close to the strategy you are outlining the administration favors versus the strategy contemplated by the Jubilee Act where a debt relief strategy failed and your approach to it was successful. Do you have any particular examples of that?

Mr. LOWERY. That is a good question, I guess. A lot of the countries that we have focused on over time have shown success, were very well indebted. I guess one country that has been successful and has not gotten any debt relief is a country like Vietnam. I am just looking at the list of countries. Vietnam has basically gotten provided to it new assistance and some capacity-building, but it has never received any debt relief to my knowledge. And it has actually been largely successful at attracting investment and actually growing its economy.

A lot of the countries, the poorest countries—many of them—as I mentioned in my testimony, 33 countries have gotten that debt relief. Some of them have been successful. We see good success with countries like Mozambique, but we also see countries like Côte d'Ivoire which have not been successful. So debt relief, as you stated very clearly, is not a panacea.

So debt relief can be a good tool to work with with some countries. So we are not against debt relief by any stretch of the imagination. What we are saying is, is this the right tool at this time for these countries? And that is where we disagree. We just do not think that that is the case. But overall, we think debt relief can be a very valuable tool.

Senator CASEY. In your experience—you can generalize in doing this, but it is helpful. Tell me how most of these countries end up in the kind of debt we are seeing. I mean, some of them have the antecedents—or the predicate for this debt is you might have a dictator who has total control and does not manage the economy very well, does not manage the government very well, but has no opposition, no accountability. But describe for me the antecedents for the kind of debt we are talking about with regard to these 23 countries or the others we have talked about. I mean, kind of the textbook case.

Mr. LOWERY. Sure. Our view is for these 23 countries, most of them do not indebtedness problems. They actually can pay what they have. They are not actually in high numbers. If you look at most of the numbers, they have 50 percent, 60 percent, or something like that of exports, whereas in the HIPC countries, we were talking about countries that had literally 1,000 percent of exports was their debt stock, 500 percent of exports was their debt stock. We are talking about now countries that have 50 to 100 percent, and the 100-percent ones are the ones that at least somewhat have troubles.

The way that I have noticed it was that there was a lot of lending that was done in the 1970s and the 1980s. Some of it was petrodollar recycling and some of it was the aid agencies had not moved to a grants basis. They were still doing things on a loans basis. The international financial institutions were doing things on a loan basis. So these countries kind of stacked up a lot of debt.

Then so what would happen is basically they said, oh-oh, we cannot handle this, so let us reschedule that debt, not reduce it, reschedule it. Well, basically when you reschedule debt, it is like a snow plow. You are basically just pushing out the debt, and so it grows.

And that kind of happened through the eighties and a little bit into the nineties, and that is when everybody just said this is crazy. We have got to get rid of this. So that is where you saw a series of initiatives over time in the nineties to start getting rid of the debt reduction. And it started really reducing all the bilateral official sector credits down, a lot of export credit agencies and things like that. And that still was not good enough, and that is when HIPC came in and that was to actually get at the multilateral development banks, the IMF, et cetera. So that is kind of how it has worked over time.

But remember, there is a big difference between having huge amounts of debt that is completely unsustainable and then countries that basically just have a little bit of debt that they are dealing with. And that is kind of the difference, we think, between the debt relief initiatives we have seen over the last 10 years and this bill.

Senator CASEY. Thank you very much. We are going to move to our second panel, but I appreciate your testimony.

Mr. LOWERY. Thank you very much, Senator.

Senator CASEY. Thank you.

We will go to our second panel. Our second panel of distinguished witnesses, all of whom have spent a significant portion of their careers working to better understand the proper role of debt relief in helping the world's poorest nations reach their development goals. As will become quickly evident, our witnesses hold divergent perspectives on the value of debt relief, and so I look forward to a robust and healthy debate.

I am also interested in your specific views on the Jubilee Act legislation which is before the Senate, your recommendations on how we can improve this bill, and anything else you think is relevant to this discussion.

I will introduce all of our witnesses at one time, and then we will go back for testimony. First of all, Dr. Nancy Birdsall is president of the Center for Global Development, an organization she helped found at the beginning of this decade. She has previously held senior positions at the Inter-American Development Bank, the World Bank, and the Carnegie Endowment. Dr. Birdsall is considered one of the world's leading experts on debt relief and we are honored to have you here with us today, Doctor. Thank you.

Next, Mr. Gerald Flood is the counselor for the Office of International Justice and Peace for the United States Conference of Catholic Bishops. Mr. Flood previously served with the World Bank and has played an instrumental role in helping move forward the goals of the Jubilee debt relief movement, and we appreciate your presence here today, sir. Thank you.

And finally, Dr. Peter Henry is a distinguished professor of international economics at Stanford University's Graduate School of Business. Dr. Henry, a former Rhodes scholar—I guess you are always a Rhodes scholar. [Laughter.]

Has done extensive academic research on debt relief and its connection to economic growth and development. And we look forward to hearing your views on this topic this afternoon.

For the interest of time and for a real dialogue with our witnesses, I would ask each of you to limit your oral statement to 5 minutes each. The remainder of your prepared statements will be formally entered into the record.

So we will begin with you, Dr. Birdsall. Thank you very much.

STATEMENT OF DR. NANCY BIRDSALL, PRESIDENT, CENTER FOR GLOBAL DEVELOPMENT, WASHINGTON, DC

Dr. BIRDSALL. Thank you very much, Senator Casey. It is a privilege to have this opportunity.

I would like to make four points, and these points are set out in the written testimony.

First, debt relief is a highly efficient form of aid and has clearly helped foster social progress and economic growth in low-income countries. I think we have heard a lot about the latter point already today, that debt relief is associated with an increase in health and education spending as a percentage of GDP. So that increased spending cannot be associated solely with growth, although we cannot be sure it was debt relief per se.

But more important in my view are two points. One is that debt relief also seems to be associated with an easing of the macroeconomic constraints that in the past pushed countries into difficulties in terms of their fiscal spending and so on. And it is that macroeconomic management that is better that can be attributed in part to the recent growth, especially in Africa.

And even more important than that, why I think debt relief is a good thing to do in general is that it is the most efficient form of aid. And I would like to emphasize this point, that for poor countries that are capable of national planning and sound management, the direct support provided by debt relief offers a cheaper, quicker, and more effective alternative to traditional aid, including traditional aid from the U.S. Government which, as is the case with many donors, requires endless negotiations, requires implementing hundreds of different projects and programs, and has very high transactions costs for countries that are already managing their economies reasonably well.

The second point I would like to make you have already made yourself, Senator Casey. Debt relief is not a panacea. It does not in itself generate growth or guarantee an escape from poverty. There is no question that the fundamental issue in these countries has to do with their own political and economic institutions. And debt relief, even the latest round which, of course, extended the initial rounds of HIPC in the mid-1990s, is still small and is no substitute for traditional aid.

I have an example in the written testimony that struck me in the case of the 15 African HIPCs that benefited from the MDRI. For the World Bank, that saved them, as a group, $19 million in debt service in 2004–05. That same year, they received almost $200 million in new aid or new grants from the World Bank and nearly $1 billion in total aid. So if we are talking about the relative value in dollar terms of debt relief, it has been and it will continue to be small.

Third, the Jubilee Act under consideration, despite its merits, raises several concerns, and let me mention three very quickly. Some of them were raised in the testimony of Secretary Lowery.

First, some countries that might be eligible are making good efforts through prudent borrowing and debt management to obtain access to private capital markets at home and abroad. This legislation, were it to become policy, might tempt them because of political pressure at home to opt in. There are, of course, a few countries like Bangladesh and Vietnam which would almost certainly not opt in, but there are others, including Mongolia, where this sort of approach does not strike me as the ideal way to help.

A second concern is that raised particularly by Secretary Lowery that the legislation—well, let me put it a different way in terms of the problem of arrears. My view is that the legislation risks further undermining already weakened U.S. credibility with its traditional allies in the donor community. Why is that? It assumes and calls for internal financing of new debt relief obligations by the World Bank or through the World Bank and the other multilateral banks that are owned in common with our allies, other nations in Europe. And this it does at a time when the United States, as the Secretary pointed out, has not fulfilled its own commitments to those institutions. So you discussed with him some of the problem of arrears. What I would like to emphasize here is that it seems inappropriate for the United States at this point in time to be calling on our allies to join with us in reducing debt when we have not finished dealing with our own commitments to the institutions through which we are trying to do more debt relief.

My third concern has to do with the point that you raised yourself, and I think you pointed out some of the counterarguments. But the bottom line is that in the case of the World Bank and the other banks, debt relief could end up robbing Peter to pay Paul, to use the expression you did. That is, financing debt relief for some poor countries on the backs of other poor countries.

This is also a problem in the World Bank and the others because it may end up financing debt relief against the wishes of middle-income countries who are also members of those institutions who will object because of their view, which is reasonable, that the additional costs, if they are not covered by contributions from the United States and the Europeans and so on, will end up, because of the financial policies of the banks, leading to higher interest charges on their loans from the hard window. So this is a political problem in terms of our maintaining relations, being a credible member of these institutions, maintaining our good relations with countries like China, India, Brazil, Turkey, and so on who borrow from those banks.

So I want to make quickly a fourth point. I am afraid I may have used my 5 minutes, but I would urge you——

Senator CASEY. You are OK.

Dr. BIRDSALL [continuing]. And your committee to consider a better Jubilee bill that would help poor countries minimize debt in the medium term and help them better manage debt.

The first thing I would say in this regard is the bill could call on the U.S. Treasury to work with the World Bank on improving and making more transparent the debt sustainability framework. It is correct that that framework is something for the United States to take pride in in terms of its leadership in moving it along, but it is still extremely opaque.

And one step that would simplify matters is to simply say for very poor countries that clearly have not grown over several decades in any significant way because their per capita income is still very low, just give them grants in the future from now on, and that will help address the problem otherwise of a buildup in debt.

Second, the legislation could encourage the Treasury to work with its counterparts in the World Bank and the International Monetary Fund to develop a facility to help poor countries cope with shocks to their economies. We see right now the cost to oil importing and food importing countries associated with the sudden price hikes in food in the secular movement upward in the oil price.

These countries also tend to be extremely vulnerable to natural disasters. A mechanism to help them cope with that kind of volatility in the debt area would be to have a facility that covered their debt service, their cash flow problem in the aftermath of these disasters for at least limited periods of time. This would make it possible for countries, which are borrowing in a prudent way and which should be able to borrow in order to make investments in order to grow, given that they are well-managed economies, this would make it possible for them at the margin to borrow a little bit more a little bit more reasonably without the risk of falling into the debt trap that we see happened in the past for many countries.

Third, I would suggest that the bill might be set up to clarify that the United States could unilaterally write off the U.S. bilateral debt of eligible IDA countries, or such a provision should be triggered only when the United States has fulfilled its existing international commitments.

Let me conclude by urging the committee and the Congress in general to help translate what is this, I think, great interest of the public, the energy and passion of the public in this country, that supports debt relief—let that be channeled into more ambitious legislation and not only for debt relief itself, but for a complete overhaul of the U.S. foreign assistance and development programs along the lines that were outlined by my colleague, Steve Radelet, yesterday in testimony before the House Foreign Affairs Committee.

Thank you very much, Senator Casey.

[The prepared statement of Dr. Birdsall follows:]

PREPARED STATEMENT OF DR. NANCY BIRDSALL, PRESIDENT, CENTER FOR GLOBAL DEVELOPMENT, WASHINGTON, DC

INTRODUCTION

Senator Casey, Senator Lugar, and distinguished members of the committee, I am delighted to have the opportunity to share with you my perspectives on international debt relief initiatives.

As many of you know, the Center for Global Development was founded in 2001 as an independent, nonpartisan think tank dedicated to improving the policies of the rich countries as they relate to the world's poor countries and poorest people. What you may not know is that it was a film growing out of the Jubilee debt movement, which portrayed the burden of debt in the world's poorest countries, that inspired my cofounder and the Center's principal benefactor, Edward W. Scott, Jr., that the rich world could do better for the poor—including through better U.S. debt and aid policy. One result is that U.S. debt policy has been a core issue for CGD since its inception.[1]

I would like to make four points.

First: Debt relief is a highly efficient form of aid and has clearly helped foster social progress and economic growth in low-income countries

The U.S. and other donor countries have supported debt relief for low-income countries because lower debt burdens create fiscal space to raise spending on social programs and public infrastructure, improving lives while investing in long-term sustainable growth.

Debt relief, moreover, is a hyperefficient way to deliver aid. For poor countries that are reasonably capable of national planning and sound economic management, the direct support provided by debt relief offers a cheaper, quicker, and more effective alternative to traditional aid, which in many poor countries requires negotiating and implementing hundreds of different projects and programs with 50-plus donors, each with its own standards and reporting requirements. Debt relief encourages poor country ownership of development strategies and makes poor country governments directly accountable to citizens for their budget priorities and program implementation, instead of to international creditors.[2]

The results of past debt relief have been encouraging. Resources freed up from annual debt payments in the group of heavily indebted poor countries, or HIPCs, are associated with substantial increases in recipient governments' own spending on health, education, water, roads and other public infrastructure.[3] Also noteworthy though less remarked, the increased fiscal space due to debt relief (along with recent faster growth and recent stability in HIPC countries) has clearly played a role in helping low-income countries sustain sound macroeconomic programs, by permitting reductions in fiscal deficits and accumulation in some cases of reserves.[4] It is the resulting price stability and investor confidence that underline recent growth of more than 5 percent in many countries, including in sub-Saharan African countries that have benefited from debt relief programs.

Second: Debt relief itself is not a panacea

Debt relief alone does not generate growth or guarantee an escape from poverty.[5] Debt relief and aid can help support countries struggling to develop their own more accountable political and economic institutions—but it is those institutions and a country's own policies that ultimately matter for generating sustained private sector-driven growth and shared development.

Nor has, or should, debt relief be considered a substitute for traditional aid programs. New aid has and will continue to be the main vehicle for assistance. In 2004, for example, under the Multilateral Debt Relief Initiative, 15 African HIPCs paid on average $19 million in debt service to the World Bank. That same year, they received $197 million in new World Bank aid and nearly $1 billion in total aid.[6]

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[1] CGD's first book, "Delivering on Debt Relief: From IMF Gold to a New Aid Architecture" by president Nancy Birdsall and John Williamson, a senior fellow at the International Institute for International Economics, helped to frame the discussions on the future of the Heavily Indebted Poor Countries Initiative and how it is financed (see http://www.cgdev.org/content/publications/detail/2922/). The Center's work played a catalytic role in the historic debt relief deal between Nigeria and the Paris Club of creditors in October 2005, resulting in Africa's biggest ever debt reduction.

[2] See Nancy Birdsall and Brian Deese, "Delivering on Debt Relief," Center for Global Development, April 2002, available at http://www.cgdev.org/content/publications/detail/2862/.

[3] See "Highly Indebted Poor Countries (HIPC) Initiative and Multilateral Debt Relief Initiative (MDRI)—Status of Implementation," prepared by International Development Association and International Monetary Fund staff, September 2007, available at http://siteresources.worldbank.org/INTDEBTDEPT/ProgressReports/21656521/HIPCProgressReport20070927.pdf.

[4] Reductions in debt service from 10 to 5 percent of GDP have been associated with increases in public investments by as much as 1 percent of GDP (see Benedict Clements, Rina Bhattacharya, and Toan Nguyen, "External Debt, Public Investment and Growth in Low-Income Countries," IMF Working Paper 03/249, 2003).

[5] See Todd Moss, "Will Debt Relief Make a Difference? Impact and Expectations of the Multilateral Debt Relief Initiative," Center for Global Development Working Paper Number 88, May 2006, available at http://www.cgdev.org/content/publications/detail/7912/.

[6] See Todd Moss, "Will Debt Relief Make a Difference? Impact and Expectations of the Multilateral Debt Relief Initiative," Center for Global Development Working Paper Number 88, May 2006, available at http://www.cgdev.org/content/publications/detail/7912/.

Third: The Jubilee Act under consideration, despite its merits, raises several concerns

The latest Jubilee Act for Expanded Debt Relief and Responsible Lending has good language and the right overall intent regarding odious debt, vulture funds, and prudent post-debt relief lending. However, I have several concerns about the latest legislation.

First, some countries who might be eligible are making good efforts through prudent borrowing and debt management to obtain access to private capital markets at home and abroad. Were this legislation to become policy at the international level as it is now structured, it could create political pressure within those countries to opt in against their own long-term interests. Bangladesh and Vietnam would almost certainly not opt in anyway, for this reason. Mongolia and other countries in the future might. I am not confident this kind of "help" is ideal.

Second, the legislation risks further undermining already weakened U.S. credibility with its traditional allies in the donor community. It assumes and calls for internal financing of new debt relief obligations by the multilateral banks that are owned in common with other nations at a time when the U.S. has not fulfilled its own commitments on existing debt relief programs and to the multilateral development banks themselves. (As committee members will know, the FY08 budget cuts slashed our current debt relief obligations from $200 million to $30 million to offset other accounts, and the U.S. still has close to $1 billion in outstanding arrears to the World Bank and other multilateral development banks ($385 million to the International Development Association of the World Bank and a total of $872 million to the multilateral development banks).

Finally, the current language in the bill, because it relies on internal financing by the World Bank and multilateral development banks of any new debt writeoffs, appears and could end up robbing Peter to pay Paul—that is financing debt relief for some poor countries on the backs of other poor and relatively poor countries. As in the case of the Inter-American Development Bank (IDB) financing of the Multilateral Debt Relief Initiative (MDRI), it may ultimately be other low-income countries that indirectly pay the cost in the form of reduced overall availability of concessional money. In the case of the multilateral banks in general, their internal financing without compensating contributions from the U.S. and other donors may mean that ultimately all developing country borrowers pay somewhat higher interest charges on standard loans to ensure prudential standards (which are admittedly highly conservative) are met.

Fourth: Consider a better Jubilee bill to help poor countries minimize and better manage debt

I urge the committee to continue to improve this legislation, with an eye to moving it forward only when the Congress has passed appropriations to fulfill the current arrears noted above. How might the bill be improved?

First, the bill could call on the U.S. Treasury to work with the World Bank and the other multilateral development banks on development and application of a simplified and more transparent approach to judging the ability of poor countries to borrow in the future (the "debt sustainability framework"). For example, countries with per capita income of as little as $500 have clearly not managed sustained past growth for one reason or another. It would make sense to provide only grants, not loans, to these countries.[7]

Second, the legislation could encourage the U.S. Treasury to work with its counterparts in the World Bank and International Monetary Fund to develop a facility, possibly at the IMF, that would provide temporary financing to relieve debt service burdens in the case of shocks to low-income countries' economies beyond their own control.[8] Low-income countries face much higher risks of costly natural disasters and terms of trade and other shocks (recent price hikes for oil and food may be examples that apply to oil and food importers, though there is a question of whether the price increases are temporary or more permanent) than does the U.S. and other OECD countries.[9] Such an insurance approach would help allow low-income countries with good growth prospects to borrow reasonable amounts on reasonable terms, while minimizing the risk of a new round of debt relief in the future due not to their

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[7] See Nancy Birdsall, Devesh Kapur et al., "The Hardest Job in the World: Five Crucial Tasks for the New President of the World Bank," Center for Global Development, June 2005, available at http://www.cgdev.org/content/publications/detail/2868.

[8] See Nancy Birdsall and Brian Deese, "Delivering on Debt Relief," Center for Global Development, April 2002, available at http://www.cgdev.org/content/publications/detail/2862/.

[9] See Table 1: Volatility of GDP, by region, and Table 2: Terms of trade volatility and shock frequency, 1975–2005 for data on the heightened vulnerability of low-income countries to trade volatility and shock frequency (tables attached at end of document).

own poor risk management but bad luck. If structured carefully, it would also contribute to the kind of confidence in the stability of poor countries that is vitally important to private sector development and growth.

Third, the bill could allow for the U.S. to unilaterally write off the U.S. bilateral debt of eligible IDA countries; such a provision could be triggered once the U.S. has fulfilled its existing international commitments.

With these modifications, a Jubilee bill would be a mechanism to effectively channel the strong public support for debt relief into demand for a better structured, overall approach to debt relief and related initiatives that the U.S. and other donors could take to help low-income countries.

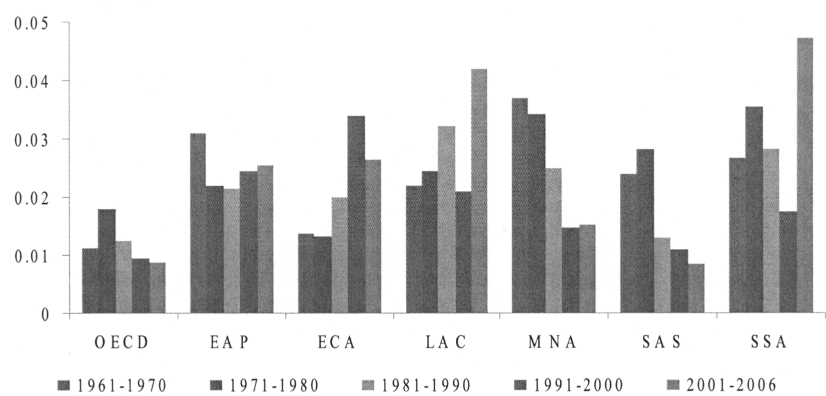
CONCLUSION

I am delighted to see the commitment of the U.S. Congress to debt relief and the robust support from American religious leaders and other advocates. I support debt relief from the U.S. in principle for good performing countries as an efficient and effective mechanism for helping countries create the fiscal space to increase spending on social programs and other investments necessary to improve lives and create long-term sustainable growth.

However, I hesitate to endorse this bill as currently structured, and indeed any bill for new debt relief, until the existing arrears on U.S. commitments to debt relief and the international institutions have been fully funded.

Finally, I urge the committee and other Members of Congress to help translate the public interest and support for debt relief into more ambitious legislation—not just for debt relief itself but for a complete overhaul of U.S. foreign assistance and development programs—along the lines outlined by my colleague, Steve Radelet, in testimony before the House Foreign Affairs Committee yesterday.[10] I hope that the next administration, together with the Congress, will find a way to reflect Americans' growing commitment to better lives in poor countries not only in debt relief programs, which are reaching their limits in any case, but via a broader set of development-friendly policies consistent with our national values and our interest in global as well as American security and prosperity.

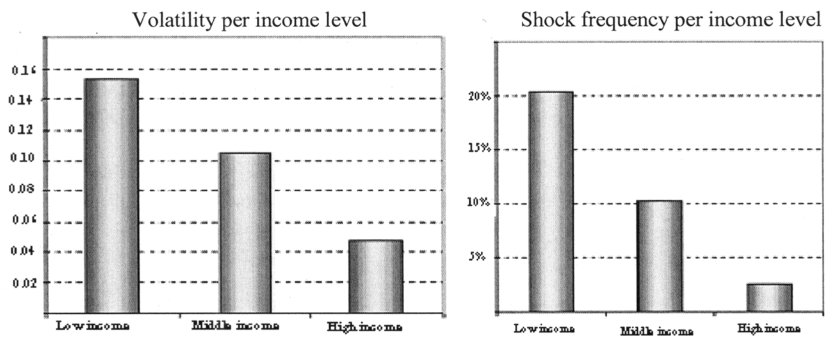
Table 1: Volatility of GDP, by region



Source: Guillermo Perry, Center for Global Development, calculations based on WDI and IFS data (April 2008).

[10] See Steve Radelet, "Seizing the Moment for Modernizing U.S. Foreign Assistance Reforms: Testimony for the House Committee on Foreign Affairs," Center for Global Development, April 23, 2008, available at http://www.cgdev.org/content/opinion/detail/15863/.

Table 2: Terms of trade volatility and shock frequency, 1975-2005



Source: C. Calderón, World Bank (2007).

Senator CASEY. Thank you very much.
Mr. Flood.

STATEMENT OF GERALD F. FLOOD, COUNSELOR, OFFICE OF INTERNATIONAL JUSTICE AND PEACE, UNITED STATES CONFERENCE OF CATHOLIC BISHOPS, WASHINGTON, DC

Mr. FLOOD. Thank you very much, Senator Casey, and I appreciate the opportunity to testify here today.

Debt relief for poor countries has been a high priority for the United States Conference of Catholic Bishops for a very long time. It was inspired by those very words which you quoted earlier from Pope John Paul II, and some of us have been at it ever since.

Just to, at the beginning, say that I will be focusing on a few issues at a level of technical detail that the bishops would not normally get into. Therefore, I am testifying primarily on the basis of my experience as a former World Bank official and somebody who has worked on these issues for a number of years at the Bishops' Conference.

I would first like to thank you for introducing this important legislation and to Senators Biden and Lugar and other members of the committee for the strong leadership that they have provided over the years in support of debt relief for poor countries.

Although I believe Mr. Lowery has left, I still would like to have the opportunity to express our appreciation for the very effective efforts of the Bush administration, particularly the Treasury Department, which worked with other countries to bring about the Multilateral Debt Relief Initiative. They subsequently worked hard to extend it to debt owed to the Inter-American Development Bank, and they also introduced the possibility of many poor countries gaining access to grant financing from the International Development Association.

You have already mentioned some of the achievements of the debt relief program so far in terms of debt stock and debt service relief. So I am going to go quickly to one or two issues that I wanted to focus on.

Now, you, or at least some of the members of the committee, might wonder why debt cancellation is necessary when so much debt relief is already being provided under HIPC and the more recent MDRI. The problem is that there is a substantial number of poor countries that are not eligible for the HIPC program, let alone the MDRI. The disparity of treatment between the HIPC countries and the non-HIPC countries became clear a few years ago when the World Bank and the IMF conducted an examination of debt sustainability in the poorest countries, the so-called IDA-only countries. The primary objective of the exercise was to determine which countries should receive their future IDA financing either wholly or partially in the form of grants.

The conclusion was that 42 countries were at sufficiently high risk of debt distress to be eligible for grant financing. The list included 29 countries plus 18 other countries. This meant that there were 18 non-HIPC countries rated as having a risk of debt distress equal to or greater than the HIPC countries. Like the HIPCs, they would get grants going forward, but unlike the HIPCs, they would get no debt relief.

Since there is a 10-year grace period on the repayment of IDA credits, the non-HIPCs would begin receiving the financial benefit of grants rather than loans only after 10 years. In the meantime, they would carry the full burden of existing debts and be unable to free up resources badly needed to move toward achieving human development and the Millennium Development goals.

When the results of the debt sustainability analysis became available, some of us argued that the HIPC and MDRI programs should be expanded to include all countries qualifying for grant financing. S. 2166, we are happy to note, would address this concern by making IDA-only status the standard of eligibility for debt cancellation. This standard would make potentially eligible all non-HIPC countries that qualify for IDA grants. It would also make eligible six large- or medium-sized countries that are not considered by the IMF and World Bank to be at high risk of debt distress.

The rationale for including the grant-eligible countries is in my view quite strong. Whether or not one agrees with the World Bank's definition of sustainable debt, the rationale for including the additional six countries is also strong for several reasons.

First and most important, the IDA-only standard means that all potential beneficiaries are among the poorest countries in the world and need to maximize their resources for promoting development and poverty reduction. And as Ms. Birdsall said—I have known her so long, I have a hard time calling her Ms. Birdsall, but I will continue to do so for the purposes of this hearing—it is a very efficient form of foreign assistance and something that these countries could badly use.

Second, the IDA-only standard will assure equity of treatment among all the poorest countries. The IMF addressed this point in an issues paper prepared a few months before the MDRI was approved. The IMF said, "Regarding country coverage, all low-income countries could potentially be made eligible. Earmarking debt relief to HIPCs only is difficult to justify because the HIPC initiative will have already sharply reduced previous cross-country differences in debt indicators." So they were, in effect, saying that a lot of the non-HIPCs were in similar situations to the HIPC countries, and it did not make sense, at least from an equity standpoint, to make this distinction.

Third, making all IDA-only countries potentially eligible addresses concerns about redistribution of aid, that is, that an aid donor will finance the cost of giving debt cancellation to poor country A by reducing the amount of aid it grants to poor country B. Making all of the poorest countries eligible for debt cancellation obviates this problem.

Fourth, there is a point made by Ms. Birdsall and John Williamson in their book, "Delivering on Debt Relief," where they said, "The danger of giving complete debt relief to a limited group of countries is that the countries that built up the deepest debt problems in the past are likely to include the countries that were most prone to waste external resources. We therefore believe that there is a strong case for making virtually all low-income countries eligible for inclusion in the HIPC initiative."

The last point reminds me of the statement made by Lesotho Finance Minister, Timothy Thahane, upon learning of the MDRI debt cancellation agreement. He told Reuters that one of the reasons Lesotho was not classified as a HIPC country was that it had never defaulted on its debt. "It is important," he said, "that those who have paid their debts well, who run their mega-finances well, should be rewarded with debt forgiveness."

I was going to touch on some additional issues related to additionality and arrearages, and perhaps there will be time to do so during discussion.

But let me just conclude by making one point. It will be very difficult for the United States to reach any kind of final agreement on a financing framework for new debt cancellation if it is not meeting existing commitments. Therefore, I very much support the inclusion in S. 2166 of the kind of sense of Congress provision included in the companion House bill that calls for the United States to pay off the outstanding arrearages to IDA and the regional banks. This is something that needs to be done quickly so that this initiative can move forward fully.

And finally, I would like to join the chorus of those who say that debt relief is not a panacea. It is not at all. The problem of the poor countries is too big. It is too complicated. It is too deep-seated for debt relief to be considered as such. All the debts of all the poor countries could be canceled tomorrow and it would not end poverty. There is just a huge, big additional agenda out there that has to be met.

[The prepared statement of Mr. Flood follows:]

PREPARED STATEMENT OF GERALD F. FLOOD, COUNSELOR, OFFICE OF INTERNATIONAL JUSTICE AND PEACE, UNITED STATES CONFERENCE OF CATHOLIC BISHOPS, WASHINGTON, DC

Mr. Chairman, members of the committee, I would like to thank the Committee on Foreign Relations for the opportunity to testify here today. Debt relief for poor countries has been a high priority for the United States Catholic Bishops Conference (USCCB) for many years.

In my testimony I will be focusing on a number of issues at a level of technical detail which the bishops would not normally address, and on which they, therefore, would not have a position. Thus I offer my testimony primarily as a former development agency official who has worked on debt and related issues with both the World

Bank and the United States Catholic Bishops' Conference (USCCB) over quite a few years.

ROLE OF USCCB

But first let me briefly mention the active role which the United States Catholic Bishops Conference has played in poor country debt relief. The bishops have issued two major statements on the issue, the first as far back as 1989 and an updated version in 1999. In the mid-1990s the USCCB intensified its work on debt, inspired particularly by the words of the late, revered Pope John Paul II in his message on the coming Millennium. He recalled the biblical tradition of the Jubilee Year. It was a time to restore social justice and equity between peoples, to give a fresh start to the poor. He called on all Christians, in the spirit of the Book of Leviticus, "to raise their voice on behalf of all the poor of the world, proposing the jubilee as an appropriate time to give thought, among other things, to reducing substantially, if not canceling outright, the international debt which seriously threatens the future of many nations."

The USCCB and its relief and development agency, Catholic Relief Services (CRS), played an active role, along with many other U.S. faith-based organizations, in the worldwide Jubilee 2000 campaign. Senators Biden and Lugar and quite a few other Senators provided strong bipartisan leadership and support in urging the U.S. administration to respond to the call of many poor countries around the world for relief from the heavy burden of international debt.

For the USCCB and CRS, support for poor country debt relief is part of a broader agenda that arises out of a conviction that the moral measure of our efforts is how we respond to "the least among us" (Mt. 25), both at home and abroad, and whether we seek justice for all. While debt relief and investments in development more generally are, for USCCB and CRS, primarily matters of moral responsibility, we believe that they contribute to a safer and more peaceful world and thus, in an important way, to the peace and security of the United States.

THE ENHANCED HIPC INITIATIVE

The Jubilee 2000 campaign led, in the latter part of 1999, to the adoption by the major creditor nations and international financial institutions of a new debt relief program called the Enhanced Heavily-Indebted Poor Countries (HIPC) Initiative. It represented a major advance over the original HIPC program, promising much more debt relief, more rapidly, to many more countries. Also, the Enhanced HIPC program incorporated a new framework for the provision of debt relief and other external assistance to HIPC countries. This new approach, called the Poverty Reduction Strategy Process (PRSP), contained elements that Catholic Relief Services, the bishops conference and many other nongovernmental organizations had long advocated. The PRSP was intended to strengthen the poverty focus of development programs and to promote country ownership, transparency and civil society participation in their design and implementation. A major objective of these provisions, from our perspective, was to ensure participation of groups who could give voice to the needs of the poor, and who could help assure that the benefits of debt relief would reach the poor.

HIPC DEBT RELIEF WAS UNEVEN AND NOT DEEP ENOUGH TO GIVE A "FRESH START" TO POOR COUNTRIES

As implementation of the enhanced HIPC program progressed, some of us noted that while substantial debt reduction was being committed to about two dozen very poor countries, the amount of relief was uneven across these countries. Under the HIPC formula, the amount of the relief is determined, in most cases, by what is needed to bring the ratio of debt to exports down to a certain level. To us, what was most important, however, was the relation between debt service and government revenues. We wanted to know how much government revenue would be freed up for expenditures in education, health, clean water, rural roads and other investments that would create opportunities for the millions living on less than $2 a day to break out of the cycle of poverty and begin to achieve their human potential.

Unfortunately, what we found was a wide variance in the amount of debt service reduction being granted. For one or two countries, the debt service obligation was being brought down to around 5 percent of government revenues. For most of the remaining countries, however, this ratio was substantially higher and in several cases remained above 20 percent. This was disappointing news as, for us, what was important was to achieve the Jubilee objective of debt relief deep enough to give a "fresh start" to the poor. Moreover, the results seemed inconsistent with the communiqué issued by the G–8 leaders at the 1999 summit in Cologne, Germany.

In announcing the new program, they succinctly stated: "The central objective of this initiative is to provide a greater focus on poverty reduction by releasing resources for investment in health, education, and social needs."

Subsequently, with Senator Biden and other members of this committee taking a lead role, the Congress incorporated into the Global Health Act of 2003 major new provisions that authorized and encouraged the administration to work to strengthen the HIPC program by tying the amount of the debt relief to the ratio between debt service to revenues and bringing that ratio down to a low level. Unfortunately, the administration did not implement these provisions.

THE MDRI

By 2004, there was a growing consensus among the United States, the United Kingdom and other major creditor nations that the HIPC program was not providing debt relief deep enough to assure that HIPC countries would not soon return to a situation of "unsustainable external debt." The U.S. Treasury referred to a never-ending "lend and forgive" cycle whereby institutions such as IDA would make loans to poor countries and then have to make new loans so that the country would have enough funds to repay the previous loans. These concerns led to the adoption by the international community in 2005 of a new Multilateral Debt Relief Initiative (MDRI).

The essence of the MDRI is to provide qualifying HIPC countries with full cancellation of debts owed to the World Bank's International Development Association (IDA), the International Monetary Fund (IMF) and the African Development Fund (AFDF). The cancellation occurs once a country has reached its "completion point" under the HIPC program, that is, that it has fulfilled conditions related to economic management and progress under the country's poverty reduction strategy. So far 23 countries have received MDRI debt cancellation, with another 17 countries potentially able to benefit from it.

A notable omission from the MDRI agreement was the substantial debt owed by the five lowest income Latin American and Caribbean countries to the Inter-American Development Bank (IDB). This omission was rectified in 2007 when the IDB agreed to give MDRI treatment to its HIPC borrowers. Since four of these countries had reached their HIPC completion points, they received immediate debt cancellation. The fifth country, Haiti, is expected to reach its completion point this year, hopefully within the next few months. Together with earlier agreements to cancel most bilateral debts, including 100 percent of debts owed to the United States, these new agreements are providing the kind of deep debt relief the Catholic Church has advocated for poor countries.

We were particularly pleased with the leadership of the Bush administration in bringing about the MDRI and in encouraging the IDB to give similar debt cancellation to the Latin American and Caribbean HIPC countries.

WHAT HAVE DEBT RELIEF PROGRAMS ACCOMPLISHED?

Twenty-three countries have reached the completion point, and thus have benefited from 100 percent cancellation of qualifying debts. These include Benin, Bolivia, Burkina Faso, Cameroon, Ethiopia, Gambia, Ghana, Guyana, Honduras, Madagascar, Malawi, Mali, Mauritania, Mozambique, Nicaragua, Niger, Rwanda, Sao Tome and Principe, Senegal, Sierra Leone, Tanzania, Uganda, and Zambia. An additional 10 HIPC countries have reached their "decision point," which has enabled them to begin receiving debt service relief. These countries are Afghanistan, Burundi, the Central African Republic, Chad, the Democratic Republic of the Congo, the Republic of Congo, Guinea, Guinea-Bissau, Haiti, and Liberia. Seven more countries remain potentially eligible for HIPC and MDRI relief: Comoros, Côte d'Ivoire, Eritrea, Nepal, Somalia, Sudan, and Togo.

How much debt has been cancelled to date? According to the most recent updates from the IMF and World Bank, debt relief under the HIPC Initiative and the MDRI has reduced the debt stock of the 23 completion point HIPCs by a total of over $70 billion, in net present-value terms, and when the additional 10 post-decision point countries reach their completion point, which is expected over the next 2 years, the total debt stock reduction should reach approximately $100 billion (NPV).

In 2007, annual debt service savings from the MDRI for the 22 post-completion point counties were expected to be $1.3 billion, equivalent on average to 1 percent of these countries' GDP. And we are talking about savings on long-term debt, which means that similar amounts of savings will be realized every year for many years into the future. Moreover, the evidence is strong that the savings are being used to fight poverty. Total poverty-reducing expenditures in countries that have received debt relief have increased from $5.8 billion in 2000 to an estimated $17 billion in

2006, or from 7–9 percent of GDP, on average. This is actually much more than the debt relief savings, and the question arises whether, and to what extent, this increase—beyond what would have been possible from debt relief alone—is attributable to the fact that all countries receiving MDRI debt cancellation are implementing Poverty Reduction Strategies (PRSP).

As I mentioned earlier, the PRSP was established as part of the 1999 framework for the provision of HIPC debt relief. There have been criticisms of the PRSP, including that they reflect more the priorities of the international financial institutions rather than the countries, i.e., that they are not sufficiently "country owned." While I have not seen an evaluation of the impact of the PRSP on expenditure patterns, the fact remains that the World Bank data shows a very large increase in poverty reducing expenditures in the HIPC countries. Citing 2005 World Bank research, the nongovernmental organization DATA (Debt, AIDS, Trade, Africa) found that for every dollar freed up from debt service, African governments have increased social spending by $2.

In 2006, The World Bank's Independent Evaluation Group did an update of an earlier evaluation of the HIPC program. It took a closer look at public expenditure patterns in countries benefiting from the HIPC program. It found that the majority of funds were allocated to expanding service delivery in the social sectors, and much less to investments to remove bottlenecks in economic or productive sectors. More specifically, based on data from five countries, it found that governments were increasing their expenditures for education, both as a share of total expenditures and as a share of GDP, but that spending for health, agriculture, and transportation had shown little change.

Improving the quantity and quality of education is, of course, critical for poverty reduction, and the focus on education should not in any way be denigrated. Nevertheless, as more debt relief savings have become available in the past few years, both by more countries fulfilling the conditions for HIPC debt relief and by the implementation of the MDRI program beginning in 2006, it becomes particularly important to increase expenditures for the productive sectors and other social sectors, such as health. It is thus encouraging that countries are using the savings generated by the MDRI program in 2006 for a more diversified range of poverty reduction activities. For example, according to the World Bank as supplemented by on-the-ground information provided by the Jubilee USA Network,

- Ghana is using the $57.9 million in 2006 savings in the energy and water sectors, for the rehabilitation of essential major highways and feeder roads in the main agricultural areas, as well as in education, health, and development of information and communication technology;
- Cameroon is using its savings of $29.8 million for infrastructure, social sector and governance reforms;
- Mali is using its $27 million in 2006 savings for water supply and roads;
- Uganda is using its $57.9 million on improving energy infrastructure to ease acute electricity shortages, as well as primary education, malaria control, health care and water infrastructure (specifically targeting the poor and underserved villages); and
- Zambia is using its savings of $23.8 million to increase spending on agricultural projects, such as smallholder irrigation and livestock disease control, as well as to eliminate fees for health care in rural areas.

But looking at the impact of debt relief programs at the "macro" level does not tell the whole story. There are examples of the use of debt relief savings at the local level, which, while they may not be reflected in national statistics, are improving the lives of thousands of poor people. Let me give you just one example from the experience of Catholic Relief Services.

A HIPC SUCCESS STORY

Catholic Relief Services has been active for many years in Cameroon. Working closely with the local Catholic Church, it has financed health, education, and community development projects in various parts of the country. In recent years it had not partnered with the government in any of its projects. Then came the HIPC program. When Cameroon qualified for HIPC debt relief a few years ago, a HIPC funding committee was set up consisting of government, civil society, church and donor representatives, with observers from the World Bank, IMF, and the African Development Bank. The committee's job is to assure that the funds generated by HIPC debt relief are used to carry out the country's poverty reduction strategy (PRSP). It approves the allocation of HIPC funds to specific projects and monitors their implementation.

CRS and other development agencies operating in Cameroon have long viewed community forestry as an important grassroots participatory strategy for fighting poverty. Uncontrolled exploitation of forestry resources by logging companies has been a longstanding problem in Cameroon. A 1994 law allows villages in and around large forest concessions to obtain authorization from the government for the sustainable management of forest resources for community benefit. Yet by 2003, very few community forestry projects had been approved. It was at this time that CRS developed and presented to the HIPC Committee a forestry project that would operate within a Catholic diocese that abounds in forestry resources. The project would mobilize 25 rural communities to manage their forests in a profitable and environmentally sustainable manner. Moreover, a portion of tax revenues owed by logging companies would be collected by the communities and reinvested in community development projects.

The HIPC Committee was convinced of the technical merits of the CRS project and, in spite of opposition from the Minister of Forestry, approved it and arranged for project funds to be released directly from the Ministry of Finance to the project managers. This was an important breakthrough in the country, and CRS and a broad group of allies are now well-placed to lead the effort to expand community forestry projects throughout Cameroon.

THE ROLE OF CIVIL SOCIETY

There are other examples of organizational arrangements designed to assure that debt relief funds reach the poor. In Uganda, resources freed up by debt relief are channeled through the Poverty Action Fund, which is overseen by representatives from government, national NGOs, churches, unions and international organizations. In Nigeria, the new Virtual Poverty Fund plays a similar role. These models can and should be replicated in other nations. I agree with Neil Watkins, National Coordinator of the Jubilee USA Network, that Parliamentarians and civil society organizations, particular those local organizations that give voice to the needs of the poor, have an important role to play in assuring accountability from national governments regarding the use of funds released by debt relief, as well as government expenditures more broadly.

While in Zambia recently, Neil saw firsthand the powerful role played by civil society groups such as Civil Society for Poverty Reduction, Jubilee Zambia, and others in pressuring the government to be more transparent and accountable for use of aid, debt relief, and new borrowing. Civil society is working in partnership with reform-minded Parliamentarians in Zambia to put forward an agenda to make the budgeting process more transparent and participatory and to involve civil society in monitoring the implementation of poverty reduction programs financed by the national budget. These efforts and others like them should be embraced and promoted by all those who advocate debt cancellation and responsible lending and borrowing.

S. 2166'S DEBT CANCELLATION WOULD FILL AN IMPORTANT GAP IN THE HIPC AND MDRI PROGRAMS

I would like now to turn to the rationale for the debt cancellation called for by the Jubilee Act for Responsible Lending and Expanded Debt Cancellation (S. 2166). It is clear that the debt reduction that has been granted to poor countries through successive debt relief initiatives represents a major accomplishment within the overall effort to address global poverty. However, we believe there is more to be done. There are a substantial number of poor countries that have not benefited from the HIPC program, let alone the MDRI. The disparity of treatment between HIPC poor countries and non-HIPC poor countries became clear in 2004 when the World Bank and IMF conducted an examination of "debt sustainability" in countries that, because of very low per capita incomes or other special circumstances, are eligible to receive only IDA funds from the World Bank. These are the so-called IDA-only countries. A primary objective of the exercise was to determine which countries should receive their future IDA financing either wholly or partially in the form of grants.

As a result of the debt sustainability analysis (DSA), it was concluded that that 47 countries were at sufficiently high risk of debt distress to be eligible for grant financing. The list included 29 HIPC countries plus 18 other countries. This meant that there were 18 non-HIPC countries rated as having a risk of debt distress equal to, or greater than, the HIPC countries. Like the HIPC's, they would get grants going forward, but unlike the HIPC's they would get no debt relief. Because of the 10-year grace period on the repayment of IDA credits, the non-HIPCs would begin receiving the financial benefit of grants (rather than loans) only after 10 years. In the meantime they would carry the full burden of existing debts and be unable to free up resources badly needed to move them toward achieving the Millennium Development Goal of reducing extreme poverty in half by 2015.

When the results of the DSA became available, some of us argued that the HIPC and MDRI programs should be expanded to include all countries qualifying for grant financing. Objections were raised in some quarters that making additional countries eligible for debt cancellation on the basis of their level of debt distress would create moral hazard problems, i.e., encourage countries to borrow more so that they would qualify. S. 2166 would address this concern by making "IDA-only" status the standard of eligibility for debt cancellation. Almost all IDA-only countries have per capita incomes below the historical standard for IDA eligibility, which is currently $1,065. (IDA-only countries above this limit are primarily small island economies.)

The IDA-only standard captures all non-HIPC countries eligible for IDA grants. These currently include Lesotho, Djibouti, Angola, Kyrgyz Rep., Tajikistan, Mongolia, Cambodia, Samoa, Solomon Islands, Tonga, and Yemen. (It also includes Myanmar, which is not eligible for U.S. assistance.) The IDA-only standard would also bring in some countries with external debt that is considered "sustainable" by the World Bank. Excluding several highly vulnerable small island economies, there are six such countries (Bangladesh, Georgia, Kenya, Moldova, Nigeria, and Vietnam). Of the six, all but two (Moldova and Georgia) have per capita incomes lower than $2 a day. Of course, debt cancellation will only occur if countries apply for it, and I believe there is a strong likelihood that at least Vietnam will not apply. The government is in the process of gaining access to international capital markets and is not likely to want to send a signal that it needs debt relief.

The rationale for including the grant eligible countries is, in my view, quite strong. Whether not one agrees with the World Bank's definition of "sustainable" debt, the rationale for including the six I just mentioned is also strong for a number of reasons:

- First, and most important, the IDA-only standard means that all potential beneficiaries of the debt cancellation provisions of S. 2166 are countries that have high levels of poverty and thus need to maximize the amount of resources they can marshal to promote human development, raise the living standards of their people and achieve the Millennium Development Goal of cutting extreme poverty and hunger in half by 2015.
- Second, the IDA-only standard will assure equity of treatment among all the poorest countries. The International Monetary Fund (IMF) addressed this point in an issues paper prepared a few months before the MDRI was approved at the Gleneagles summit in 2005. In commenting on eligibility criteria for new debt relief, the IMF said: "Regarding country coverage, *all* low-income countries could potentially be made eligible. (Emphasis added.) A main argument was: "Earmarking debt relief to HIPCS only, is difficult to justify, because the HIPC Initiative will have already sharply reduced previous cross-country differences in debt indicators."
- Third, making all IDA-only countries eligible addresses concerns about redistributing aid resources away from poor countries that are not eligible for debt relief. The concern is that an aid donor will finance the cost of giving debt cancellation to poor country A by reducing the amount of aid it grants to poor country B. Making all of the poorest countries eligible for debt cancellation obviates this problem.
- Fourth, there is the point made in "Delivering on Debt Relief," by Nancy Birdsall and John Williamson (2002): "The danger of giving complete debt relief to a limited group of countries is that the countries that built up the deepest debt problems in the past are likely to include the countries that were most prone to waste external resources. We therefore believe that there is a strong case for making virtually all low-income countries eligible for inclusion in the HIPC Initiative."

This last point reminds me of the statement made by Lesotho Finance Minister Timothy Thahane upon learning of the MDRI debt cancellation agreement. He told Reuters that one of the reasons Lesotho was not classified as a HIPC country was that it had never defaulted on its debt. "It is important," he said, "that those who have paid their debts well, who run their mega-finances well, should be rewarded with debt forgiveness."

The companion bill to S. 2166 in the House is H.R. 2634. When this bill was introduced in the House a year ago, Bishop Thomas Wenski, chairman of the Committee on International Policy of the USCCB wrote Representavies Waters and Bachus to express support. He said that despite important progress in debt reduction, "a substantial number of needy countries are not eligible for the existing debt relief initiatives. H.R. 2634 represents a major new step toward correcting this deficiency and making debt cancellation a reality for virtually all very poor countries that have participatory processes and financial management systems sufficient to assure that debt cancellation savings will be used to benefit the poor. We look forward to working with you and your congressional colleagues to help complete the unfinished business of poor country debt relief." As you know, H.R. 2634 passed the House last week with strong bipartisan support, and we were very pleased that this happened during the very days when our Holy Father, Pope Benedict XVI, was visiting our Nation's capital.

I'd like to touch on several other issues.

ADDITIONALITY

One objective of USCCB advocacy for debt relief has always been to assure that the debt relief received by a poor country frees up additional resources for combating poverty. In other words, we did not want donors to reduce other aid to that country in order to offset the loss resulting from debt cancellation (nor, as discussed above, did we want the loss offset by reduced aid to other poor countries.) We were, therefore, pleased to note the finding on this issue by the Independent Evaluation Group (IEG) of the World Bank in its 2006 HIPC update. It said that, with respect to the 28 countries that had reached their decision point, HIPC debt relief "appears to have been significantly additional to other net resource transfers." Between 1999 and 2004, net annual transfers attributable to debt relief increased by $4 billion, while other net annual aid transfers increased by $4.5 billion.

ARREARAGES TO IDA

My understanding is that the U.S. has outstanding arrearages to IDA and regional development banks of almost $600 million. It will clearly hamper the administration's effort to carry out the mandate of S. 2166 if these arrears are not cleared up quickly. S. 2166 calls for the cost of the bill's proposed multilateral debt cancellation to be financed, to the extent possible, by the multilateral institutions themselves. We believe that substantial resource should be available for this purpose particularly from the IMF (gold sales) and the World Bank (which has accumulated reserves sufficient to bring its equity-to-loans ratio well above the range its management considers necessary for long-term capital adequacy).

Moreover, we estimate that probably 8 to 9 countries of about 24 potentially eligible countries currently meet the financial management conditions for receiving the debt cancellation called for in the bill. (The nine are Lesotho, Kenya, Cape Verde, Mongolia, Moldova, Georgia, Samoa, Vanuatu, and, if it participates, Vietnam). Thus the need for financing to cover the cost of the debt cancellation is likely to be spread out over a number of years. Nevertheless, I expect that significant funding will be still required over time from the U.S. and other governments of the richer countries to finance multilateral debt cancellation. It will be very difficult for the U.S. to negotiate an agreed financing framework for new debt cancellation if it is not meeting existing commitments. I, therefore, very much support the inclusion in S. 2166 of the kind of "sense of Congress" provision included in the House bill (H.R. 2634) that calls for the U.S. to pay off the outstanding arrearages to IDA and the regional banks.

DEBT RELIEF IS PART OF A BROADER AGENDA

A final point that is important to emphasize is that while new debt cancellation would be a major achievement, debt relief is in no way a panacea. Even if the debt of poor countries were reduced to zero tomorrow, it would not end poverty. The problem is much too large, complex, and deep-seated for that. It must be addressed first and foremost by the countries themselves, with their governments and people working together on a variety of fronts for the common good. But their resources are not sufficient for them to do it alone. They need aid and just policies from the wealthier countries.

Senator CASEY. Thank you very much.

Dr. Henry.

STATEMENT OF DR. PETER B. HENRY, KONOSUKE MATSUSHITA PROFESSOR OF INTERNATIONAL ECONOMICS AND GUNN FACULTY SCHOLAR, GRADUATE SCHOOL OF BUSINESS, STANFORD UNIVERSITY, STANFORD, CA

Dr. HENRY. Good afternoon, Senator Casey. Thank you for the opportunity to discuss the implications of my research for the Jubilee Act.

Let me preface my remarks by saying that I am deeply sympathetic to the sentiment of this bill and to the debt relief movement in general. I am originally from a developing country, not a low-income developing country. I am from Jamaica, but even though Jamaica is a middle-income developing country, there is no shortage of poverty in Jamaica. So the issues that this bill raises are deeply important to me.

Let me also mention, just for the record, I am a card-carrying Episcopalian and the Episcopal Church cares a lot about these issues. I am not speaking for Episcopal Church here today, but I just want to echo the fact that I am deeply sympathetic to these issues.

But I do have some questions about whether this bill and whether the debt relief movement in general is going about addressing the problems of poor countries in the most efficient way.

Since there is not enough time to talk about all aspects of the bill, my comments will focus on the areas where I can add the most value. Specifically, I want to address the issues of grants versus loans and the efficacy of debt relief.

When my colleague, John Taylor, was Under Secretary for International Affairs at the Treasury from 2001 to 2005, he argued that instead of lending to poor countries, the multilateral financial institutions should give grants instead. This is a good idea and I am glad to see it emphasized in section 1626(c)(3) of the bill under consideration.

Poor countries are poor in part because they require large investments in public goods such as schools, roads, hospitals, and clean water. Prudent investments of this nature can generate a high rate of return to society in the long run by laying the foundation for future economic growth. But they are not likely to produce the short- to medium-run revenues needed to service loans. Therefore, using grants instead of loans to pay for public investments in low-income countries makes a lot of sense.

Of course, the track record of foreign aid programs to date does not inspire confidence that grants can be conditioned and monitored to achieve their intended goals. This does not mean that we should not try. Past failures and current research provide important clues about how to design more effective and realistic aid endeavors. The Millennium Challenge Corporation provides an example of one such work in progress, and I would emphasize work in progress.

The realization that poor countries need large infusions of financial resources to upgrade their social and economic infrastructure leads many to advocate for debt relief as a way of doing that. Keeping in mind the caveat that aid is not a cure-all and that we need to improve the efficiency with which we deliver aid, I turn now to the question of whether debt relief initiatives provide an efficient way of trying to address the social infrastructure problems of poor countries.

The bill under consideration essentially proposes to extend the reach of the G–8 Multilateral Debt Relief Initiative, MDRI. MDRI is itself an extension and deepening of the Highly Indebted Poor Countries Initiative, HIPC. Accordingly, I will use my previous analyses of HIPC and MDRI as the basis of my comments about the implications of debt relief for the efficacy of S. 2166.

If you believe that increased financial flows are an important part of the solution to the problems of poor countries, then a fundamental problem with MDRI and debt relief initiatives in general is that the amount of money at stake is trivial. The roughly $2 billion of annual debt payments forgiven under MDRI equals 0.01 percent of the gross domestic product of the OECD countries. Replacing the funds that would have been received by the multilateral development banks costs 1 penny for every $100—not 1 penny per dollar; 1 penny for every $100—of OECD gross domestic product.

Put another way, the reduction in annual debt servicing under MDRI is a mere one-seventieth—one-seventieth—of the quantity of official development assistance agreed to by world leaders on at least three separate occasions, dating all the way back to 1970.

For the United States alone, honoring this pledge would provide roughly $70 billion per year, 35 to 70 times the quantity of debt forgiven under MDRI. Currently the actual U.S. aid contribution is closer to 0.1 percent of GDP per year than the 0.7 percent that the G–8 countries have pledged to provide time and again, including agreeing to reach those levels by 2010.

One could argue that if the G–8 is unwilling to live up to its aid goals, then debt relief provides a smaller but still positive boost in resource flows to developing countries. For example, if poor countries receive $3 billion per year in aid and pay $2 billion in debt service, then they receive a net financial inflow of $1 billion. The general public thinks that by writing off the debt service of $2 billion, net financial flows to poor countries would rise to $3 billion. This is not the way debt relief works in practice. Debt relief is not free.

When one of the multilaterals, say, the International Development Association arm of the World Bank, writes off debt, like any other bank, its capital base shrinks. Without new capital, it has less money to distribute. To continue with the example, when debt service falls by $2 billion, aid drops by roughly the same amount. There is no increase in the net flow of resources to poor countries.

Turning from textbook examples to real life, the record shows that increased debt relief results in less foreign aid. The sum of new lending and grants to the heavily indebted poor countries increased steadily from 1970 to the mid-1990s, but starting with the onset of the HIPC initiative in 1996, aid as a fraction of GDP decreased. Prior to 1996, aid amounted to roughly 13.7 percent of GDP in the highly indebted poor countries. Since 1996, that figure has dropped to somewhere between 9.9 and 11.1 percent. Those numbers are as of 2003.

Now, section 1626(a)(5) of bill S. 2166 calls for the Secretary of the Treasury to ensure that the provision of debt cancellation is not simply offset by a decrease in development assistance. I applaud this language, but if history is a reasonable predictor of future actions, the words simply may not translate into reality.

As we craft policies directed at low-income countries, we must ask whether we are interested in symbolic gestures of noblesse oblige or substantive efforts to help poor countries help themselves. Forgiving debt does not address the fundamental problem of inadequate economic institutions that impedes investment and growth in the world's poorest countries. To the extent that additional resources are part of the solution, the assistance provided by the indirect approach of debt relief pales in comparison to the size of unfulfilled aid promises. One of the central development issues of our day is whether the high-income countries of the world will stand ready to help with real money when the low-income countries show that they are ready to put the resources to good use. The danger is that debt relief may amount to a Pyrrhic victory, a symbolic win for advocates of debt relief that clears the conscience of the rich countries but leaves the real problems of the poor countries unaddressed.

Thank you.

[The prepared statement of Dr. Henry follows:]

PREPARED STATEMENT OF DR. PETER BLAIR HENRY, KONOSUKE MATSUSHITA PROFESSOR OF INTERNATIONAL ECONOMICS, STANFORD UNIVERSITY GRADUATE SCHOOL OF BUSINESS, STANFORD, CA

Good afternoon Chairman Biden, Ranking Member Lugar, Presiding Member Casey, and distinguished members of the committee. My name is Peter Blair Henry. I am the Konosuke Matsushita Professor of International Economics at the Stanford University Graduate School of Business, a research associate of the National Bureau of Economic Research, and a nonresident senior fellow of the Brookings Institution. I have published a number of research articles on the topic of debt relief. Thank you for the opportunity to discuss the implications of this research for the Jubilee Act under consideration by this body (S. 2166).

The bill under consideration essentially proposes to extend the reach of the G–8 Multilateral Debt Relief Initiative (MDRI). The proximate impetus for MDRI was the Gleneagles summit in July 2005, where the G–8 heads of state called on the International Monetary Fund (IMF), the World Bank, and the African Development Bank to forgive the roughly $55 billion owed to them by the world's poorest nations. MDRI itself is an extension and deepening of the Highly Indebted Poor Countries Initiative (HIPC), so I will use my previous analyses of HIPC as the basis of my comments about the implications of debt relief for the efficacy of S. 2166.

Debt relief is not free. Like any other policy intervention it entails costs—political capital to garner support and financial capital to pay for the writeoff. So the fundamental question is whether the potential benefits are greater. Over a decade ago, debt relief helped to restore investment and growth in a number of middle-income developing countries that arguably suffered from debt overhang. But debt relief is unlikely to help the world's poorest countries because they suffer not from debt overhang but from an absence of the economic institutions that provide the foundation for profitable investment and growth.

THE HIPC INITIATIVE TRIES TO RAISE GROWTH AND REDUCE POVERTY BY RELIEVING DEBT

In 1996 the World Bank and the International Monetary Fund (IMF) launched the Heavily Indebted Poor Countries (HIPC) initiative in order to "provide a framework for all creditors, including multilateral creditors to provide debt relief to the world's poorest and most heavily indebted countries, and thereby reduce the constraint on economic growth and poverty reduction" (World Bank, 2004). The original HIPC initiative specified that in order to obtain debt relief a country must have: (1) A GNP per capita of $695 or less and (2) a debt burden deemed to be "unsustainable" even after the full use of traditional debt-relief mechanisms under the Paris Club. Unsustainable means a ratio of the net present value (NPV) of debt to exports in excess of a country-specific threshold of 200 to 250 percent, or, for very open economies, a NPV of debt exceeding 280 percent of government revenue.[1] In 1996, 41 countries met these criteria (see the appendix for a list).

After qualifying for debt relief, the eligible countries needed to produce a track record of reform for 3 years in order to reach a "decision point." At the decision point, the creditors arranged a debt relief package, given an adequate track record of reform. After no more than three additional years of proven policy implementation, countries reached their "completion point" and debt relief transpired.

THE ENHANCED HIPC INITIATIVE

Under the original framework, only six countries reached their completion points, and a consensus emerged that the process needed to move more quickly. Consequently, the G–7 introduced the enhanced HIPC initiative at its fall 1999 meeting in Cologne, Germany. The enhanced initiative reduced the ratios that qualified a country's debt burden as unsustainable to 150 percent for net-exports and 250 percent for government revenue. The second initiative also made it easier for countries to reach a decision point, allowed them to begin receiving debt relief as soon as they did so, and provided greater relief. Under the enhanced HIPC initiative, 16 additional countries began receiving debt relief in 2000, and 4 more joined this group in January 2003.

The HIPC Initiatives Show No Signs of Increasing Growth Or Reducing Poverty

To assess the impact of the HIPC initiatives to date, consider first the countries that reached their decision points and began receiving debt relief in the year 2000. Panel A of Table 1 shows that from 1990–95 the GDP per capita of this subset of HIPCs grew at negative 0.5 percent per year. From 1996—the year in which HIPC was initiated—through 2000 their growth rate was 1.5 percent (the poverty indicators show a similar pattern). At a glance, the 2-percentage-point increase seems to suggest faster growth stemming from debt relief, but more careful consideration produces at least three pieces of evidence to the contrary.

First, Panel B of Table 1 shows that the growth rate of the entire set of HIPCs from 1996 to 2000 was 2.4 percentage points higher than it was from 1990 to 1995. This means that the change in the growth rate of those HIPCs still waiting to receive debt relief (as of 2000) has been almost identical to those with debt burdens already reduced. Second, since the actual receipt of debt relief, as opposed to the qualifying process, did not begin until 2000, it is not clear that debt relief drove the increase in growth. Third, and related to the second point, since growth increased before the implementation of debt relief, the reforms required as a precondition may be the principal cause of the increase in growth for both sets of HIPCs. These three points notwithstanding, many argue that more generous debt relief delivered with greater dispatch would yield better results.

THE GLENEAGLES DECLARATION PROMISES COMPLETE DEBT RELIEF

In contrast to the piecemeal approaches of the two previous initiatives, the Gleneagles declaration promises forgiveness of all the debt. For the HIPCs, the critical number is not so much the stock of debt being forgiven—$55 billion—but the reduction in debt service, which is somewhere between $1 and $2 billion per year. To get a better sense of the economic significance of the numbers at stake, it is helpful to introduce the concept of the annual net resource transfer (NRT). The NRT of a country is simply its annual net inflow of capital: Gross capital inflows minus gross capital outflows. Because most capital flows to the HIPCs take the form of either grants (also referred to as aid) or new lending, we can write their NRT as follows:

$$\text{Net Resource Transfer} = \text{New Lending} + \text{Grants} - \text{Debt Servicing (1).}$$

Table 2 highlights three central facts about the impact of the Gleneagles debt relief proposal on the net resource transfers to heavily indebted poor nations. First, the quantity of money at stake for the developed nations of the world is trivial. The $2 billion of annual debt payments is equal to roughly 0.01 percent of the GDP of the OECD countries. Replacing the funds that would have been received by the multilateral development banks would cost about 1 cent for every $100 of OECD GDP—not exactly a budget-busting expense.

Second, contrary to popular belief, debt service does not cause a net drain of resources from the group of 38 heavily indebted poor countries. Although capital outflows in the form of debt service amount to a nontrivial fraction of the GDP of the heavily indebted poor countries—roughly 3 percent between 2000 and 2005—

[1] See Rieffel (2003) for a detailed discussion of Paris Club logistics.

their gross inflow of capital over the same period of time was much larger—roughly 15 percent of GDP. In other words, despite their debt servicing obligations, the heavily indebted poor countries receive more capital than they pay out to their creditors.

Third, for the past 30 years rich country governments have made no significant increase in the net quantity of resources that they transfer to the heavily indebted poor countries. Given this third fact, it follows from equation (1) that debt relief cannot have a major impact on the overall magnitude of net resource flows. Debt relief reduces debt servicing, but instead of the net resource transfer rising when this occurs, grants or new loans tend to fall. In other words, debt relief in the past has been given instead of, not in addition to, foreign aid. The sum of new lending and grants to the heavily indebted poor countries increased continually from 1970 to the mid-1990s. But starting with the onset of the HIPC initiative in 1996, aid flows (i.e., grants) as a fraction of GDP decreased. Prior to 1996, aid flows amounted to roughly 13.7 percent of GDP in the heavily indebted poor countries. Since 1996 that figure has dropped to between 9.9 and 11.1 percent. Together, the fall in aid flows and the postponed reduction in debt service has been associated with a decline in the HIPCs' net resource transfers (although they are still positive).

Since its impact on the NRT is minimal, debt relief cannot propel the HIPCs toward sustained growth and poverty reduction unless it produces benefits not captured by the numbers in Table 2. The likelihood of such a possibility is the topic of the next section.

DEBT RELIEF PROMOTES INVESTMENT AND GROWTH WHEN COUNTRIES HAVE DEBT OVERHANG

Debt relief promotes investment and growth when debt overhang inhibits a country's economic performance. "A country has a debt overhang problem when the expected present value of potential future resource transfers is less than its debt" (Krugman, 1988). In other words, a country suffers from debt overhang if it owes more money to its creditors than it is able to pay.

Debt overhang arises when a country accumulates too much debt, but it can also occur when a previously manageable stock of debt becomes intractable due to a change in a country's circumstances. When a country not suffering from debt overhang experiences a bad shock (e.g., a fall in its terms of trade) or bad policy (e.g., poor economic management), the expected present value of its future resource transfers will fall. For a given stock of debt at the time of the shock, if the fall in expected value is large enough, the country will find itself in a position of debt overhang. The country will also be unable to attract new creditors, because lending to it would, by definition of debt overhang, result in a stream of expected repayments whose present value is less than that of the loan.[2]

Importantly, a country suffering from debt overhang will also invest less than it would in the absence of an overhang and consequently may forgo efficient (i.e., positive net present value) projects (Sachs, 1984). Underinvestment occurs because the stock of debt acts as an implicit tax. A country's government raises the resources it needs to service its debt by taxing firms and households. An increase in the government's debt increases the private sector's expected future tax burden. Because higher taxes divert the benefits of new investment from the private sector to the existing debt holders, they also reduce the private sector's incentive to invest. In summary, a country suffering from debt overhang is unable to service its debt, obtain new loans, and invest as much as it should.

Krugman (1989) and Sachs (1989) point to a way out of this inefficient equilibrium. By extending the analogy between debt and taxes to a Laffer-Curve analysis, they show that both borrower and lenders can gain from debt relief. The logic runs as follows. At reasonable levels, the market value of the debt rises one-for-one with its face value. As the face value of the debt increases beyond a critical threshold, however, debt overhang ensues. The market value of the debt begins to fall—even as the face value continues to rise—and physical investment slumps along with the country's expected future growth rate. Consequently, if the creditors reduce the face value of the debt, the market value of the debt will rise. Debt relief also makes the borrower better off, because eliminating the debt overhang reduces the implicit tax on investment and reinstates the incentive for: (1) The country to undertake efficient investments and (2) for new lenders to extend credit.

But debt relief will not happen without coordination, because any individual creditor would prefer to maintain the full value of its claims while others write off some

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[2] Existing creditors, on the other hand, have an incentive to continue lending in an effort to preserve the value of their initial loan (Krugman, 1988).

debt (Sachs, 1989). By forcing all creditors to accept some losses, a third-party-coordinated debt relief program has the potential to solve this problem and pave the way for profitable new lending, investment, and growth (Cline, 1995).

DEBT RELIEF HELPED RESTORE INVESTMENT AND GROWTH IN THE BRADY COUNTRIES

The theory of debt overhang and efficient debt relief captures the experience of the middle-income developing countries hit by the debt crisis in the 1980s. During the international commercial bank lending boom from 1970 to 1981, the net resource transfer to these countries was strictly positive. Starting in 1982, however, rising interest rates, a global recession, and poor economic policy choices substantially reduced the expected value of the banks' loan portfolios in the debtor countries. As their current and future economic prospects dimmed, debtors began defaulting, new lending to them ceased, and their net resource transfers turned negative for an extended period of time.

In March 1989, U.S. Treasury Secretary, Nicholas Brady, initiated a plan under which 16 of the debtors reached debt-relief agreements with their private creditors. The commercial banks wrote off a fraction of the debt owed to them, and the countries agreed to implement major economic reforms.[3] In the 12 months preceding the signing of its debt-relief agreement, the average Brady country's stock market appreciated by 60 percent—a $42 billion increase in shareholder value—while there was no significant increase in the stock market values of a control group of countries that did not sign Brady agreements (Arslanalp and Henry, 2005a).

Debtor-country stock prices rose, in part, because debt relief restored capital inflows. After roughly 10 consecutive years of negative net resource flows, the NRT in all 16 debtor countries turned positive immediately after the signing of their Brady plan and remained so for the next several years. In order to appreciate the full significance of the change in net resource transfers, it is important to distinguish between two effects of debt relief. The direct effect is that debt relief reduces a country's debt servicing obligations. The indirect effect is that debt relief cleans the books and paves the way for new creditors to lend (Summers, 2000). The direct effect is quantitatively less important than the indirect one. The Brady plan led to the forgiveness of approximately $60 billion of debt, but that number is small in comparison to the $210 billion of cumulative net resource transfers the Brady countries received in the 5-year period following the official settlement with their creditors.[4]

The resurgence of capital inflows reflects the pithy Dornbusch maxim: "Unresolved debt problems, not debt per se, are an obstacle to investment. It is hard for a man to establish a relationship with a lender if the estranged wife keeps barging in claiming alimony" (Dornbusch, 1993, p.103). Indeed, the Brady countries' experienced an investment boom in the aftermath of debt relief. The average annual growth rate of their capital stocks rose by 1.9 percentage points—from 1.6 percent per year in the 5 years prior to debt relief, to 3.5 in the subsequent five. The data on GDP per capita paint a consistent picture of economic recovery, rising from an average of 0 to 1.6 percent per year over the same time period.[5]

THE HIPCS EXHIBIT NO SYMPTOMS OF DEBT OVERHANG

Debt relief helped the Brady countries, because it removed an obstacle standing in the way of new lending, investment, and growth.[6] If all else were equal, one might plausibly argue that debt relief for the HIPCs would achieve similar results. The problem is that all else is not equal. There are at least three reasons why debt overhang does not deter capital flows to the HIPCs (and hence their investment and growth).

First, if debt overhang hinders capital flows to the HIPCs, then just as the Brady countries experienced negative net resource transfers during their bout with overhang, the HIPCs should now be experiencing negative NRTs. But this is not the case. And nor has it ever been. In contrast to the Brady countries, NRTs to the HIPCs have always been positive (Table 2). If debt relief works by restoring positive NRTs in scenarios where it has turned negative, then the means by which it will help a set of countries in the midst of an uninterrupted stream of positive NRTs

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[3] See Cline (1995) for a detailed discussion of the restructuring terms.

[4] See Arslanalp and Henry (2005b) for the source of the $210 billion figure.

[5] The increase in growth can't be accounted for solely by the rise in the capital stock, so total factor productivity may also have increased due to the accompanying economic reforms (Henry, 2003).

[6] This is not to say that debt relief solved all of their problems. Starting with Mexico in 1994 and most recently in Argentina in 2001, a number of Brady countries have encountered severe economic crises since the Brady plan.

since 1970 is not clear. One counterargument to this line of reasoning holds that even if the HIPCs do not suffer from debt overhang, debt relief would make their already positive NRTs even larger. After all, Equation (1) shows that holding the quantity of grants and new loans constant, reducing debt service will surely increase the country's net intake. The problem with this counterargument, as we discuss in greater detail below, is that it ignores budgetary reality: Historically, capital inflows such as grants do not remain constant when countries receive debt relief.

Second, the concept of debt overhang is incongruous with the very nature of lending to the HIPCs. Debt overhang and the potential for efficient debt relief that stems from its presence are predicated on the incentives and rationale that drive lending by profit-maximizing entities. In contrast, official lending, the primary source of HIPC debt, responds to a very different set of considerations. For example, the international commercial banks lent to the Brady countries because they expected to make a profit for their shareholders by doing so. The HIPCs' principal creditors, multilateral lending institutions such as the International Development Assistance arm of the World Bank, have a broader mandate. At least part of their mission is to channel funds, through a combination of concessional loans and grants, to development projects that may yield large social gains in the long run, but are not immediately profitable (Taylor, 2004).

Since debt relief is designed to enhance efficiency in the market for private lending, it is unclear what effects it would have in a market with a significantly different incentive structure. More generally, a case can be made that the multilateral financial institutions should not lend to poor countries at all but give grants instead (Bulow, 2002; Bulow and Rogoff, 1988, 2005; Taylor, 2004). The history of aid does not inspire confidence in the ability of such transfer schemes to achieve their intended goal (Easterly, 2003). But past failures and current research contain important clues for the design of more effective (and realistic) future aid endeavors such as the Millenium Challenge Corporation (Besley and Burgess, 2003; Birdsall and Williamson, 2002; Brainard, Graham, Purvis, Radelet and Smith, 2003; Burnside and Dollar, 2000).

The third point relates closely to the second. The private sector investment channel, which plays a central role in models of debt overhang, is all but absent in the HIPCs. In models of debt overhang, the government's debt burden deters investment because it imposes an implicit tax on private sector investment. Therefore, in order for debt overhang to act as a deterrent to private investment, the country must have a private sector with viable investment projects to deter. One indication that a country's private sector has viable projects is that it attracts capital to fund those projects. Again, the Brady countries and the HIPCs show stark differences on this score. As early as 1974, capital flows to the Brady countries' private sector (private debt + foreign direct investment + portfolio equity) comprised nearly half of their total net resource flow, but the HIPCs' private sector never attracted a significant amount of capital. Inflows to the private sector in the HIPCs have accounted for as little as 4 percent of inflows and have never exceeded 13 percent (Arslanalp and Henry, 2005b).

Furthermore, the difference between the composition of capital flows to the Brady and the HIPCs continues to widen. At the peak of the debt crisis (1985–89), grants plus public and publicly guaranteed debt accounted for 73 percent of the net resource transfer to the Brady countries, but by 1994, the private sector was the destination for the majority of their net resource flows (Arslanalp and Henry, 2005b). No such shift has taken place in the HIPCs. In fact, the opposite has occurred—official flows and flows to the public sector have become more, not less, important. The role of grants has increased to the point where they now constitute the majority of net resource flows to the HIPCs.

The resurgence and expansion of the private sector in the Brady countries drove their post-debt-relief recovery in investment and growth, with foreign capital flows playing a significant financing role. Since the HIPCs' private sector has never attracted a comparable quantity or composition of foreign resources, it is hard to believe that even complete and immediate debt relief would generate capital inflows, investment, and growth of any consequential magnitude.

THE HIPCS' PRINCIPAL PROBLEM IS WEAK INSTITUTIONS

Recent advances in law and finance help to explain why private capital does not flow to the HIPCs and would be unlikely to do so even in the event of complete and immediate debt forgiveness. In a series of papers, La Porta, Lopez-de-Silanes, Shleifer and Vishny (1997, 1998, 2002) demonstrate that the degree to which a country's laws protect the rights of investors exerts a significant influence on its access to external finance. They measure investor protection by constructing a composite index of shareholder rights, creditor rights, efficiency of the judicial system, rule of law, and the accounting system.

The first row of Table 3 shows that the median Brady country ranks lower than the median G–7 country on the Laporta, et al., index of investor protection. The Brady countries' relatively low ranking may help explain why the quantity of capital flows they receive pales in comparison to the magnitude we would expect on the basis of the predictions of the neoclassical growth model (Lucas, 1990; Shleifer and Wolfenzon, 2002; Stulz, 2005). Although the median Brady country ranks low, the HIPCs do not even make the list. If private capital trickles to the Brady countries because they provide weak investor protection, then woe to the HIPCs whose capital markets and investor protection laws lack sufficient development to even merit a ranking.

More generally, poorly developed capital markets tend to be correlated with a weak economic infrastructure. The second row of Table 3 demonstrates this point by comparing the institutions of the HIPC and Brady countries using the index of economic infrastructure constructed by Hall and Jones (1999). The index ranks 130 countries and attempts to capture the extent to which a country's economic infrastructure provides "an environment that supports productive activities and encourages capital accumulation, skill acquisition, invention and technology transfer" (Hall and Jones, 1999). A ranking of 1 indicates the most development-friendly infrastructure, a ranking of 130 the most inimical. The median G–7 country ranks 14th while the median Brady country 63rd; the median HIPC comes in a distant 102nd. The third row of Table 3 shows that a comparison of the Bradys' and the HIPCs' economic infrastructure using the Heritage House Index of Economic Freedom gives similar results.

In combination with the earlier data on net resource transfers, Table 3 demonstrates a point almost too obvious to state: Unlike the Brady countries during the 1980s, the HIPCs' principal problem is not debt overhang but an absence of economic infrastructure—both hard infrastructure like roads and schools, and soft infrastructure like markets and property rights. Without the crucial foundations for profitable economic activity, it strains the imagination to believe that even full and immediate debt forgiveness will precipitate the burst of foreign capital flows, investment, and growth that it did in the Brady countries.

Ironically, the political and financial resources devoted to securing debt relief for the HIPCs might be more profitably employed toward a number of countries not being considered for such programs at all. These include a group of six highly indebted (but not as poor) developing countries—Indonesia, Pakistan, Colombia, Jamaica, Malaysia, and Turkey—whose economic infrastructures closely resemble those of the Bradys (Column 4 of Table 3). Because the group of six have viable private sectors and reasonably well functioning capital markets, it is more plausible to expect the response of their economies to mirror the experience of the Brady countries described earlier in the paper.

DEBT RELIEF WILL NOT HELP BUILD INFRASTRUCTURE AND MAY HAVE UNINTENDED EFFECTS

The principle of policy targeting states that distortions arising from a market failure should be tackled with policy instruments that address the failure directly (Bhagwati, 1971; Dixit, 1994). Both debt overhang and inadequate economic infrastructure produce inefficient outcomes that result from market failure. However, the nature of the market failure, and therefore the appropriate policy intervention, differs in each case. Debt relief is an efficient policy response to debt overhang, because it forces each lender to internalize the negative impact of its intransigence on the borrower and other lenders.

But the HIPCs market failure stems not from lender intransigence, but a classic public goods problem in the following vein: Infrastructure investment in the HIPCs could raise the rate of return to a range of private projects in these countries. For example, by allowing them to get their goods to market, building a road where none exists could encourage farmers to invest in technologies that increase crop yields. But no single farmer will want to build a road, because he will bear all of the costs while society reaps the benefits. In other words, left to their own devices, markets will not provide sufficient roads, or any other public good, so long as the private rate of return to doing so is less than the social return.

Rich-country governments address this type of market failure by collecting taxes to pay for public goods like roads, schools, and hospitals. Since the HIPCs' tax base is not large enough for this task, they require foreign resources to help fill their public goods deficit. The question, then, is whether debt relief for the HIPCs will increase their net intake of capital from abroad?

Ironically, past debt relief efforts have actually reduced net resource transfers to the HIPCs. The net resource transfer identity, equation (1), shows that debt relief increases a country's net resource transfer only if the reduction in debt service does not reduce other capital inflows. Historically, this has not been the case. Debt relief has been given instead of, not in addition to, foreign aid. Again, Table 2 displays the point. Aid flows to the HIPCs increased continually from 1970 to the mid-1990s. But starting with the onset of the HIPC initiative in 1996, aid flows as a fraction of GDP decreased significantly. Prior to 1996, aid flows amounted to roughly 16 percent of HIPC GDP. Since 1996 that figure has dropped to between 10 and 12 percent. Together, the fall in aid flows and the postponed reduction in debt service has caused a decline in the HIPCs' net resource transfers (although they are still positive).

CONCLUSION

The main beneficiaries of the Gleneagles debt relief proposal would appear to be the rich countries who garner good political press at a trivial cost (Rogoff, 2005). Forgiving debt does not address the fundamental problem of inadequate economic institutions that impedes investment and growth in the world's poorest countries. And, to the extent that additional resources are part of the solution, the indirect approach of debt relief does little, if any, good. In the past debt relief has had a minimal impact on net resource flows, and there is nothing in the Gleneagles proposal to suggest that it will be much different. One of the central development issues of our day is whether the high-income countries of the world will stand ready to help with real money when the low-income countries demonstrate that they are ready to put the resources to good use. The danger is that the Gleneagles declaration may amount to a Pyrrhic victory: A symbolic win for advocates of debt relief that clears the conscience of the rich countries but leaves the real problems of the poor countries unaddressed.

TABLE 1.—THE HIPCS RECEIVING DEBT RELIEF ARE NOT GROWING ANY FASTER, OR REDUCING POVERTY ANY MORE QUICKLY THAN THE HIPCS STILL WAITING TO RECEIVE DEBT RELIEF

	1990–95	1996–00	2001–03
Panel A: HIPCs That Began Receiving Debt Relief in 2000:			
Growth of GDP Per Capita	−0.3	1.7	2.3
Human Development Index	0.40	0.41	0.43
Panel B: All HIPCs:			
Growth of GDP Per Capita	−0.5	1.9	2.0
Human Development Index	0.41	0.42	0.43

Source: World Bank, World Development Indicators.

TABLE 2.—NEW LENDING, GRANTS, AND DEBT SERVICE FOR THE HEAVILY INDEBTED POOR COUNTRIES

	Billions of Dollars	% of HIPC GDP	% of OECD GPD
1970–79:			
Net Resource Transfers	4.5	7.7	0.10
New Lending	2.1	3.6	0.05
Grants	2.9	5.0	0.07
Debt Service	0.5	0.9	0.01
1980–89:			
Net Resource Transfers	13.2	12.2	0.13
New Lending	6.1	5.6	0.06
Grants	9.1	8.4	0.09
Debt Service	2.0	1.9	0.02
1990–95:			
Net Resource Transfers	18.9	15.9	0.10
New Lending	6.0	5.0	0.03
Grants	16.3	13.7	0.08
Debt Service	3.4	2.9	0.02
1996–99:			
Net Resource Transfers	13.9	10.4	0.06
New Lending	4.8	3.6	0.02
Grants	13.2	9.9	0.06

TABLE 2.—NEW LENDING, GRANTS, AND DEBT SERVICE FOR THE HEAVILY INDEBTED POOR COUNTRIES—Continued

	Billions of Dollars	% of HIPC GDP	% of OECD GPD
Debt Service	4.0	3.0	0.02
2000–03:			
Net Resource Transfers	17.7	12.2	0.07
New Lending	4.5	3.1	0.02
Grants	16.0	11.1	0.06
Debt Service	2.8	2.0	0.01

Source: The data on net resource transfers, new lending, and debt service are obtained from World Bank's Global Development Finance Data Base. The data on grants come from the World Bank's World Development Indicators Data Base.

TABLE 3.—THE HIPCS HAVE MUCH WEAKER ECONOMIC INFRASTRUCTURE THAN THE BRADY COUNTRIES

	G–7	Brady countries	HIPCs	"Group of 6"
Laporta, et al., Score	7.5	4.9	N/A	4.6
Hall and Jones (1999) Rank	14	63	102	61
Heritage House Index of Economic Freedom Rank	14	59	110	58

The first row lists the median La Porta, Lopez-de-Silanes, Shleifer and Vishny (LLSV) score of social infrastructure for the G–7 countries, Brady countries, HIPCs, and the group of six countries. The countries in the group of six are Indonesia, Pakistan, Colombia, Jamaica, Malaysia, and Turkey. The second row lists the median Hall and Jones (1999) rank for each country group. The third row lists the median Heritage House Index of Economic Freedom rank.

APPENDIX A, THE HIGHLY INDEBTED POOR COUNTRIES ELIGIBLE FOR DEBT RELIEF AT VARIOUS STAGES

The original 41 HIPC countries are: Angola, Benin, Bolivia, Burkina Faso, Burundi, Cameroon, Central African Republic, Chad, Congo, Côte d'Ivoire, Democratic Republic of the Congo, Equatorial Guinea, Ethiopia, Ghana, Guinea, Guinea-Bissau, Guyana, Honduras, Kenya, Lao PDR, Liberia, Madagascar, Mali, Mauritania, Mozambique, Myanmar, Nicaragua, Niger, Nigeria, Rwanda, São Tomé and Príncipe, Senegal, Sierra Leone, Somalia, Sudan, Tanzania, Togo, Uganda, Vietnam, Yemen, and Zambia.

After a revised debt sustainability analysis, three countries were added (Comoros, the Gambia, and Malawi), while six countries were taken out of the group (Angola, Equatorial Guinea, Kenya, Nigeria, Vietnam, and Yemen). Currently, the HIPC group consists of 38 countries.

The six countries that reached their completion points under the original HIPC Initiative are: Bolivia, Burkina Faso, Guyana, Mali, Mozambique, and Uganda.

The sixteen additional countries that reached their decision points under the Enhanced HIPC Initiative, and began receiving debt relief in 2000 are: Benin, Cameroon, Gambia, Guinea, Guinea-Bissau, Honduras, Madagascar, Malawi, Mauritania, Nicaragua, Niger, Rwanda, São Tomé and Príncipe, Senegal, Tanzania, and Zambia.

The five additional countries that had reached their decision points under the enhanced HIPC Initiative (as of June 2005) are: Chad and Ethiopia in 2001, Ghana and Sierra Leone in 2002, and Democratic Republic of Congo in 2003.

The eighteen countries that have reached their completion points under the enhanced HIPC Initiative (as of June 2005) are: Benin, Bolivia, Burkina Faso, Ethiopia, Ghana, Guyana, Honduras, Madagascar, Mali, Mauritania, Mozambique, Nicaragua, Niger, Rwanda, Senegal, Tanzania, Uganda, and Zambia.

The nine countries expected to reach their completion points in the next 1 to 3 years: Cameroon, Chad, Democratic Republic of Congo, The Gambia, Guinea, Guinea-Bissau, Malawi, São Tomé and Príncipe, and Sierra Leone.

APPENDIX B, THE BRADY COUNTRIES

Argentina, Bolivia, Brazil, Bulgaria, Costa Rica, Dominican Republic, Ecuador, Jordan, Mexico, Nigeria, Panama, Peru, Philippines, Poland, Uruguay, and Venezuela.

Senator CASEY. Thank you very much, Doctor.

I wanted to move to questions for our panelists. Dr. Birdsall, I wanted to start with you. You have a book entitled "Delivering on Debt Relief," and in your book, among other things, you address the advantages of debt relief as an alternative mechanism of delivering aid to developing countries as well as the possibility of selling IMF gold to finance debt cancellation.

Could you discuss your views on these issues in greater detail? Could you provide a commentary on that aspect of your book?

Dr. BIRDSALL. Certainly, Senator Casey. Let me make just two points. One is that my remarks in the written testimony that refer to debt relief as a hyperefficient form of aid are a reflection of the thought that I gave to the issue in writing that book some years ago and also to the more recent work of myself and colleagues at the Center for Global Development on the terrible inefficiencies in what I would call the aid industry. And those inefficiencies are a problem in the U.S. foreign assistance programs, but they are also a problem in the foreign assistance programs of many other bilateral donors and in the work of the World Bank and the multilateral development banks.

I would not want to suggest that those aid programs do not make sense at all, just to suggest that they impose very high administrative burdens on the recipient countries, particularly the poorest countries which are receiving about 10 percent, sometimes more, of their GDP annually in aid, which means that they are sometimes covering more than 40 percent of their expenditures with aid inflows. And they end up spending a lot of time talking to the 50-plus donors, the many NGOs, the U.N. agencies, and being responsive to all these different demands for monitoring, reporting, disbursement procedures, protocols with respect to procurement on infrastructure deals instead of being responsive to their citizens.

So I think any step that moves the United States in a direction for the poorest countries of making the aid process, including debt relief, more efficient for those countries, particularly those that are performing well, is a good one. So that is my first point that I am happy to have had a chance to emphasize.

The reference to the IMF gold. Let me put it in the context of this particular bill. I think it is important to distinguish in a technical sense between the call in this bill for the World Bank to finance any additional debt writeoff for all IDA countries from its internal resources and that call on the IMF.

In the case of the IMF, it is possible for the IMF to mobilize or sell gold in order to deal with these liabilities of the poorest countries which may remain to the IMF without creating the problem that it is robbing Peter to pay Paul. In effect, the IMF can sell gold. It would not take all that much in the case of these countries here, assuming that Vietnam and Bangladesh and some of the other big ones did not opt in. And the cost in a sense, I have said in other work, is that the central bankers of the rich countries sleep slightly less well. They have a slightly lower capital resources to cover any risks that might occur to financial stability in the global system.

In the case of the World Bank and the other banks, as I suggested in my initial testimony, unless new debt relief—new relief to low-income countries for the debts owed to those institutions is covered by new contributions from the United States, the Europeans, the Australians, and so on—if that does not happen, if the World Bank uses its internal resources, those internal resources have to come either from existing IDA money, which will reduce lending and grants to those very countries or to other countries which may be more deserving in terms of performance, more able to use the resources well, or they will come from transfers from the hard window at the World Bank.

If they come from transfers at the hard window at the World Bank, that eventually circles around to reduce, all other things the same, the capital available in the World Bank, which in turn comes around to slightly higher or more than slightly higher interest charges to those countries that are borrowing from the hard window.

This is not really a big financial problem. You could say, let us have the Chinese and the Turks and the Mexicans pay for debt relief to Moldova, Lesotho, Kenya, et cetera. But it is a credibility issue. It is a reputational issue. It illustrates the point that the United States needs to develop any approach like this one in concert with the other rich nations which are the traditional donors.

And then we come back to my point in my testimony that the United States is not now in a very good position to do that, given that it is in arrears to these institutions, which are like global clubs. So one member of the club is not behaving very well, and it does not seem appropriate for that member of the club, without paying up its dues, to be creating new demands, much of which will be borne by other members.

It is very interesting, in particular, that of the nine countries that would qualify under the current Jubilee bill, given their performance—they meet the performance requirements—four or five of them have virtually no debt to the U.S. bilateral aid system. So we are calling on other creditors in Europe and so on to do something that, at least on the bilateral side, we do not need to do. I think we should do that only when we have cleared up the existing arrears.

Sorry for the long answer.

Senator CASEY. That is OK.

Let me ask a question to you and our other two witnesses. You can all take time to answer this. You heard a good bit today by way of oral testimony and also the written testimony with regard to the administration. If you can assess that, in other words, assess the administration's approach to this issue as it contrasts with the one that is contemplated by the Jubilee Act bill.

Dr. BIRDSALL. I would say that what has been accomplished under this administration and the Clinton administration in the nineties on debt relief has been extraordinary. So I would give a lot of credit to the executive branch for following a lead set in the legislative branch on these issues in a way that has been technically sound and has been politically prudent. So I put some weight on the fact that the Treasury officials are concerned about the arrears in the context of this bill.

I would urge the Congress, through this bill, to use the opportunity to ask Treasury to push harder on the insurance type facility that I mentioned. I think the events of the last few months illustrate the tremendous value of doing that, and I believe that such an approach is consistent both with the interests of the Jubilee movement and your interests and those of other legislators that have signed onto this bill in finding additional efficient ways to respond to poor countries' needs in supporting their development objectives, while at the same time not creating questions about whether there is something wrong with debt in itself and not creating political pressure in some countries, which honestly, frankly, I saw when I was at the Inter-American Development Bank in the case, for example, of Bolivia, which was an early HIPC beneficiary.

Initially it was not really clear that the Government of Bolivia wanted to enter into the HIPC program—this is way back in the nineties—because at that time, that government was steaming ahead on a set of economic reforms with considerable support from the United States and wanted to lock in access to private capital markets. In the end, they made the tradeoff and they went ahead with opting in for HIPC eligibility.

But the point is that we should respect countries' own processes for trying to get into the capital market and their own efforts at better debt management, at prudent borrowing when they are ready to do it and not create a sort of allure of new rounds over and over of debt relief when that may not be the single best instrument to help them out. It may be that they are better off to have more grants from the United States and from the World Bank and from other donors and at the same time be building up the reputation for good management that allows them eventually to go to private capital markets and allows borrowers inside those countries, small and medium enterprises, for example, to—it creates the environment where there is a better domestic capital market as well where some of the capital that does exist on the part of the rich in those countries, instead of going outside, begins to stay inside and be intermediated through the financial system for high return investments at home.

This is all part of a process of developing a market-based, sustainable growth approach. So I am not sure I have answered your question very directly except to say I think we need to respect and take carefully into account the views that are developed in the U.S. Treasury and in these other institutions. They may not always be exactly right. No doubt. As I think you mentioned, the Center for Global Development has been pushing the IMF with success, by the way, to be less risk-averse in its recommendations on fiscal and monetary policy in poor countries. At the same time, we need to respect those views and take them into account. And in this instance, I would say that I would take pride as a U.S. taxpayer in the approach over the last decade or more that has emerged on this debt relief issue.

Senator CASEY. Mr. Flood.

Mr. FLOOD. Thank you, Senator.

Senator CASEY. With regard to the administration's testimony——

Mr. FLOOD. Yes. Well, I was very interested when Mr. Lowery said that Secretary Paulson had spoken to ministers from several African countries and none of them brought up debt relief. I was thinking to myself, that is great, because almost all of the countries in Africa that he might have met with—and my guess would be all of them—have already received debt relief. They are already beneficiaries of the HIPC debt relief program and the MDRI. So the fact that they are not talking about debt relief means that they are going beyond it now to deal with some other issues and hopefully the fiscal space that has been provided by the debt relief that they received puts them in a better position to begin to move forward toward a more dynamic path of growth and poverty reduction. So I thought that was fine.

But what we have here is countries that have never been through the process, and we are talking about completing the process now by bringing in those few remaining countries—it is not a huge number—who have been left out and who I think that for all the reasons that I tried to make clear in the oral testimony, merit being brought in so that we can say we have completed the job.

The idea is not that countries should come back in every 2 years and get another round of debt relief. That is not it at all. The idea is to give them a fresh start, which these countries have never had, and quite a few of them are in serious debt situations. There are a few that are not, but for the reasons I mentioned, the justification for bringing them in I think is strong as well.

Now, on the question of the arrears, I think that is a serious question, and I certainly agree with that. I think that the United States should deal with that. I do not think this should be seen as a tradeoff, you know, either we do the debt relief or we clear up our arrears. I think we have to do both, and I think the sooner we get the arrears cleared up, the better. Only then will we be in a position to really go out and negotiate strongly a program like this, but let us get started working on it. In the meantime, get those arrears cleared. I think it is very important to do that.

I had—well, I will let it go for the time being.

Senator CASEY. Thank you.

Dr. Henry.

Dr. HENRY. Thank you.

So let me start by saying again that the grants versus loans idea is one of the better ideas to come out of this administration. Actually it was started to some extent under the Clinton administration. So let us give credit in both places there. And the idea was pushed very hard early on in this administration, but it sort of fell out of view for other reasons.

But the grants versus loans idea is really essential because when you think about the difference between the low-income countries of the world and the Brazils, Mexicos, Argentinas, Turkeys, the middle-income developing countries of the world, you really start to see very clearly why grants versus loans make sense. In countries like Brazil, Argentina, Mexico, where there is access to private capital markets, you ask yourself, why do they have access to private capital markets? Because they have a certain amount of institutional capability that works. Markets do work. And if you think back to a case where debt relief actually did work, it was in the case of the Brady plan in the late 1980s and early 1990s precisely in middle-income developing countries.

So debt relief is really designed to solve a very specific problem. It is really designed to solve a problem that occurs in private capital markets that Secretary Lowery actually alluded to, which is that if you have profitable borrowers who have just become overly indebted and actually suffer from debt overhang, then in those instances, writing off debt can actually lead to an efficient stall on payments to all creditors, forcing all creditors to take some losses so that the borrowers can actually recover. And then we end up seeing new flows of money going to these countries, and we see an increase in investment, increase in growth, and these countries are able to turn themselves around.

The channel for that to happen is completely absent in the low-income countries because they have never had much private capital to speak of in the first place. So actually writing down the debt is not going to spur investment or growth in these countries. As I said in my testimony, it is an indirect way of trying to deal with the problem. The key investments in the poor countries of the world are really what we call high social rate of return investments, public goods, schools, roads, clean water, things that the private sector is not necessarily in a position to finance, and things which are going to be long gestation in terms of generating returns.

That is the classic argument for actually giving foreign assistance. So if you really want to directly address the problems of the poor countries, then give assistance directly at that margin. That is the point that I really would like to emphasize.

So I am not arguing that we should not help poor countries. The question is how. And then there is also the question of quantities. And this is where I think priorities are very important.

As it stands, if you take the world as it is, there really does seem to be currently kind of a fixed amount of good will in the world, so to speak. The amount of resources that we are willing to transfer to poor countries has been fixed over time. If that is true, then all debt relief effectively does is change the form in which you are actually giving assistance to these countries. I happen to think it is not the most efficient way of doing it.

It also becomes a distraction from the real issue, which is why are we not willing to provide the resources that we say we are going to do over and over. And I really do worry that all the focus on debt relief is an enormous distraction from the key issue.

So if I were thinking about how to rewrite this bill, if I may be so presumptuous, I would put more emphasis on the fact that we are continually falling short on past aid promises and that while aid is not the answer in and of itself, there are ways to think about making aid more efficient, and we can do that in concert with actually ratcheting up our commitment to past promises rather than arguing about debt relief and accounting issues which really are beside the point because the money at stake is really trivial.

Senator CASEY. I wanted to start a little argument here, to have a response to the points you just made, Mr. Flood or Dr. Birdsall, if you want to respond to Dr. Henry's points.

Dr. BIRDSALL. I will leave the last push to you.

Mr. FLOOD. Go ahead.

Dr. BIRDSALL. Well, I would like to differ slightly. I am not sure that it is fundamental to the challenge that you face, Senator Casey, with this legislation. But I would like to differ a little bit with what Peter Henry just said.

I think that there is a great passion out there amongst Americans for what is seen justifiably as an approach to helping the poor in the world that is fair, that has an element of fairness about it, and that there is something patently unfair about the fact that many countries that are very poor have been burdened with these high debt payments. In that sense, I would say it is worth riding the horse of debt relief, frankly, because it is channeling a reasonable and really admirable passion and a sense of generosity out there in a way that I believe is very efficient, given the current structure of the aid industry.

I agree with Dr. Henry that we could do a lot better in the way we deliver aid, and that is another entire hearing in my view, as some of your colleagues on your staff will know.

So I just wanted to make that point. So I do think that it is useful to have this Jubilee Act. I think even this hearing has brought out the potential, frankly, through your good offices to use this in a good way to move on and get these arrears covered, which would make, frankly, myself, and I perceive the U.S. Treasury staff and managers, much more enthusiastic about thinking about this approach in and of itself.

I do think it is also important to address the volatility problem, the vulnerability problem that I raised. I think that is probably in a technical sense a much better way to approach the overall difficulties of so many low-income countries than to go down to the last intensive margin of debt relief, particularly in countries like, frankly, Vietnam, Mongolia, even Bangladesh, Kenya. I think a lot of these countries—it is very good to have a system in which they are working toward entering the market while at the same time benefiting from some forms of assistance in the volumes that are critical so that the public goods can be covered which are critical inputs to the growth process.

So these are highly technical points. In the end, I do not want this hearing, or at least my testimony, to come out seeming not to support the concept of debt relief. It is more about the specifics. The devil is in the details of how it is done and, in particular, the timing of such legislation with respect to the arrears problem.

Senator CASEY. I think, Mr. Flood, you may have the last word. I have a conflict. I have to appear with Senator Specter at an event that pertains to our State and I cannot miss it. I have another 25 questions, but what we might do is, after your answer, we could propound questions to each of you for the record and have you answer them in writing for the purposes of this hearing. But I apologize that I have to cut this short, but I wanted to make sure that Mr. Flood had the last word, at least responding to that basic question pertaining to what Dr. Henry said.

Mr. FLOOD. Well, I do not have a whole lot to add to what Dr. Birdsall said about the overall value of debt relief.

I just wanted to comment on two points made by Dr. Birdsall. One, I have always thought that the idea of some sort of insurance program or structure going forward was a good idea, and I certainly would support any efforts along those lines to make that sort of thing possible.

On the financing of this particular debt relief that is being proposed here, I would have agreed with Dr. Birdsall 10 years ago about the World Bank, but I really do not today. They are doing very, very well. Now, I am not saying that I think that it is realistic to expect that there will not be some requirement of budgetary support for this program. I think there definitely will. I do not think, even if one could argue that it was financially quite possible for the World Bank to finance all this out of its own resources, that its shareholders would agree with that.

But I do think that with a bit of political will here, one would see clearly that the World Bank is in a very, very strong position right now. They issued a report only a few months ago showing that they had, by their own calculations, $10 billion in excess reserves. In other words, their equity-to-loans ratio was high enough to give them much more than they needed for long-term capital adequacy. They said that themselves. Of course, then they said we still think we have to keep it all to ourselves and not, for example, transfer funds to IDA for debt relief. They would not agree with that.

But there is a basic assumption that they are making in saying that they cannot transfer a large part of this, if not all of it, to IDA, for example, for debt and perhaps other funding for poor countries, and that is that they say that their loans are going to grow at 3 percent a year over the next 30 years or so. It is a very, very long time. The fact of the matter is that they have been in a long-term decline in terms of the amount of loans outstanding. Since 1994, it has dropped on an average of 2 percent a year, and that is even including the bulge of lending that they did during the Asian debt crisis.

So the idea that their outstanding levels are going to grow at 3 percent a year is extremely optimistic. Instead of growing at 3 percent a year they grow at, say, 1 percent a year, which would be a big turnaround from the recent trend, there should be a very large portion of that very large amount of excess capital that could be available and could be transferred to IDA and could finance a large part of the debt relief that is being proposed here for the World Bank. And it would not mean that there would be any rise in interest rates to any of the borrowers because, by definition, this is excess. These are not funds which they need to retain to preserve their financial soundness. They are well, well beyond anything that might, arguably, be needed in order to maintain a AAA rating, for example.

Finally, the bill does not say that this all has to be financed from the institutions from their own resources. It just says to the extent possible, and recognizes that it may not be possible to get it all out of the international financial institutions.

Senator CASEY. Thank you very much. Unfortunately, I have to go, but we appreciate your testimony. We will get more for the record, but thank you very much.

The hearing is adjourned.

[Whereupon, at 3:57 p.m., the hearing was adjourned.]

Additional Material Submitted for the Record

Prepared Statement of Hon. Richard G. Lugar, U.S. Senator From Indiana

I join the chairman in welcoming our witnesses. In 1999, the United States and other industrialized nations established the Highly Indebted Poor Countries Initiative in response to crippling levels of debt combined with anemic economic growth in dozens of developing countries. This was followed several years later by the more comprehensive Multilateral Debt Relief Initiative.

These initiatives allowed poor countries to receive debt relief in exchange for adopting economic policy reforms and channeling their debt savings to poverty reduction activities. For example, Uganda is using its debt cancellation savings on primary education, health, and infrastructure. Zambia is devoting its savings to improvements in agriculture and health.

However, despite many examples of successful debt relief, the debt problem in the developing world continues to threaten stability; impede economic growth; and constrict investments in health care, education, sanitation, and other elements essential to development. In response, Congress is now considering the Jubilee Act, which would expand the concept of debt relief to additional countries.

Much of the international debt due to be forgiven is owed to the multilateral development banks and the International Monetary Fund. Since 2003, the Foreign Relations Committee has reviewed U.S. policy toward the development banks. We examined how to maximize development bank efforts and how to continue the fight against corruption linked to development bank financing. We found that corruption not only enriches the undeserving and undermines the effectiveness of development projects, it leaves the resulting debts to the impoverished. One important way to combat the need for future debt relief is to ensure that development loans are implemented effectively and ethically.

It is critical that Congress fund our current commitment to debt relief and the development banks. The United States pledges for debt relief and the development banks are not being fulfilled. The gap between our pledges and our actual contributions jeopardizes U.S. efforts to advance key reforms promoting anticorruption, the measurement of results, and increased transparency of development bank operations. Our arrears status is leading to U.S. shares at some development banks being auctioned off to other countries, further undermining our ability to leverage the development banks for our foreign policy interests.

Congress must also reauthorize debt-for-nature swaps through the Tropical Forest Conversation Act (TFCA), which is one of our most cost-effective diplomatic and conservation tools. Through TFCA, more than 47 million acres of tropical forests in developing countries have been conserved, helping to absorb internationally generated carbon. TFCA uniquely leverages the contributions of private donors, who have given more than $12 million to TFCA swaps.

As an original cosponsor of the Senate version of the Jubilee Act, I appreciate the opportunity today to discuss the dynamics of debt relief and receive expert commentary on the bill. The Jubilee Act carries great promise, but we should be open to additional ideas that may improve the effectiveness of debt relief. I look forward to the insights of our witnesses.

Prepared Statement by Muyatwa Sitali, Coordinator, Debt, Aid and Trade Programme, Jesuit Centre for Theological Reflection, Lusaka, Zambia—"The Benefits and Challenges of Debt Cancellation in Zambia"

A. Introduction and Background

On behalf of the Jubilee campaign in Zambia, I would like to express our sincere appreciation to the Jubilee USA Network and Senators Casey, Lugar, and Dodd for their leadership and support for the Jubilee Act for Responsible Lending and Expanded Debt Cancellation (H.R. 2634). We are also grateful for the opportunity to submit this written testimony on the occasion of today's hearing.

We are also grateful to the institutions and committees that have already considered the Jubilee Act and have subsequently voted for it. We are particularly grateful to the House of Representatives for its strong bipartisan support for the legislation.

It is with pride and a sense of solidarity that today we witness debt cancellation in 23 countries, including Zambia. At the same time, many more countries which are deserving of similar benefits are still being denied the opportunity to get space to concentrate on development which does not only help them meet their national development targets but also contributes to the achievement of the Millennium Development Goals (MDGs). This is due to the eligibility limitations of the current debt cancellation initiatives.

Brief Historical Context, Challenges and Benefits of Debt Cancellation

Both Zambia's external and internal debts were very high before the HIPC Initiative, but it was the huge external debt and the country's poor export performance that qualified the country for entry into the Heavily Indebted Poor Countries (HIPC) initiative.

Before reaching the Decision Point of the enhanced HIPC Initiative in 2000, Zambia's external debt stood at US$6.5 billion, more than twice Zambia's GDP. In 2004, Zambia's debt stock stood at US$7.1 billion. With Decision Point qualification, debt servicing started reducing but marginally.

With the attainment of the HIPC Completion Point (HIPC–CP) in April 2005, many people had hopes rekindled and anxieties rose. Further debt cancellation under the Multilateral Debt Relief Initiative (MDRI) increased expectations. This was described by the Minister of Finance as "optimism and a sigh of relief at having achieved one of the landmarks in the history of Zambia" (Budget speech, 2006).

After attaining HIPC–CP efforts were made to recruit 8,500 teachers in 2005 and a further pledge by the government to employ 5,000 more teachers, 1,700 more health personnel, build 31 high schools, 1,500 classrooms in 2008. The local currency, the Kwacha, appreciated by 27 percent (Development Zambia, 2006). This basically proves that debt relief can work and that debt relief can also reach some of the poor communities.

Parliamentarians in Zambia attest to this fact. The Chair of the Economic Affairs and Labour Committee, Honourable Given Lubinda, in his presentation to the Jubilee Prayer Breakfast in the U.S. House of Representatives on October 16, 2007, alluded to the fact that "the US$23.8m savings from debt relief for my country is going into agricultural projects, eliminating of school fees and user fees in rural health care centres and to infrastructure development."

Zambia's historical challenges stemming from a huge external debt problem did not only deny the citizens of Zambia benefits from their resources but also substantially constrained governments' abilities to plan effectively and implement national plans. For example, in 1986, Zambia spent 86 percent of its export earnings on debt service and was left with only 14 percent percent to distribute to other sectors. This trend continued even with the onset of HIPC when in 1999 Zambia paid over three times of its combined budget for health, education, and social security in debt service.

With both HIPC and the subsequent Multilateral Debt Relief Initiative, Zambia's debt repayment has now come to an average of US$60–80 million per year as opposed to over US$300 before the attainment of HIPC completion point as well as entry into the MDRI initiative. These benefits are only party to a list of which the following is by no means exhaustive:

a. Irrevocable debt relief which totaled US$3.8bn under HIPC and over US$2bn under the MDRI.

b. Significant annual debt savings. The country will be saving annually about US$180 million or K500 billion in debt service.[1] At the time of reaching the completion point of the HIPC initiative, annual debt service was projected to fall below US$150mn per year at least up to 2020. Last year, 2007, foreign debt service was K244 billion (approximately US$65 million) against the pre-HIPC and pre-MDRI figure of US$373.2 million in 2004.[2] The amount of US$65 million (K244 billion) was about 2 percent of the budget while the pre-MDRI figure of K373.2 billion was 3.7 percent of the budget in 2006. These savings arising from debt relief under both the HIPC Initiative and MDRI are expected to assist the country in its development efforts so as to reduce the current levels of poverty by 50 percent by 2015.

c. Substantial reduction in the overall stock of external debt. Preliminary information indicates that the country's external debt stock stood at US$635 million as at end of December 2006, a reduction of 86.7 percent from the end of 2005 stock of US$4.5 billion.[3]

d. Increased policy space. Upon the attainment of HIPC completion point, primary rural education and health care were made free, enabling thousands of rural children and citizens to access free basic education and primary health care. It is worth stressing that of Zambia's 11.9 million, 65 percent are in rural areas. Preliminary reports from Zambia's Central Statistical Office indicate that

[1] Zambia's National Budget: 2006.
[2] Zambia's National Budget speech, 2007.
[3] Zambia's National Budget speech, 2007.

between 2004 and 2006 rural poverty increased by 2 percent to 80 percent while urban poverty reduced from 53 percent to 34 percent.

e. Increased focus on poverty through increased expenditures on social sectors like education and health. The two post HIPC/MDRI budgets for Zambia have showed some modest increases in social sector spending. For example, in 2005, social sector spending totaled 30 percent of the budget; this increased to 36 percent in the 2007 budget and subsequently over 37 percent in 2008. With increased focus on poverty, the remaining ingredient to halving poverty by the year 2015 is increased commitment and consolidated action from donors to meet their aid pledges to poverty reduction.

B. REMAINING CHALLENGES IN DEBT MANAGEMENT

The gains highlighted above are not without challenges. The challenges are both domestic and external and their resolution will not only depend on national reforms but also on the international communities' response to the post HIPC/MDRI challenges.

Macroeconomic Policies and Harmful Conditionalities

Zambia's macroeconomic indicators reveal that there has been steady growth recorded at an average of over 4 percent in the last 5 years, as opposed to GDP growth of 2.2 percent in the 4 years before the government embarked on a return to national planning induced by the Poverty Reduction Strategy Programme under HIPC. Inflation has also been below 10 percent in the last 2 years. While this favourable macroeconomic outlook is necessary for the improvement of economic and human development; in itself, it does not guarantee human development and poverty reduction.

In Zambia, the results of a stable macroeconomic outlook have not translated into direct benefits for communities. It is clear that striking the delicate balance and tradeoffs between macroeconomic stability and economic growth are ignored, while certain social priorities are subordinated. This is as a direct consequence of the policy prescriptions of International Finance Institutions whose impetus has always been built around macroeconomic reform rather than ensuring that social-economic progress is assured.

The meddling of IFIs into Zambia's governance structure originates from the 1970s when Zambia's economy was faced with both internal and external shocks relating to the fall of world copper prices and the simultaneous increase of oil prices. This gave rise to the IFIs advice commonly known as Structural Adjustment Programmes in the 1980s. SAPs aimed at reducing the role of the state in the economy by stabilizing and liberalising the economy including external trade and privatizing state-owned enterprises (World Bank 2002a, 3).

While SAP measures achieved macroeconomic stability, the GDP growth in the reform decade 1990–2000 was negligible, averaging 0.6 percent, while between 1991 and 1995 the economy contracted by 1.6 percent and external aid dependence increased. In 2002, 43 percent of the Government of the Republic of Zambia's (GRZ) annual budget was financed from external resources that included loans (Saasa 2006). Consequently, Zambia's external indebtedness rose from US$3.2 billion in 1980 to US$5.6 billion at the beginning of 1987. By 2000, it had skyrocketed to approximately US$7 billion. As the levels of Zambia's public debt rose, concurrently did the level of leverage of its creditors, especially the IFIs in determining Zambia's economic and social policies (White, 1999 in Chisala 2006).

The result of these policies are undoubtedly visible even in Zambia's current high levels of unemployment which the Central Statistical Office of Zambia indicate that employment between 2004 and 2006 continued to take a downward trend. The CSO 2006 preliminary report of living conditions states that "more people were employed in 2004 than in 2006, 54 percent and 43 percent respectively, while more people were classified as unpaid family workers in 2006 (12 percent) compared to 2004 (5 percent)."

Honourable Given Lubinda, the Zambian MP, in his speech to the Jubilee Prayer Breakfast, laments the current situation which is historically linked to the role IFIs play in low-income countries: "As though they were a panacea to the unsustainable debt that my country and other poor countries had accumulated creditor nations and the Breton Woods institutions imposed various conditions such as privatisation, wage freezes, downsizing of the civil service, introduction of user fees for primary health care and basic education, cancellation of government subsidies to water and sanitation and so on. As we have now come to acknowledge the results of these formulations have been reduced productivity, increased joblessness, deepened poverty and even heavier debt. Under these circumstances, the attainment of the most important United Nations Millennium Development Goals (MDGs) by countries such as my own will be a far cry."

The international community has come to realise the dangers of the inappropriate conditionalities based on flawed assumptions. Even the World Bank staff has admitted this fact. The admission by Edward Jaycox, the then-World Bank vice president in charge of the African region, is particularly insightful as it underscored not only the strategic role multilateral bodies such as the IMF played in Zambia's structural reforms but, more significantly, confirmed how the IMF's Zambian Programme was poorly handled: Writes Jaycox: "Zambia's was a terribly underfunded Programme. We overestimated copper revenue, overestimated aid flows, and did everything we could to paint a picture of an internally consistent financing plan based on the resources that we and others could bring to bear. If the case had been looked at more closely or more sceptically, the plan's lack of realism would have become apparent. A great number of shocks took place as the adjustment process went along: Copper prices went down or stayed at the same level when they were expected to go up; aid that was expected did not arrive; deals with the Paris Club that were normative were made less liberal when the aid was increased . . . In sum, the Zambian Programme was administered in a very chaotic way, and the chaos resulted in part from the inadequacy of financing and unrealistic financing projections." [4]

The consequences of the bad conditionalities Zambia needed to satisfy in order to attain completion point are still being reversed. A study on the Use of Conditionality by International Finance Institutions to encourage privatisation and liberalisation indicates the frustrations. "It is noteworthy that, in spite of the acknowledgements regarding the acceptability of IMF's Poverty Reduction and Growth Facility conditionalities, some level of frustration has been recorded at lower levels within the Government system itself. A senior economist at the Ministry of Finance and National Planning shortly before the country was put on a Staff Monitored Programme following its failure to meet PRGF fiscal targets in 2003, the response (below) is illustrative":

> Zambia is a case of a so-near-yet-so-far situation. We have complied with all the benchmarks and targets save for one on fiscal management and this has thrown the entire economic programme with creditors off course. The implications of this situation are obvious. Firstly, as a country we have forgone US$3.8 billion, which should have been knocked off our total debt stock had we reached the Completion Point this year. This essentially means that we still remain heavily indebted to the creditors. Secondly and more importantly, the amount of money required to successfully implement the PRSP has been drastically reduced meaning that some poverty reducing programmes have simply been shelved aside. For instance, this year's national budget allocation to the PRSP was K420 billion out of which Government has only managed to mobilize K110 billion. The balance in the national budget was to come from donors who have since imposed an aid freeze. Put differently, the PRSP is slowly being rendered irrelevant as it cannot be implemented and thus national development plans are at best inconsequential if they cannot be implemented or realized. [5]

The Minister of Finance, in June 2005 during a meeting with civil society groups and after the country attained the HIPIC Completion Point, is acknowledged that "creditors have substantial amount of control in the affairs of the nation when it comes to setting conditions on loans," but was quick to add that ". . . this can be avoided if Zambia reduced on borrowing." [6]

In the past 8 years a number of internal processes have taken place within the creditor community to respond to criticism on openness, accountability, and the power asymmetry. The responses of the IMF and World Bank are summarised in the figure below.

IMF and World Bank response to Conditionalities

- IMF:
  - Adopting the "new aid architecture": PRSP-alignment and donor coordination;
  - Reaffirming of IMF's role to address balance of payment problems;

[4] Jaycox, E., 1991, "Comments on Africa," in Thomas V. et al. (eds), "Restructuring Economies in Distress: Policy Reform and the World Bank," Oxford University Press, Oxford.

[5] Interview with Dr. Situmbeko Musokotwane, Deputy Secretary to the Cabinet, 20 October 2006.

[6] Jubilee-Zambia, National Conference Report on the theme "Beyond the HIPC Completion Point-Which Way Forward for Jubilee-Zambia," Conference held on 9 June 2005.

  - 2002 Guidelines on Conditionality.
- World Bank:
  - Adopting the "new aid architecture": PRSP-alignment and donor coordination;
  - Devising a selectivity approach to aid allocation;
  - 2005 Conditionality Review.

A study commissioned by the Norwegian Government in 2006 assessing "The World Bank's and the IMF's use of Conditionality to Encourage Privatization and Liberalization: Current Issues and Practices" in Bangladesh, Mozambique, Uganda, and Zambia also concludes that while the IFIs have embarked on some important reform, their stewardship role is still highly prevalent. These conclusions are summed in the figure below:

Do the IFIs adhere to their own guidelines?

- There is a stronger sense of national "ownership" of the programs, but this is reduced by:
  - Weaknesses in participatory processes;
  - Extensive dependence on IFIs and foreign consultants in elaboration of policies, and lack of local input;
  - Lack of "policy space" and analysis of policy alternatives; and
  - Lack of unified view within the government, frequently used by IFIs to promote their own cause.
- The IFIs are more flexible in their enforcement of conditionalities. Sometimes bilateral donors and civil society have demanded less flexibility.
- Donor coordination is strengthened, but this may reduce policy space and weaken borrowing member countries' bargaining power.
- Local IFI representatives show little in-depth knowledge of the World Bank's GPPs.

The same study also poses critical questions as to whether the IFIs (World Bank and IMF) still use Conditionalities to promote privatisation and liberalisation? The conclusion is that "though less common, these conditionalities are still prevalent."

Do the IFIs still use condionalities to promote privatization and liberalization?

- Privatization and liberalization are still included as conditionalities in World Bank and IMF loans, but are less common than before.
- The policy advice given by the IMF and the World Bank on privatization and liberalization has changed; a clear trend towards greater pragmatism and focus on complementary policies, but changes not uniform across cases and sectors.
- The IFIs exert considerable influence through providing policy advice, and have not generally elaborated alternative policies to those involving privatization and liberalization.

Of critical concern for countries like Zambia, is the role the IMF and the Bank have continued to play in stewarding the process of development. In illustrating this point, in his 2006 study on the Use of Conditionality by International Finance Institutions to encourage privatisation and liberalisation, Professor Saasa quotes a former Ministry senior official who at the time of the interview was Managing Director of Zambia National Commercial Bank, "There were times when we officials will . . . sit in the Minister's conference room [awaiting the Minister to join us] . . . Then he will come in the room accompanied by IMF officials and inform us the . . . already agreed position before we the officials] are given the opportunity to table the pertinent issues." [7]

In light of the above, the overbearing weight of the IMF and the World Bank in influencing the outcome of the PRGF negotiations as well as other development processes has been stressed by nearly all civil society organizations and this is said to have been caused by the restrictive dialogue approach to economic policymaking, generally.

[7] Personal interview with Mr. Likolo Ndalamei, Managing Director of ZNCB, Lusaka, 31 October 2006.

Weak International Response to the Problem of Vulture Funds

Zambia's post HIPC/MDRI debt situation is also challenged by the rise of "vulture funds."[8] Donegal International Limited, an incorporated company of Debt Advisory International LLC (DAI) of Washington area of the U.S. was the Vulture Fund that sued Zambia. It was registered in the British Virgin Island (BVI) on 18 December 1997. Donegal is owned and run by Mr. Michael Sheehan, a citizen of the United States. Donegal's major asset was its claim of over US$55 million against Zambia from a loan it bought from Romania at a cost of only US$3.3mn.

Though this was not the first case of a commercial creditor seeking super profits from a country striving to provide basic social services and put its citizens back onto the path of development, the international community was not impressed with the development. While CSOs did what they could to stop this injustice, the authorities with the ability to change the situation responded in ways that leave much to desire. The World Bank put in place a Debt Reduction Facility which assists poor countries to buy back such debts but not actually dealing with the real cause of the problem, which is the lack of regulation to control the activities of "vulture" creditors such as Donegal.

Jubilee-Zambia and partners opposed the directive which called on Zambia to pay Donegal US$15mn and also opposed the view point that Donegal should even make such a claim in the first place.

In a publication entitled "Vulture Funds and Debt Relief. The Immoral Tactics of Vulture Funds: The Case of Zambia"; Jubilee-Zambia and its partners state that:

Why is Jubilee-Zambia and Its Partners Opposed to This Claim?

- We feel it is immoral for Donegal to ask for a profit of several millions dollars (US$55 million) over and above the price (US$3.3 million) it paid for the debt from Romania.
- We feel debt repayments to Donegal International will upset Zambia's fiscal stability and ability to deliver public services. Our position is that Zambia cannot afford to lose millions of dollars as the country needs to address pressing poverty and development problems, which require immediate financial resources.
- We also feel and agree with Judge Smith of the London court that Mr. Sheehan and his agents did not act very honestly in the acquisition of this debt. As Jubilee movements, we are convinced that the purchase of the debt undermines and erodes the full intended benefits from debt relief arrangements initiated through the Highly Indebted Poor Country Initiative (HIPC) and the Multilateral Debt Relief Initiative (MDRI).

Additionally, this case has not only revealed the lack of an international mechanism to safeguard vulnerable countries against claims by rich companies but has also brought to the fore, weaknesses in international agreements. While debtors were bound to abide by every conditionality of the HIPC process, creditors were not bound by law not to cancel their debts.

Additionally, the HIPC process and the MDRI were only limited to bilateral and some multilateral creditors. The creditor community also includes commercial creditors such as Commercial Banks and Private investors including Donegal International whose main interest is profit at all costs, however, the debt cancellation initiative was left to the mercy of creditors to join such important pro-poor mechanisms. It is essential that a mechanism be developed to make debt relief all encompassing and mandatory.

The weaknesses of the HIPC process as a whole are evident by the lack of a binding agreement on the part of creditors to deliver their part of debt relief. According to the Ministry of Finance and National Planning (MoFNP), some creditors have not yet delivered their part of debt relief.

The amount of US$635 million reported in last year's budget (2006) was adjusted upward during the year. This adjustment was to reflect undelivered HIPC Initiative

[8] A "Vulture Fund" is a financial organization that specializes in buying securities which can be in the form of company shares, industries, and debts in distressed economic environments. These securities could be high yield bonds/shares in or near default and debts where debtors are struggling to pay. The goal of the vulture fund is to make profit by buying cheap debts of struggling companies and recently, heavily indebted third world countries facing debt repayment difficulties. These organizations work like circling vultures that patiently wait to pick up the remains of a rapidly weakening debtor and later claim huge interest repayments through litigation. According to Jubilee-U.K., currently, there were at least 40 lawsuits by "Vulture Funds" against poor countries by May 2007.

debt relief from some of the bilateral creditors with whom we have not yet reached agreement. Budget speech, 2008.

It is clear that bilateral creditors were not bound to deliver their part of the deal even when they required Zambia and other HIPC countries to adhere stringently to their austere conditions and those of the multilateral institutions.

Accountability Issues: What Government, Parliamentarians, and CSOs are doing

It is worth mentioning that there are commendable efforts to fight corruption and increase financial accountability. Since the inauguration of the current government in 2001, the President has embarked on the crusade against corruption to the extent that his predecessor has been relieved of his immunity to pave way for a free and fair trial in several cases of alleged corruption.

The Auditor General has also been meticulous in bringing out cases of misuse or misapplication of resources. For example, the lack of expenditure returns which was reported to be approximately US$1mn (K3,567,598,553) in 2005 was no longer the case in 2006. The 2006 report of the Auditor General only indicates that less than US$500,000 irregularly transferred. While these are regrettable occurrences and should not be inevitable, their magnitude is evidently reducing.

To assist in this area, the Jesuit Centre for Theological Reflection has developed a simple tool that can be utilised by local communities in assessing the efficacy of debt resources. This tool, called the Debt Resources Monitoring Manual, which the Jubilee-Zambia campaign members are using in five districts of four provinces will help clarify the following:

a. To what extent are both new and old loans benefiting the communities in Zambia;

b. Have the local communities been involved in the identification, design, and implementation of projects/programmes benefiting from loans or debt relief in their communities;

c. Are the programmes/projects under loans demand driven or supply driven; are they part of Zambia's development agenda;

d. What is the rationale, conditions, and requirements for the loans.

With this tool, we are confident that we will not only bring about early warning but we will also augment other processes and tools which seek to raise transparency and accountability in Zambia.

Zambia has also embarked on a number of standard international accountability systems and tools including operationalising the Public Expenditure Management and Financial Accountability (PEMFA), which includes the Integrated Financial Management Information System (IFMIS). During the fifth national development plan period, 2006–2010, the government will implement routine tracking studies and periodic and detailed Public Expenditure Reviews (PER). The FNDP states "Public Expenditure Tracking Surveys will be developed and implemented."

While recognising that the work of the Auditor General is extensive, the release of the report 1 year after the period in review does not rid it of worries around the possibility of recovering what has been lost and of course like in many places prosecution on defaulters has either tarried or nonexistence. Therefore the need for early warning cannot be ignored. Therefore the work of the JCTR-hosted Jubilee-Zambia campaign on monitoring of debt resources is extremely essential.

CSOs in Zambia have also been actively engaged with Parliamentarians to ensure that the oversight role of Parliament in the loan contraction process in the future is made constitutional through the proposals for a Debt Management bill. Members of Parliament, particularly those in Reforms and Modernisation Committee, the Estimates of Budget Committee, and the Committee on Economic Affairs have been making significant efforts to introduce the following pieces of legislation:

a. The Budget Act to provide for a transparent and participatory budget preparation process, the development of medium- and long-term development plans indicating corresponding sources of income and submission to relevant committee of Parliament of anticipated revenues and expenditures for the year prior to submission of the final estimates to Parliament.

b. The Government Borrowing Act to provide for a transparent loan contraction process and to provide Parliament to authorise any borrowing after considering the source of the loan, the extent of the total indebtedness by way of principal and interest, provisions made for repayment of the loan and its intended utilisation.

c. Access to Information Act whose aim is to give every citizen the right to information held by the state and to compel the state to publicise any important information affecting the welfare of the nation.

d. The Code of Conduct of Public Officers legislation to address conflicts of interest for public officers and for declaration of incomes, assets, and liabilities by specified public officers.

e. The Budget Monitoring Framework to provide for the setting up of a unit involving Civil Society Organisations and other interest groups to monitor the implementation of poverty reduction programmes financed by the national budget.

C. THE NEED FOR LEGISLATION

Debt cancellation should be expanded to all countries that it need to meet the Millennium Development Goals. In doing so, it is necessary to ensure that:

a. Mechanisms to provide debt relief are expanded in order to provide space for all low-income countries to reorient their priorities toward national sustainable development rather than external debt service.

b. The International community's responses to the problem of low-income countries' debt are secured from incessant litigations and claims made by creditor institutions/companies which have chosen to free-ride by claiming their part of debt repayments while others have provided debt cancellation.

c. Gains made by debt cancellation are not eroded due to poor or weak institutions, and there must be accountability, greater transparency and effectiveness.

d. Interference of external institutions is circumscribed only to necessary areas such as those listed above.

To do the above, legislative actions are necessary. It is therefore essential that such proposals as the Jubilee Act which encompass all these are put in place.

In Zambia, the Jesuit Centre for Theological Reflection has already come up with similar proposals which are meant to increase parliamentary oversight in the contraction and management of loans. This proposal will also be discussed between the JCTR and the parliamentary committee for Economic and Labour Affairs on April 28, 2008. The Zambian community is also becoming aware of the proposed legislation through the activities of the JCTR-hosted campaign, Jubilee-Zambia. Government intentions in the 2008 budget are "to consolidate the legal framework governing the contraction and management of debt."

With the Jubilee Act and the Debt Management bill in place in the United States and in Zambia respectively, it is clear that coresponsibility envisaged in the Monterrey consensus is possible and this can herald many such processes. The Monterrey consensus in 2002 declared, "Debtors and creditors must share the responsibility for preventing and resolving unsustainable debt situations." Here lies the challenge: Generating the political will to ensure both expanded debt cancellation and responsible lending and borrowing practices in the future.

LETTER FROM DAVID H. MCCORMICK, UNDER SECRETARY FOR INTERNATIONAL AFFAIRS, DEPARTMENT OF THE TREASURY, TO REPRESENTATIVES BARNEY FRANK AND SPENCER BACHUS

WASHINGTON, DC, *April 2, 2008.*

Hon. BARNEY FRANK,
Chairman, Committee on Financial Services,
U.S. House of Representative, Washington, DC.

DEAR MR. CHAIRMAN: I am writing regarding H.R. 2634 "Jubilee Act for Responsible Lending and Expanded Debt Cancellation of 2007," scheduled to be marked up by the House Committee on Financial Services.

This Administration has provided strong international leadership on debt relief for the world's most heavily indebted poor countries. Building on the work of the previous Administration and with strong congressional support, we have deepened and broadened the Enhanced Heavily Indebted Poor Countries (HIPC) debt reduction initiative. This Administration then initiated, largely designed, and negotiated the Multilateral Debt Relief Initiative (MDRI) and the recent agreement in the Inter-American Development Bank for 100 percent debt relief for heavily-indebted poor countries. These initiatives combined are providing over $100 billion in debt reduction to 32 countries, and there are another 8 countries that could eventually become eligible. In addition, to avoid repeating the "lend and forgive" cycle, this Administration led the efforts in the multilateral development banks to switch to grants for the poorest countries. For instance, in 2001, IDA provided less than one percent of its resources in grants to the poorest countries (IDA-only)—today it is over 40 percent. The Administration has also worked to put in place an internationally agreed debt sustainability framework to help guide future lending.

The goals of the proposed Jubilee Act are laudable, but we think the consequences of such a bill are problematic and the Administration does not support it. While there are a number of problems with the bill, let me note four.

The countries to be covered by the Jubilee Act are managing their debt, and some of the countries that would be covered by this bill are now actively working towards expanded access to international capital markets. Providing debt relief to countries that can service their debt sends the wrong message, and undermines efforts to assist countries in developing sound debt management practices that will allow them to transition gradually toward access to private capital markets.

Any debt relief should be conditioned on the adoption of policies that promote sound economic practices, or it could easily be seen as throwing "good money after bad," though in this case the money has not gone "bad." Policy conditionality is important and often necessary to ensure that debt relief is used in a manner that will promote economic growth and provide real benefits to the poor.

The budget impact of such a program would be significant, and would require trade-offs that could affect key foreign policy priorities. The Treasury Department estimates that the budget cost to forgive the $2.5 billion in nominal debt (including loan guarantees) owed to the United States by non-HIPCs would be approximately $1 billion. (This cost estimate assumes that all IDA countries qualified in FY 2008 and would change depending on the year each country qualified for debt relief.) These countries also owe the World Bank and IMF over $32 billion in nominal debt, in addition to other bilateral and multilateral debts. While the bill calls for international financial institutions (IFIs) to fund debt relief from internal resources, the availability of such resources is very likely to be limited, as recently demonstrated by the donor funding for the Multilateral Debt Relief Initiative (MDRI), as well as by the financial engineering that was required to make Liberia debt relief work. Therefore, the U.S. would need to be prepared to make a significant contribution, at the expense of other development assistance.

Finally, the Responsible Lending Framework described by the bill could hinder access by poor countries to private capital. The bill calls for the creation of a binding international legal framework for lending by all multilateral, bilateral, and private creditors. While we recognize the goals underlying such a framework—to encourage sustainable lending and borrowing levels—the prospects for such an agreement are doubtful. Given the wide range of international creditors, creation would be very difficult and enforcement would be nearly impossible. Finally, the threat of sanctions from such a framework will likely discourage legitimate creditors from lending to poor countries, further reducing these countries' access to financial markets.

My staff is ready to go into much more detail on these issues with your staff, but I believe that one other obvious problem should be highlighted. The United States is far from making good on its current commitments to the current debt reduction initiatives—that help the poorest, most heavily indebted countries. We find ignoring this reality to be a serious flaw in this bill.

The Office of Management and Budget advises that from the standpoint of the Administration's program, there is no objection to the submission of this letter.

Thank you for your consideration of these issues. I look forward to a continued dialogue and to working with Congress to develop the best possible policies in this area.

Sincerely,

DAVID H. MCCORMICK,
Under Secretary for International Affairs.

DEPARTMENT OF THE TREASURY,
Washington, DC, April 2, 2008.

Hon. SPENCER BACHUS,
Ranking Member, Committee on Financial Services,
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Any debt relief should be conditioned on the adoption of policies that promote sound economic practices, or it could easily be seen as throwing "good money after bad," though in this case the money has not gone "bad." Policy conditionality is important and often necessary to ensure that debt relief is used in a manner that will promote economic growth and provide real benefits to the poor.

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The Office of Management and Budget advises that from the standpoint of the Administration's program, there is no objection to the submission of this letter.

Thank you for your consideration of these issues. I look forward to a continued dialogue and to working with Congress to develop the best possible policies in this area.

Sincerely,

DAVID H. MCCORMICK,
Under Secretary for International Affairs.

RESPONSE OF DR. NANCY BIRDSALL TO QUESTION SUBMITTED BY SENATOR LUGAR

Question. Your testimony provides clear suggestions to improve the Jubilee Debt Relief Act which is before this committee. Are there additional accountability, anticorruption and democracy conditions that should be considered as well?

Answer. The standards used for HIPC completion (including an IMF program or equivalent) should apply equally to any new debt reduction for all IDA-eligible countries. It would be reasonable for the bill to call for Treasury, or another agency such at the GAO or World Bank, to assess the application of those standards in the past, and propose any improvements in their application given experience in the last decade, particularly with respect to corruption, financial management, budget transparency and so on. (A standard on democracy would best be framed in terms of transparency, rule of law, public access to information.) Such an assessment could compare the existing HIPC program standards to the Millennium Challenge Corporation standards for eligibility, for example.

The addition of an insurance-style facility which I recommended in my testimony has the following advantage: In contrast to a one-time, upfront debt writeoff, it creates a healthy incentive for countries to maintain eligibility for benefits from it into the future, while allowing for reasonable new borrowing, including from the IMF and the multilateral banks.

RESPONSE OF GERALD FLOOD TO QUESTION SUBMITTED BY SENATOR LUGAR

Question. Could you please provide additional examples of the tangible benefits to poor countries of debt relief? Would we have seen the same improvements in those poor countries if debt relief had not occurred?

Answer. The following are additional examples of how debt relief is benefiting poor countries:

COUNTRY EXAMPLES

Tanzania

When Tanzania reached its completion point under the Heavily Indebted Poor Countries Initiative (HIPC) in 2001, it received debt stock relief totaling $3 billion. Former President Benjamin Mkapa explained what this meant to his country in a letter to the Jubilee Debt Campaign in 2004: “When I became President of Tanzania in 1995, our country was witnessing a serious deterioration of basic services, and a high and unsustainable debt burden. One of my first priorities was to reverse these trends by increasing government revenue and seeking debt relief . . .” He said that when HIPC debt relief was received in 2001,

> [It]enabl[ed] us to increase resources for poverty reduction by 130 per cent. We have already witnessed tremendous successes. The primary school population has increased by 66 per cent—the greater part of an extra 2 million children—and the shortfall in the enrolment of girls has been eliminated. We have built 45,000 classrooms, 1,925 new primary schools and over 7,500 homes for teachers in partnership with their communities; between 2000 and 2004, we recruited 37,261 new teachers, and retrained another 14,852. The pass rate in the Leaving Examination doubled in 2 years.
>
> Much has been attained in other sectors as well. For instance, hospitals are being rehabilitated and refitted with diagnostic equipment; the previous shortage of basic drugs is now history; and the rate of immunization has reached 83 percent. We are now introducing the hepatitis vaccine and this will save 20,000–25,000 lives annually.

(Tanzania received an additional $3.7 billion in debt cancellation in 2006 under the Multilateral Debt Relief Initiative—MDRI.)

Niger

Niger, located in the Sahel region of sub-Saharan Africa, is one of the poorest countries in the world. It began receiving HIPC debt relief in 2001, reached its completion point in 2004 and received MDRI debt cancellation in 2006. The following is an excerpt from “Debt Relief Yields Results in Niger” by Emilio Sacerdoti and Philippe Callier, IMF African Department, January 25, 2008:

> In the landlocked Western African country of Niger, lower debt service, together with continued significant budgetary aid and higher domestic revenue mobilization, is having an impact on spending in education, health, and the rural sector, where budgetary allocations increased by 4 percent of GDP between 2002 and 2007.
>
> The debt stock was reduced through the [HIPC and MDRI] from 76 percent of GDP at end-2002 to 14 percent at end-2006, or by the equivalent of $1.3 billion. . . . Debt cancellation yielded a drop in debt service of about 2 percent of GDP between 2003 and 2006. . . .
>
> The higher spending associated with debt relief has resulted in progress in improving key social indicators, which are among the weakest in Africa.

The country is finally moving up in the rankings of the U.N. Human Development Index.

- The infant mortality rate dropped from 156 deaths per 1,000 births in 1997 to 81 per 1,000 in 2006. Under-5 mortality is still among the highest in Africa.
- The primary school completion rate improved from 16 percent in 1997 to 28 percent in 2005. Overall primary school enrollment is among Africa's lowest.
- Access to potable water increased from 40 percent in 1996 to 69 percent in 2005.

Thus, while Niger still has a long way to go to emerge from extreme poverty, debt relief is helping to launch the country and its people toward a brighter future.

Zambia

The case of Zambia illustrates the importance of debt relief to a country facing severe fiscal constraints. Zambia had a difficult road to the completion point. When I looked into the problem in 2004, I found that the completion point was apparently being held up in large part because pressures to increase salaries led to an overshooting of the wage bill target agreed with the IMF. I noted that the World Bank had recently examined the wage bill problem as part of a comprehensive review of public expenditure management. It found that:

> [L]ow remuneration in the public sector is a major factor contributing to the problem of poor productivity, motivation, and recruitment and retention. At a time when government is seeking efficiency improvements, in part by reducing the size of the civil service, there exist significant staff shortages in a wide range of professional and technical jobs owing to poor pay compared to that available in the private sector and within regional labor markets. . . .
>
> The problem of low pay . . . notwithstanding, the wage bill in Zambia has remained large relative to overall government expenditures, thereby crowding-out operational expenditures. The challenge for Zambia is therefore how to design and implement a pay reform strategy that is consistent with the macroeconomic goal of containing the size of the wage bill (as a proportion of GDP).

The World Bank report outlined a broad strategy for addressing the issue, but the challenge was an enormous one—how to make wages sufficiently remunerative to attract as well as retain qualified staff while at the same time minimizing the cost. It was difficult to see how it could be dealt with effectively except, at best, over the medium term. In the meantime, Zambia continued to be plagued by a severe fiscal constraint, attributable in large measure to its heavy debt service obligations. According to the IMF and World Bank, Zambia's debt service in 2004 was expected to reach an extremely high 31 percent of government revenues. It was a kind of catch-22 situation. Zambia badly needed the fiscal space that debt relief would provide, but because fiscal pressures were so great, it had difficulty meeting the IMF fiscal target that would have made it eligible to receive debt relief.

Eventually, in April 2005, Zambia satisfied the conditions for reaching the HIPC completion point, and a year later it became eligible for MDRI debt cancellation. Debt cancellation under the two programs totaled more than $6.5 billion. Fiscal relief was at hand at last, and the World Bank reports that a significant number of new teachers and health workers were hired in 2005 and 2006.

Moreover, in April 2006, just after qualifying for MDRI cancellation, the Zambian Government abolished "user fees" in all rural health clinics in Zambia. This meant that while costs previously may have deterred the poorest from coming into health clinics, care was now free. This was particularly important for a country facing one of the world's most severe HIV/AIDS pandemics. Early last year, Neil Watkins, National Coordinator of Jubilee USA Network, led a delegation of a dozen Jubilee USA supporters to Zambia. In Neil's own words:

> On our first day in Zambia, we drove south of the capital, Lusaka, to a town called Siavonga, to witness the impact of debt relief. After a long, bumpy ride through the Zambian countryside, we arrived at the Siavonga Rural Health Clinic. As we toured the clinic, Grace Chibanda, a pharmacist, showed us the pharmacy, which was full of antiretroviral drugs for HIV/AIDS. "Debt relief is a good thing," Grace told us. "It is getting medicines for people who didn't have it before." Nurses and doctors we talked with confirmed that they had seen an increase in patients since April. It was in-

spiring to see the impact of debt relief firsthand and to know that debt relief is improving the lives of many Zambians in need.

TRANSPARENCY AND PARTICIPATION

A facet of the HIPC program that often does not get much attention is that it became a vehicle for establishing transparent and participatory processes for allocating and monitoring the use of debt relief savings, and in some cases for allocating and monitoring poverty-oriented budgetary resources more broadly. Debt campaigners, locally and internationally, had always stressed the importance of such processes in assuring that the funds would, in fact, benefit the poor. In my written testimony I mentioned the case of Cameroon, where a broad-based HIPC funding committee overcame political opposition to allocate debt-relief savings to a path-breaking program for uniting sustainable forestry with rural community development throughout the country. Another example is:

Malawi

Several years ago local civil society organizations came together to form a federation called the Malawi Economic Justice Network (MEJN). Once HIPC funds were granted, they worked closely with the Parliamentary Budget and Finance Committee to identify 12 key categories of priority poverty expenditures in the budget. They persuaded the Malawi Ministry of Finance to produce periodic expenditure figures for each of these categories and worked with the Parliamentary Budget and Finance Committee to monitor the allocation of funds to the relevant line ministries.

The MEJN formed subgroups to monitor the delivery of services in different parts of the country. They selected dozens of local districts and provided training to local leaders in the use of questionnaires to discover, for example, whether clinics had medicines, schools had books, and teachers were trained. The information was compiled and analyzed by experts, and the findings were publicized. The survey results were shared first with communities, then with the government, donors, and other stakeholders. As of 2004 (when I examined this case) the monitoring exercise was having an impact. For example, the national budget was revised, e.g., to shift allocations from nonpriority items (foreign travel, expenditures of the office of President, etc.) to priority poverty programs. The Ministry of Education was using the findings in its own planning, and Parliament was using them to question the line ministries.

The broader point in the Malawi and Cameroon examples is that the procedures instituted with the HIPC debt relief program appear to be making a contribution to the strengthening of democratic processes in a number of countries where historically weak governance has often led to serious neglect of the needs of the large majority of very poor and vulnerable citizens.

THE ECONOMIC IMPACT

Another noteworthy effect of HIPC and MDRI debt relief that is often overlooked is its impact on the overall economy of the beneficiary countries. As Dr. Nancy Birdsall, President of the Center for Global Development, observed during her testimony before the committee, "[T]he increased fiscal space due to debt relief (along with faster growth and recent stability in HIPC countries) has clearly played a role in helping low-income countries sustain sound economic programs, by permitting reductions in fiscal deficits and accumulation in some cases of reserves." In a 2003 IMF Working Paper entitled "External Debt, Public Investment and Growth in Low-Income Countries," the authors conclude that the substantial reduction in the stock of external debt projected for highly indebted poor countries (HIPCs) would directly increase per capita income growth by about 1 percentage point per annum. While 1 percent may not seem high, its significance increases when one takes into account that most of the HIPC countries are in sub-Saharan Africa, and according to the World Bank, GDP growth per capita in these countries during 1995–2005 was 1.88 percent. (It should also be noted that the Working Paper did not take into account—because it did not exist—the major additional debt stock reduction provided by the MDRI.)

Another interesting and potentially highly significant development is reported in a recent edition of the IMF Survey Magazine. According to an article entitled "Africa's Improved Debt Outlook Sparks Investor Interest,"

> Strengthened macroeconomic fundamentals and lower debt levels following debt relief from the IMF and other international institutions have increased the attractiveness of low-income African countries to a broader universe of investors. A larger group of bilateral lenders is now active in Africa, with creditors outside the traditional OECD-based donor community initiating or expanding their operations in the continent.

Private investors have also stepped up their lending markedly. In the past year, two sub-Saharan African (SSA) countries have issued international bonds and in at least eight, a significant share of domestic securities are held by foreign investors.

Reflecting these trends, more than a dozen SSA economies are now the subject of an international credit rating. Although immature, some African stock markets are also starting to take off.

This new investor interest is a promising development, but it also presents major challenges. It places a special premium on both strong debt management by African governments and responsible lending by the new creditors (a topic addressed in S. 2166). Otherwise, the benefits of the HIPC and MDRI programs may prove ephemeral as countries fall back into unsustainable debt. It is in the interest of all parties to make sure that this does not happen, and that the new investor interest will translate into opportunities for a substantial number of African countries to move beyond exclusive reliance on traditional aid donors to a new level where they can tap diverse sources and types of financing on a sustainable basis for critical investment needs.

RESPONSES OF DR. PETER HENRY TO QUESTIONS SUBMITTED FOR THE RECORD BY SENATOR RICHARD LUGAR

Question. You noted many concerns with debt relief. If debt relief has not been as effective as expected, can anything be done to structure debt relief so that it truly helps to reduce poverty?

Answer. If the goal is to reduce poverty, then debt relief is not an efficient tool to achieve that end. As I outline in my testimony, holding debt service constant and increasing the flow of foreign assistance to anything approximating the quantities that we have promised to deliver time and again would provide a much more effective way of reducing poverty. See my answer to your next question for ways to improve the allocation of foreign assistance.

Question. From your perspective, what are the most effective economic policy and foreign assistance tools to help countries fight poverty? If we had one additional dollar foreign assistance available, how would you specifically recommend it be spent?

Answer. Much has been made of the fact that foreign assistance has not helped promote economic growth and development in poor countries. This should come as no surprise, because much of our foreign assistance was given with no such intent. Aid that we grant for political reasons, or tied-aid that requires the recipient to buy goods from U.S. corporations, irrespective of the appropriateness of those goods for the recipient country, cannot be expected to promote development.

The aid that we grant through multilateral organizations such as the International Development Association arm of the World Bank has a better record than our direct foreign assistance, but the results have still been disappointing.

This does not mean that all is lost. A large body of research that uses randomized trials (a technique similar to the way medical researchers test the effectiveness of new drugs) to evaluate the effectiveness of antipoverty programs, points to a potentially promising path for the use of foreign assistance. Surveying the results of this research, Professor Abihijt Banerjee of MIT identifies several areas where foreign assistance can be put to use efficiently: Education, Provision of Vitamin Supplements, HIV Prevention, Spraying for Malaria, Fertilizer, and Vaccination.

In his survey, Professor Banerjee identifies specific micro level programs that were successful in each of these areas in various countries. He also estimates the cost of scaling up such interventions from the micro level to include all low-income developing countries.

Based on my read of the evidence, if we had one additional aid dollar to spend, I would recommend that we give it as a cash transfer to a mother in a poor country in return for vaccinating her children and sending them to school.

RESPONSES OF ASSISTANT SECRETARY CLAY LOWERY TO QUESTIONS SUBMITTED FOR THE RECORD BY SENATOR RICHARD LUGAR

Question. How has debt relief been important from a U.S. foreign policy perspective?

Answer. Economic development and poverty reduction are important foreign policy priorities not only for the direct benefits they provide, but also to reduce the desperation and radicalism that poverty can breed. As President George W. Bush stated on March 22, 2002, “We fight against poverty because hope is an answer to terror. We fight against poverty because opportunity is a fundamental right to human dignity. We fight against poverty because faith requires it and conscience demands it. We fight against poverty with a growing conviction that major progress is within our reach.” Further, as the 2006 National Security Strategy of the United States notes, “America’s national interests and moral values drive us in the same direction: To assist the world’s poor citizens and least developed nations and help integrate them into the global economy.”

When external debt levels become so high that they interfere with a country’s basic economic sustainability, as was the case with the countries eligible for the HIPC initiative, they can become a major obstacle to achieving these goals, and therefore need to be reduced. Debt relief can be a valuable tool to help the poorest, most heavily indebted countries reestablish a sound economic footing and reengage with the international community, thereby supporting their efforts to lift people out of poverty. For countries with unsustainable debts, the prospect of debt relief, particularly when provided in a coordinated fashion by all external creditors on comparable terms such as under the HIPC initiative, can also create an important incentive for governments to consult with their citizens and make the reforms necessary to sustain growth. However, while debt relief is a valuable tool in these cases, it must also be balanced against other policy instruments, such as direct development assistance. In countries where debts are sustainable, other development tools can offer a more immediate, targeted method to encourage economic growth, support poverty reduction, and achieve U.S. goals.

Question. Have the current debt relief programs, HIPC and MDRI, hurt the ability of the development banks to finance projects in the poorest countries?

Answer. Although the financing for debt relief initiatives has been slightly different at each development bank, implementation of HIPC and MDRI debt relief at the development banks has generally been financed through a combination of increased bilateral donor contributions and limited use of the institutions’ net income and internal resources. One example of these donor contributions is that donors have agreed to offset, dollar for dollar, the cost of MDRI debt relief at the World Bank and the African Development Bank.

As a result of these financing arrangements, including increased donor contributions, debt relief under HIPC and MDRI has not caused a decrease in the overall financing levels provided by the development banks for projects in the poorest countries. In the long term, the ability of the development banks to provide debt relief without reducing their overall level of financing for the poorest countries will largely depend on donor countries successfully meeting their funding commitments to these institutions. In FY 2008, we anticipate the U.S. Government will have over $870 million in arrears to the multilateral development banks, including $385 million to the World Bank’s IDA alone. Our budget request this year for payment of arrears to the multilateral development banks is specifically targeted at fulfilling our commitment to MDRI and our annual commitment to IDA.

Question. Did HIPC and MDRI include adequate accountability and anticorruption mechanisms? If Congress moves forward with Jubilee debt relief, what accountability and anticorruption requirements should be included in the legislation?

Answer. In our view, HIPC and MDRI include adequate accountability and anticorruption mechanisms. In order to qualify for debt relief under these programs, the country must develop a strategy for poverty reduction and a prudent economic plan. The international financial institutions and donors work with the country to lay out a course for improved performance and accountability at the beginning of the program.

When the country qualifies for HIPC, it begins to receive interim debt relief. However, in order to receive full HIPC debt cancellation, the country must demonstrate satisfactory performance over time in carrying out its poverty reduction strategy and economic reform program, including satisfying a number of country-specific requirements for improvements in areas such as fiscal management, anticorruption measures, and improved social programs. Since debt relief under MDRI is nearly always conditioned on successful completion of the HIPC process, the accountability and anticorruption mechanisms included in HIPC also apply to MDRI.

The Senate Jubilee bill (S. 2166) includes provisions that require eligible countries to develop and implement effective policy reforms to ensure that savings from debt cancellation are redirected to poverty reduction efforts, and requires that the beneficiary government produce an annual report detailing how debt relief savings were used. The inclusion of these requirements is a positive element of the bill. However, the accountability and anticorruption requirements in the Jubilee bill (S. 2166) are not as extensive as the requirements included in the HIPC legislation. For reference, the relevant standards for the HIPC Initiative are found in Public Law 106–113, Appendix E, Title V (1999).

Question. The International Monetary Fund has recently suggested selling a significant portion of its own gold reserves to fund operating expenses. Could some of this gold be used to fund additional debt relief as well?

Answer. The sale of IMF gold requires an 85-percent majority vote in the IMF Board. The IMF Board supported a sale of gold, as recommended by the Crockett Committee, strictly limited to the 12.9 million ounces to fund an endowment for operating expenses.

We believe there would be little support in the IMF Board for gold sales to finance the additional debt relief called for in the Jubilee bill, since there appears to be very limited support in the IMF Board as well as among G–7 governments for the proposals contained in the bill. In addition, compared to other institutions, debt to the IMF represents only a small portion of the total debt of the Jubilee countries. Even if there were backing in the IMF Board to sell IMF gold to finance forgiveness of the IMF's loans to these countries, the Fund's membership would not support IMF gold sales to finance debt reduction at other institutions. Finally, while the IMF Board agreed to a limited gold sale, selling IMF gold to fund debt relief at other institutions would require a very large gold sale that could disrupt gold markets and harm the poorest gold producing countries. Therefore, we see very little chance that such a sale could gain the support it would need in the IMF Board.

Question. You mentioned Bangladesh during the question and answer portion of the hearing. Is it true that the Government of Bangladesh is sending debt repayments to the United States Government that are close to the amount that the U.S. provides Bangladesh in foreign assistance? Could you please provide the committee with the amount that Bangladesh is now repaying the U.S. (including Public Law 480 debt repayments) and the amount that the U.S. is giving Bangladesh?

Answer. In 2006 (the most recent year for which complete data is currently available), the United States disbursed $77.67 million in gross official development assistance for Bangladesh. During that same period, Bangladesh paid $51.5 million to the United States Government in debt repayments. Currently, all of Bangladesh's outstanding official bilateral debts to the United States are low-interest rate, concessional Public Law 480 debts owed to the U.S. Department of Agriculture.

Question. On the second panel, Dr. Henry noted that the G–8 has repeatedly committed to providing 0.7 percent of GDP in foreign assistance. Is this correct? If so, was the U.S. party to such a commitment?

Answer. The G–8 has not committed to providing 0.7 percent of GDP in foreign assistance, and the U.S. is not party to such a commitment in the G–8 or elsewhere.

While many countries use this target, the 0.7-percent target bears no relationship to the ability of partners to use aid effectively. The United States strongly endorses continued efforts to increase aid effectiveness, and is a signatory to the 2005 Paris Declaration on Aid Effectiveness.

○