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Debt Relief from a Donor Perspective: The Case of the Netherlands

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The Netherlands recognised relatively early that the debts of the international financial institutions (IFIs) were a heavy burden on developing countries. Loans from the IFIs were not only part of the solution, but also part of the problem. Out of the 1.6 billion Euros that the Netherlands spent on debt relief between 1990 and 1999, an increasing share was spent on multilateral debts. Multilateral debt relief included contributions to the "Fifth Dimension" of IDA (providing funds to repay earlier non-concessional IBRD loans to enable IDA-only countries to repay past IBRD loans), to Multilateral Debt Funds under supervision of the debtor country from which multilateral debt service was paid, and more recently to the HIPC Trust Fund.

From 1995 on, the Dutch government also played an active role in promoting the creation of the Enhanced HIPC Initiative in 1999. The Dutch Minister for Development Cooperation supported, for

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[1] This chapter is largely based on an evaluation of debt relief carried out for the Policy and Operations Evaluation Department (IOB) of the Ministry of Foreign Affairs of the Netherlands. The text draws heavily on the second synthesis report of that study, *Results of International Debt Relief* (IOB, 2003), written by the author, but also on the first synthesis report, *Dutch Debt Relief Policy* (IOB, 2002, only available in Dutch), written by Dick van der Hoek, IOB Inspector and responsible for the overall study.

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example, the Jubilee 2000 activities for putting pressure on the G-7 meeting in Cologne, where the principal decision in favour of Enhanced HIPC Initiative was made (IOB, 2002). Once the Enhanced HIPC Initiative had been approved in the Annual Board Meetings of the World Bank and the IMF in September 1999, the Dutch officials expressed themselves firmly in favour of the Initiative. The Netherlands immediately began providing resources to the HIPC Trust Fund managed by the World Bank, and urged other donors to do the same. The Dutch view was that multilateral debt relief and debt relief from the IMF should be financed as much from bilateral contributions as possible, in order to not reduce the IFIs' lending capacity for the poorest countries. Furthermore, these contributions should be in addition to the regular foreign aid flows from bilateral donors. By August 2001, the Netherlands was the biggest contributor to the HIPC Trust Fund in terms of actual disbursements, bypassing much larger countries like the US, Japan and the UK (IOB, 2002).

The Dutch government also strongly supported the conditions for the HIPC Initiative. It expected that the requirement of elaborating a PRSP with participation of civil society would bring an end to the traditional form of policy conditionality by the IFIs, leading to more "ownership" of the receiving country. In addition, it would enhance participation and democracy, and favour increased donor coordination in aid. PRSPs also became the leading device for Dutch bilateral development cooperation policy in general.

In sum, the Netherlands embraced the HIPC Initiative as an ideal solution to the debt problems of the poor countries, and appears to be the ideal donor in relation to this HIPC Initiative. This chapter aims to add some question-marks to each of these statements. It brings to the fore some problematic aspects of the HIPC Initiative, aspects related to the international decisionmaking processes on debt and debt relief and to the financing of debt relief, in particular: (i) the role of donors and creditors in perpetuating debt problems by providing (the means for) new loans, thus raising the question of the coherence of debt relief policies; (ii) the lack of additionality of debt relief; and (iii) the problematic consequences of setting conditions for debt relief.

These three issues are discussed in the following sections, and where possible illustrated for the case of the Netherlands. Whether debt relief is additional to other aid flows may vary from donor to donor, and therefore this is examined extensively for the Netherlands. The last section summarises the changes that should be made around HIPC debt relief and around aid in general.

The analysis in this chapter is largely based on an evaluation of debt relief carried out for the Policy and Operations Evaluation Department (IOB) of the Ministry of Foreign Affairs of the Netherlands. This evaluation comprised a study of Dutch debt relief policies, a literature review and econometric study, and eight country studies: Bolivia, Jamaica, Mozambique, Nicaragua, Peru, Tanzania, Uganda and Zambia, out of which three were field studies (Mozambique, Nicaragua and Tanzania).

1 The Role of Donors in Perpetuating Debt Problems

One of the characteristics of current debt problems of the poorest countries is that they have persisted for such a long time, despite successive rounds of debt relief. Today's heavily indebted poor countries have, on average, experienced low growth rates in the past 20 years, and they still need more debt relief. Two different conclusions can be drawn: (i) some argue that the international community has done far too little in alleviating the debt burden of poor countries, giving them debt relief just sufficient to enable them to pay their primary creditors, but not enough to allow their economies to grow, let alone to reduce poverty (Hanlon, 2000; Sachs, 2002); (ii) others conclude that too much relief has already been given, and that more debt relief is likely to perpetuate bad policies (Easterly, 2002).

Thus, the primary question is whether the HIPC Initiative will be no more than just another round of rescheduling, unable to end the debt burden and stop low growth in poor countries, either because it delivers too little debt relief or because it delivers debt relief leading to a continuation of bad policies. Many authors (also in this book) have already pointed to the optimistic GDP and export growth projections in the Debt Sustainability Analyses (DSAs) made for HIPC countries at decision point, which suggest that future debt sustainability is unlikely. But much less attention has been given to the numerator of the debt sustainability ratios, in other words, the creditor side of the loan relationships. All DSAs project large amounts of new loans. Although these loans are expected to be mostly concessional (that is, on soft conditions), the past ten to fifteen years have shown that this is no guarantee for the ability to repay these debts.

The IOB evaluation of the results of international debt relief efforts in the 1990s has shown that the volume of new loans to the eight countries involved in the study exceeded debt forgiveness during the 1990s. Eighty per cent of the new loans to governments originated from the international financial institutions.[2] The share of multilateral debts in total debts increased during the 1990s, and since multilateral creditors are preferred creditors, the actual debt service paid did not decrease. The large volume of new loans was one of the reasons for the limited effectiveness of debt relief. Long-run debt sustainability analysis shows that continuation of the trends of the 1990s with respect to new loans and export growth will quickly make debts unsustainable again (IOB, 2003).

Why was there so much new lending to these countries during the 1990s? The most general reason is that the international community apparently posed the wrong diagnosis of the debt problems in the early 1990s. It acted as if countries had a temporary liquidity problem. The response to a temporary liquidity problem was to grant debt reschedulings and to extend new loans and grants, so that countries could grow out of their debt problems. However, these countries in fact had a solvency problem.

This wrong diagnosis was very much related to the fact that the creditors were official governments and multilateral agencies, and not private institutions. During the 1980s, the debt crisis was primarily a problem of private creditors, mainly big US and European banks. They began to withdraw from the debtor countries, no longer providing them with new money and writing down on the old loans. Yet, and partly due to large incoming official flows, they managed to get large flows of debt service out of these countries (Dooley, 1994). Official creditors, on the other hand, never wrote down on their dubious loans. There are no agencies enforcing them to do so, so both the bilateral export credit agencies (ECAs) and the multilateral institutions always maintained the fiction that they would receive the full value of their claims. Since the IFIs are preferred creditors, they indeed received most of their debt service in time, but these were often paid for from bilateral

2 Only in Nicaragua this figure was lower, at about 60 percent.

grants to these countries. While during the 1980s official creditors bailed out private creditors, during the 1990s and especially in low-income countries, bilateral creditors and donors bailed out multilateral creditors. This implies that the IFIs experienced moral hazard. They could continue their imprudent lending behaviour much longer than if they had had to suffer the consequences of non-repayment themselves.

The bailing-out of the IFIs, thus allowing moral hazard, is only one of the ways in which bilateral donors helped to maintain this flow of new loans and, as a consequence, the debt problems. The bilateral donors also made these loans possible. In fact, bilateral donors and creditors paid in three different ways for the concessional loans of the IFIs. First, they contributed to the special funds of the IFIs that provide the interest subsidies or other means to make these concessional loans possible. Bilateral donors like the Netherlands spend part of their development grants as contributions to the ESAF Trust Fund of the IMF, to the IDA Replenishment Fund and to similar funds of the regional multilateral development banks, such as the Fund for Special Operations of the IADB. Second, the preferential status of the IFI loans reduced the value of bilateral debt claims, making more bilateral debt relief necessary than otherwise would be the case. Third, bilateral donors provided debtor countries with programme aid or even direct debt relief on multilateral debt service so that these countries can pay the multilateral creditors.[3] This is not an efficient use of aid money. Although most bilateral donors themselves only provide grants to these heavily indebted countries, they perpetuate debt problems indirectly through these three mechanisms. In a way, they throw "good money" after "bad money".

Over the course of the 1990s, Dutch contributions to the IDA Replenishment Fund amounted to 1.6 billion euros (IOB, 2002, p. 112), or about equal the entire amount of Dutch debt relief in the same period. The Netherlands also contributed substantially to the subsidy account of the Enhanced Structural Adjustment Facility (ESAF) of the IMF. With the creation of the original HIPC Initiative in 1996, and since debt relief granted by the IMF had to be financed partly from this Trust, its name was changed into an ESAF-HIPC Trust in 1996, and later into the PRGF-HIPC Trust. In 1996,

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3 In the context of the HIPC Initiative, they contribute to the HIPC Trust Fund.

the Dutch Minister of Finance announced another large contribution to this Trust, making the Netherlands the largest donor. In 1999, when the Enhanced HIPC Initiative was launched, the Netherlands immediately became the biggest contributor to the HIPC Trust Fund of the World Bank – at least, in terms of actual disbursements. The Netherlands had disbursed $138 million, plus $34 million through the European Union (IOB, 2002, p. 111). The US had disbursed $122 million, Canada 114 and the UK 90 million.

Will these debt dynamics change with the HIPC Initiative? At first glance, there is a change. With the HIPC Initiative, the IFIs bear part of the costs of debt relief for the first time. Further consideration of the financing of debt relief on multilateral debt, however, reveals that bilateral contributions are still essential. As regards the World Bank, IBRD profits only provide for $2.15 billion of the expected total costs of $8.1 billion. The remaining $5.95 billion will have to be met from bilateral contributions in the framework of the 14th IDA Replenishment, planned for 2005 (IMF and IDA, 2002b). If that additional money is not forthcoming, debt relief will be at the expense of new World Bank loans to the poorest countries.[4] So far, bilateral donors have pledged more than $2.5 billion to the HIPC Trust Fund, but that money is used to finance debt relief for other multilateral development banks.

The costs of the HIPC Initiative for the IMF are estimated at $2.7 billion (SDR 2.2 billion), a large part of which will have to be met from the IMF's own resources. At first, the IMF planned to sell part of its gold reserves for the purpose, but the major gold-producing countries objected to this. The IMF then proceeded to 'off-market' gold sales, meaning that a quantity of gold is to be sold symbolically and then bought back in the framework of a transaction with a member state. This 'paper' sale and repurchase of gold enables its book value to be upgraded. The investment income on the proceeds of this upgrading, to the amount of SDR 1.8 billion, is then used for the HIPC Initiative. The disadvantage of using the bookkeeping profit of symbolic gold sales is that a slightly larger part of IMF's capital becomes illiquid (Felgenhauer, 2000), thus reducing the basis for future loans. To restore this lending capacity,

4 If the funds do become available, it will probably be at the expense of bilateral grants (see the remarks on additionality in the next section).

the IMF would have to appeal to its shareholders, i.e. the bilateral donors.

Given that bilateral donors are expected to finance part of the relief given on IFI debts, moral hazard can continue. It is already clear that multilateral institutions continue to provide new loans to countries that have reached their decision point of the HIPC Initiative. Although these loans are concessional and have a grace period of 10 years (World Bank and other development banks) or five years (IMF), they will eventually increase debt service. If problems should re-appear regarding debt sustainability, and debtor countries are again unable to pay off their debts, it is likely that the multilateral institutions will again be preferred creditors and that bilateral donors once again will have to step in with relief on multilateral debt service.[5]

In sum, the success of the HIPC Initiative requires that the volume of new loans from the IFIs be reduced. A simple measure is to have the multilateral development banks extend only grants to these poor and heavily indebted countries, as the Meltzer commission has proposed for IDA (International Financial Institution Advisory Commission, 2000). Another measure to stop the IMF from long-term lending to poor countries, is to abolish the PRGF. This has also been proposed by the Meltzer commission, on the very justifiable grounds that these poor countries do not suffer from temporary liquidity or balance of payments problems, which was the original rationale for IMF borrowing. There are more reasons for abolishing the PRGF, and these will be discussed below.

2 The Lack of Additionality

Debt relief provided under the HIPC Initiative was meant to be additional to regular aid flows, so that debtor countries would experience an increase in net transfers. The HIPC Review of the Operations Evaluation Department (OED) of the World Bank, however, showed that net transfers to all HIPC countries between 1995 and 2000 were lower than between 1990 and 1995 (OED,

[5] In two out of the four countries that had reached their completion points under the HIPC Initiative in 2000 and 2001, debt-to-export ratios had again become unsustainable in 2002 (IMF and IDA, 2002a).

2003, p. 53). The decline was even greater for all developing countries, indicating that there has been some redistribution from non-HIPC to HIPC countries in the second half of the 1990s, within a declining total aid budget. This redistribution seems to have continued in recent years: after 1998, the 26 HIPC countries that have reached their decision points in the HIPC Initiative, have experienced an increase of their relative share in total net transfers to developing countries (OED, 2003, p. 54). Nevertheless, these 26 countries received a smaller net transfer in 2000 than had been anticipated in the decision point documents.

Although the lack of additionality of HIPC debt relief is a cause for concern, it should be put in perspective and should not lead to the conclusion that the HIPC Initiative is not effective. I will argue, first, that there may be more additionality than the figures on aggregate net resource flows indicate. Second, even if there would be no additionality of debt relief, debt relief may have positive effects on the recipient countries. And third, even if debt relief to HIPC countries leads to a declining aid flow to other, less indebted countries, the effect on those less indebted countries may ultimately be positive. I first elaborate on these three issues and then look at the additionality of Dutch debt relief, in particular.

The first issue is that additionality may be greater than if we just look at the developments in net resource flows. What matters for the additionality issue is what would have happened to aid volumes in the absence of debt relief. In all eight countries of the IOB evaluation, debt relief of the 1990s was found to be additional to regular aid flows in the 1990s (IOB, 2003). As the OED review also observed, one reason may be that there has have been a redistribution of net flows from countries with low debts to countries with high debts (see also below). Another reason is that debt relief is not financed from aid budgets and there are two possibilities here.

First, creditors that were no longer donors, such as Russia or some OPEC countries, granted a large amount of debt relief. Debtor countries were usually not paying on these debts since they were not getting new resources from these creditors. The only way for the creditors to see at least part of their money back, was to substantially reduce the debt stocks. These debt stock reductions are not included in the OED data on net resource flows, thus reducing registered debt relief.

Second, creditors that are still donors may provide part of debt relief from budgets other than their aid budgets. There are again two possibilities here. Some modalities of debt relief do not qualify as net Official Development Assistance (ODA) according to the definition of the Development Assistance Committee (DAC),[6] and are by definition additional. The other possibility is that debt relief does qualify as ODA, but that institutional arrangements within donor countries imply that it is financed from other budgets than the aid budget. In this case, debt relief is also additional since the net ODA flow from the donor country is larger than if only the foreign aid budget would be taken into account. This may be different from country to country and we therefore examine the additionality of debt relief for the case of the Netherlands in the next section.

The second issue is that debt relief may also have a positive influence on economic growth and, ultimately, poverty reduction for other reasons than its effect on the reduction of the debt service flow. Most publications only pay attention to a possible "flow effect" of debt relief. However, the reduction in the debt stock may also be important. A lower debt stock may lift the "debt overhang" that hampers private investment and may also prevent good government policies. Debt relief on a debt that was unpaid before is not leading to additional resources, but may be very positive if it reduces the debt overhang. This argument has recently also been brought forward by Birdsall and Williamson (Birdsall and Williamson, 2002).

Third, there is the issue of the redistribution between recipient countries. To the extent that debt relief is financed from aid budgets and does substitute for other ODA flows, this may imply redistribution from countries with low debts to countries with higher debts. This appears to have been the case in the 1990s (Birdsall *et al.*, 2001; OED, 2003). To the extent that countries with higher debt levels had less adequate policies and governance – and the OED Review establishes this to be the case, using the "Country Policy and Institutional Assessment" measure of the World Bank – this points to adverse selection in the aid allocation: Countries with better policies and governance get less aid. However, rather than being concerned that a HIPC Initiative does not bring additional resources to the highly indebted poor countries, one could see this

[6] DAC is the Development Assistance Committee of the OECD, the Organisation for Economic Cooperation and Development.

particular lack of additionality at the country level also as a positive feature of the Initiative. In other words, even if all debt relief would be financed from aid budgets so that there is no aggregate additionality, it could still be beneficial for the less indebted countries if it brings an end to this adverse selection. Once the debt levels have been lowered, there is no longer any reason for the international community to support these highly indebted countries more than other countries. These other countries may suffer temporarily, but they may ultimately benefit. However, this pleads for granting debt relief in a once-and-for-all fashion. Since the financing of multilateral debt relief has not been secured yet, this is difficult to achieve in the current situation. According to current HIPC arrangements, that extend multilateral debt relief over fifteen to twenty years, this may reduce aid flows to other countries for a long period.

3 The Financing of Debt Relief in the Netherlands

The Netherlands has been active in alleviating all types of debt in developing countries: bilateral, multilateral and private. Debt relief on multilateral debt, via takeovers of debt service to the IFIs or via contributions to the HIPC Trust Fund of the World Bank, is included in the definition of ODA and has always been financed from the aid budget. The same holds for debt relief on private debts of developing countries, in particular the contributions to the World Bank "Debt Relief Facility" that financed debt buybacks of private debts. In these two cases there is no additionality. Yet, debt relief on private debts has been effective in decreasing debt stocks and in reducing the debt overhang of developing countries.

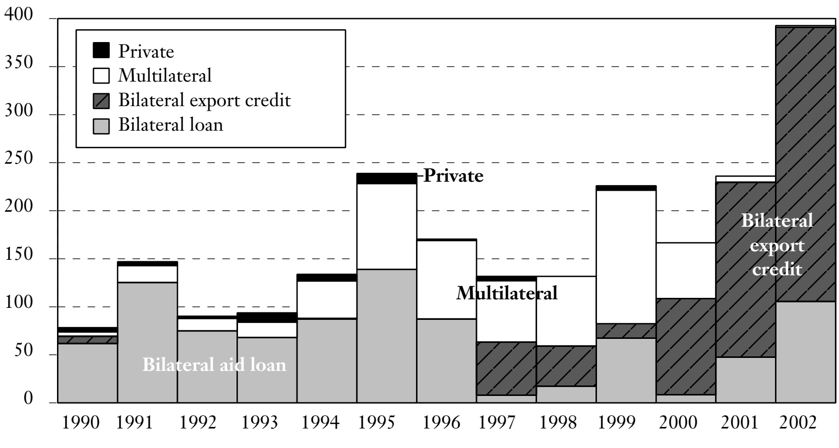
The case of relief on bilateral debt is more complicated. There are two types of bilateral debt: debts following from bilateral aid loans, and debts following from the state insurance of export deliveries from donor countries dealt with by export credit agencies (ECAs). With respect to alleviating the latter, the Netherlands followed international agreements in the Paris Club, the informal group of creditors dealing collectively with bilateral debts of developing countries. With respect to the former, the Netherlands has often gone beyond the agreements in the Paris Club.

Until 1997, the classification of what was aid in the Netherlands had no relationship with the international ODA definitions. In 1997, however, the institutional environment of Dutch aid policies changed drastically. The size of the Dutch aid budget became fixed as 0.8 percent of GNP and became fully linked to the official ODA definition. This change had substantial consequences for the amount of aid available apart from debt relief, i.e. for the additionality issue.

Dutch Export Credits

Until 1997, the forgiveness on export credits as agreed upon in the Paris Club (33 percent and later higher percentages of debt service due in a certain period) was financed from general budget resources,[7] and not from the budget for development cooperation – in spite of the fact that it classifies as ODA. This means that this debt relief, amounting to about 180 million Euros, was fully additional. After 1997, this forgiveness on commercial credits was financed from aid budgets, precisely because this modality of debt relief classifies as ODA and as a result of the changed determination of the Dutch aid budget.

Figure 1 Dutch Debt Relief Financed from the Aid Budget, by Type of Debt, 1990-2002
(millions of current euros)



Source: IOB Database debt relief, extended up to 2002.

[7] With a small exception in 1990, as can be seen in Figure 1. See IOB, 2002.

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Figure 1 shows that the amounts of debt relief for export credits became substantial from 1997 onwards. In the years 2000-2002, when the Enhanced HIPC Initiative began to be implemented, the volume exploded, leading to an all-time high of total debt relief in 2002. This means that much less money became available for regular aid.

The Dutch case raises the question to what extent the DAC is right in classifying all relief on export credits as ODA. Most debts began to be restructured in the 1980s or early 1990s. The part of debt service due that was not forgiven was rescheduled and capitalised so that it maintained its real value. However, the Dutch export credit agency, NCM, had to compensate the insured Dutch firm immediately for the full value of both the forgiven and the rescheduled parts of debt service due, and the Ministry of Finance in turn had to compensate the NCM. Given that the Netherlands had and still has a cash budget, this implies that debt relief has already been registered as expenditure. Nevertheless, the Dutch state maintained the full claim on the developing country for the rescheduled part of debt service due; there was no writing down or writing off – in spite of the fact that it could be foreseen at the time that the debtor country would never be able to repay the debt fully.

With the HIPC Initiative, creditor countries finally recognise that debts will not be repaid, and Paris Club creditors agreed to forgive about 90 percent of the remaining bilateral debt stocks. However, a large part of these debt stocks consists of earlier rescheduled and capitalised debt service due. In the Dutch case, this implies that at least part of the "debt relief" that is now granted just implies a compensation of the Dutch Ministry of Finance for expenses made a long time ago, namely when it had to compensate the NCM.

The IOB evaluation also brought to the fore that the Ministry of Finance even charges the aid budget for more than the amount paid to the NCM in the past (IOB, 2002). This is, first, because the bill includes the own risk of the exporting firms that the NCM never had to pay to the involved firms. Second, the Ministry of Finance does not subtract the insurance premiums paid to NCM by those firms from the amount charged to the aid budget. The bill presented by the Ministry of Finance includes the full nominal value of the debt – since that appears to be allowed by the DAC definition of ODA. These two issues in particular have raised a lot of attention in

Dutch press and in Parliament. In response, the government wrote a letter to the DAC asking for clarification of the ODA definition on this point. In the expectation of a reply from the DAC, members of parliament have not pushed the government yet to make an end to this hollowing out of the aid budget on the basis of what could be considered a weird application of the DAC definition.[8] More in general, one can wonder whether debt relief should be classified as ODA if it concerns debts that, in the absence of debt relief, should have been written down a long time ago, namely, when it was clear that it would never be paid fully. Birdsall and Williamson have also made this argument (2002). Furthermore, and more fundamentally, one can question whether the Ministry of Finance should bail out the NCM in the first place. As Jubilee Netherlands has pointed out time and again, this bailing-out is in contradiction with an EU directive which states that all national export credit agencies (ECAs) should be self-supporting. This directive obviously aims to avoid unfair competition between firms from different European countries, and implies that ECAs should finance their unrecoverable claims from the premiums received and not from government (aid) budgets.

Bilateral Aid Loans

With respect to the Dutch relief on bilateral aid loans, the situation is almost the reverse since this forgiveness is treated differently in the DAC definition of ODA. The forgiveness of interest on aid loans classifies as net ODA. The forgiveness of amortisation on aid loans classifies as *gross* ODA, but there has to be an imaginary compensating flow so that registered *net* ODA is not increased. Otherwise, the same aid loan would be registered as ODA twice: first when the original concessional loan is extended, and then when it is forgiven. However, in the absence of this forgiveness and assuming the debt service would be paid, there would be an amortisation flow from debtor to creditor so that net ODA would be lower. Therefore, net ODA is higher with debt relief than without, *if* the amortisation due would be paid (Renard and Cassimon, 2000). In sum, forgiveness on both interest and on amortisation lead to

[8] In November 2003, a parliamentary motion to ask the government to end this practice of including own risks and premiums, has been kept on hold.

higher registered net ODA as compared to the case in which this debt service would have been paid. Conversely, if debt service would *not* have been paid in the absence of relief, this debt relief does *not* increase registered net ODA. This appears to be fully correct. The DAC definition of ODA, however, does not mention the case of forgiveness on principals, i.e. debt stocks that are not yet due. This means this forgiveness is *not* counted as ODA. If and to the extent that one assumes that donors forgive these principals only if they do not expect to be repaid, this accounting is consistent with the rules on forgiveness of debt service due.

In the Netherlands, until 1997 all forms of relief on bilateral debt were financed from the aid budget, despite the fact that part of it does not classify as ODA. The latter holds, in particular, for forgiveness on principals. After 1997, the forgiveness of remaining stocks of aid loans shrunk to almost zero, because paying this from the aid budget would have reduced the budget to below the fixed norm of 0.8 percent GNP. Forgiveness of debt service on aid loans continued after 1997.[9] Yet, the share of forgiveness on aid loans decreased as of 1997 (Figure 1).

In the context of the HIPC Initiative, creditor countries have promised to forgive 90 percent of remaining stocks of bilateral aid loans. The Dutch Minister for Development Cooperation has announced the intention to grant forgiveness on the full stock of bilateral aid loans in these HIPC countries. For some countries (the – so far – nineteen countries that have a special status within Dutch development cooperation), this is done at decision point; for the other HIPCs, this is done at completion point. Since this stock forgiveness does not classify as ODA, the costs involved are financed from the general budget, and this debt relief has thus become additional to regular aid. This debt relief is not included in Figure 1, but the amounts are much smaller than the amounts involved in forgiveness on export credits. Many aid loans had already been forgiven before 1999.

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[9] In practice, the annual development cooperation budget of 0.8 percent GNP is topped up by the amortisation payments due. If these payments are forgiven, these amounts are not forthcoming and the actual budget remains at the 0.8 percent. According to the DAC rules, gross ODA is then increased by the forgiven amortisation amounts and this is corrected by a counteracting flow so that in the end net ODA is again equal to 0.8 percent of GNP.

The – generous – Dutch contributions to the HIPC Trust Fund have been presented by the Dutch government as “additional” to regular aid flows and as helping to guarantee additionality of multilateral debt relief. The – then – Dutch Minister for Development Cooperation even urged other bilateral donors to also make their contributions to the HIPC Initiative “additional”. However, since the Dutch contributions have been financed from the aid budget, they can only be called additional by changing the usual definition of that concept. In practice, the Dutch government defended its position by pointing to the growing aid budget during those years (1999-2001) since it was fixed as 0.8 percent of GNP, and GNP was growing. However, contributions to the HIPC Trust Fund have reduced the amount of aid that would have been available for other destinations in the absence of these contributions. This policy probably contributed to the observed redistribution of flows among recipient countries from low-debt countries to high-debt countries. In addition, this policy implies a redistribution of flows between donors, in the form of a re-allocation of aid money from the bilateral channel to the multilateral channel. The Dutch effort to guarantee “additionality” of debt relief of the IFIs in fact boils down to maintaining the regular lending volume of the IFIs while reducing the bilateral grant volume. This is another way in which donors contribute to the maintenance of debt problems and does not seem to be an appropriate use of aid money.

In sum, it is important that official creditors are also forced to write down and eventually write off their bad loans, and that the costs involved should not be charged to aid budgets. The case of the Netherlands shows that this could be achieved by changing the ODA definition: debt relief on export credits of countries that are suffering from debt problems already for a long time, evidenced in series of debt reschedulings, should not be registered as ODA. These debts should be written down at the moment that countries are unable to pay and can be expected not to pay the full value of their debt service due.

4 Adverse Effects of Conditionality

The last problematic issue of the HIPC Initiative is its conditionality. Before the HIPC Initiative, the most important condition for debt relief was that there should be an agreement with the IMF regarding structural adjustment. The original HIPC Initiative required countries to have successfully completed an IMF programme for three years in order to reach the decision point, and to do so for another three years to reach the completion point. Basically, the first HIPC Initiative evaluated past performance. With the Enhanced HIPC Initiative, however, an additional condition was set for reaching the decision point. Countries had to elaborate a strategy for reducing poverty (Poverty Reduction Strategy Paper, PRSP) and had to do so with civil society participation. Furthermore, countries must begin to implement the strategy in the "interim period" (between the decision and completion points of the HIPC Initiative), to be evidenced by Progress Reports, so that the international community can be sure that debt relief given in this period is used to implement the PRSP. The interim period is no longer fixed at three years, but became "floating", depending on the country meeting the conditions for it. Apart from implementing the PRSP, the country must also execute a number of more conventional reforms and must be on track with an IMF agreement. The conditions for debt relief are thus more comprehensive than in the 1990s and also far more elaborate than those of the original HIPC framework.

Strangely enough, in roughly the same period, broad consensus was reached in academic circles (Collier *et al.*, 1997; Killick, 1998) that it was useless to draw up conditions ex ante because they were ineffective. Governments generally implement policies only if they had already intended to do so. The broad acceptance of the increased ex ante conditionality for the Enhanced HIPC Initiative can therefore be considered as inconsistent with this academic consensus. In fact, policymakers also broadly accepted the ineffectiveness of policy conditions. The case of the Netherlands illustrates this.

In 1998, the Dutch Minister for Development Cooperation embraced the Assessing Aid Report of the World Bank (World Bank, 1998), which was another study concluding that ex ante policy conditionality was ineffective. The report became the basis for a far-reaching change in bilateral aid policy. From then on, Dutch bilateral aid would be focused on those countries that had demonstrated to be able to carry out good policies and to maintain good governance in the past. Aid would thus become more selective.

Despite this, the Dutch government welcomed the requirement of a PRSP and its accompanying required participatory processes as additional ex ante condition for the Enhanced HIPC Initiative. Not long after that, PRSPs even became the basis for Dutch bilateral development cooperation in general.

Basically, there are three arguments against setting conditions for debt relief to the poorest countries. A first and important reason is that debt relief does not always provide additional resources to the recipient countries. On top of the substitution for regular aid that may be involved, even debt relief itself does not always free resources as compared with the situation without debt relief. If debt relief concerns debts that were not paid before, the country does not receive additional money. As the IOB evaluation concludes, a large part of relief from the Paris Club in the past concerned debt service that would not have been paid in the absence of this relief (IOB, 2003). This may still hold for part of the Paris Club relief under the Enhanced HIPC Initiative.

The HIPC Initiative may even lead to increased debt service actually paid to particular creditors, for example, if because of the comprehensiveness of the Initiative creditors must now be paid that were not paid before, or if bilateral grants to take over debt service to the IFIs are no longer forthcoming (and not replaced by budget support). Debt service may also increase due to the particular scheduling of multilateral debt service. The HIPC relief on multilateral debts is computed as a fixed percentage of debt service due; if debt service due increases, for example because the loan volume from development banks increased ten years before,[10] the debt service that must annually be paid also increases.

In all of these cases, debt relief does not free resources and the requirement to "spend" these resources for poverty reduction policies may imply higher government expenditure and a higher deficit, possibly (depending on how the deficit is financed) provoking higher inflation, or may be at the cost of other government expenditure. This may also occur in countries that have expended little on the social sectors so far (Berthelemy, 2001). The

[10] Soft loans from multilateral banks have a ten-year grace period, so debt service payments begin after that period. In Nicaragua, for example, loans from the IFIs were vetoed by the US between 1983 and 1990, and their volume almost annually increased since 1990. This implies that debt service due increases almost every year during 2000-2010.

HIPC Initiative forces such countries to spend more on social projects from their tax income, possibly at the risk of a greater deficit or at the cost of expenditure that would have had more effect on economic growth.

A second reason is that setting conditions for debt relief could be termed bad donor governance since it implies the “double tying” of aid[11] – a practice that has been condemned by donors in the context of the Special Programme of Assistance to Africa (SPA). In the case of debt relief, conditions are first set for the original (aid) loan, either in the form of policy conditions but more likely in the form of particular projects to be carried out, or of particular goods to be purchased from the donor country. Recipient countries are then unable to repay these loans. This points to donors and creditors having made the wrong lending decision: their expectations may have been too optimistic or perhaps they recommended inappropriate destinations (projects or supplies) for the use of this money. Instead of accepting their incorrect expectations or mistakes and taking their losses, donors and creditors now pose new conditions to the relief on these same loans. This is double tying of the same aid money, and can therefore be termed bad donor practice. Even worse, there is no guarantee that the mistakes of the past will be avoided: are donors sure that conditions will have beneficial effects this time?

The third argument against conditions for debt relief is that the setting of conditions to aid in general is ineffective, as already discussed above. Furthermore, the setting of conditions for debt relief may even have perverse effects. Earlier research demonstrated that two factors are responsible for the fact that setting conditions has little effect. One is that governments are not likely to carry out policies if they are not convinced themselves that these are the right policies, and second is that the donors seldom impose real sanctions on lack of performance. These two factors probably still hold for the PRSP process.

As for the first, it has been shown that domestic political factors are most important in determining government policies (Dollar and

11 Double tying means that donors set conditions for the same amount of aid money twice. For example, a donor provides foreign exchange with which the country must purchase donor countries’ export goods. The recipient government must sell these goods in the local market, and the donor then requires that the proceeds in local currency be used for particular projects.

Svensson, 1998). If countries are under severe pressure to reach an agreement with IMF and World Bank, for example because of a high debt, conditions may be implemented but often only cosmetically or partially, or additional measures may be taken to undo the effects of these earlier measures, for example, by granting many exemptions to trade liberalisation. The Enhanced HIPC Initiative required governments to elaborate a PRSP and to do so with participation of civil society. The idea was that countries would write and own their own strategies. For this reason, PRSPs would only have to be "endorsed" by staffs of the IFIs, not "approved". In practice, however, recipient countries did not observe any difference in endorsement and approval. The three field studies carried out for the IOB evaluation showed that the fact that strategies had to be approved detracted from their degree of ownership, and also reduced the chances for real participation (IOB, 2003). NGOs in the three investigated countries felt that they had not been given a real chance to influence the strategy, and that they had not had much actual influence. In Mozambique, NGOs maintained that they were not really interested in influencing the strategy because it was also in their interest that the country would qualify for the Enhanced HIPC Initiative as soon as possible. Without country ownership, it is also less likely that strategies will be implemented. In two out of the three countries examined, differences were observed between what the government set out to do in the PRSP, and what the government actually did (IOB, 2003).

The second cause for the ineffectiveness of policy conditions according to earlier research is that actual sanctions are seldom imposed. They are not applied because of the conflicting interests of individual donors, who have an interest in continuing the aid relationship, or they have little effect because donors do not act collectively. The HIPC Initiative guarantees greater donor co-ordination, but it still seems difficult to impose sanctions that are effective. Partly owing to pressure brought to bear by international NGOs such as Jubilee 2000 and EURODAD, it is in the interest of the international community that many countries should be admitted to the HIPC Initiative. In December 2000 in particular, this led to the approval of PRSPs that did not really deserve it, or to the admission of countries that could only stay on track with the IMF with the aid of numerous artificial waivers. Later, in Nicaragua for example, the full PRSP was approved due to the political interests of one or two donors, although the donor community as a whole considered the government in power to be corrupt and not interested in the reduction of poverty (Dijkstra and Evans, 2003).

Therefore, although in theory the setting of conditions guarantees that countries receiving debt relief will "use" it to combat poverty, in practice this is not certain. Furthermore, as long as debt relief remains tied to policy conditions, it is unlikely that donors will apply greater selectivity. Debt relief is in itself so necessary and inevitable that even countries where corruption is rife, those with poor policies, and those where genuine participation does not exist, have received it or will eventually do so. Highly indebted countries will also continue to receive more aid than others do. Because countries are highly indebted, the cycle of debt relief, aid and new loans will continue, also in countries with bad policies and bad governance. Such adverse selection will only be put to an end if debt relief is no longer tied to conditions. Donors can then start to be really selective in the allocation of new foreign aid disbursements.[12]

The IMF plays a crucial role in maintaining this adverse selection. As a creditor, the IMF has an interest in reaching a new agreement with these countries. A new PRGF agreement brings a small new IMF loan, but more importantly, frees the way for debt relief and for other and much larger multilateral and bilateral programme aid, with which earlier IMF loans can be paid. The IMF is therefore at the same time gatekeeper for international finance, and beneficiary of such finance (White and Dijkstra, 2003). This implies that there is a conflict of interest. This conflict maintains the adverse selection in the aid allocation. Donors look at the IMF for giving a stamp of approval on countries that are performing well and thus deserve programme aid (debt relief and budget support), while the Fund is least likely to bring this selectivity into practice. This is another reason for proposing that the IMF no longer provides long-term concessional finance to poor countries.

[12] Donors can of course still support the poor people in these countries with bad policies and bad governance, but they will no longer support the governments of these countries.

5 Conclusions

This chapter has analysed three problematic aspects of the HIPC Initiative: the fact that donors continue to extend large amounts of loans, thereby perpetuating debt problems, the limited additionality of debt relief, and the conditionality associated with the HIPC Initiative. The first two imply that debt problems are not likely to be solved by the Initiative, the third implies that adverse selection in the aid allocation is likely to continue.

All of this points to a need to change international decision-making around the HIPC Initiative and around aid in general. In the preceding pages, some recommendations for changes have been made. These include:

- All IDA loans should become grants;
- The IMF should no longer provide long-term finance to the poorest countries;
- A mechanism must be created to ensure that official creditors, just like commercial creditors, write down on bad loans;
- The writing down on bad loans should not be charged to aid budgets;
- The debt relief on export credit debts that should long have been written off, no longer counts as ODA – in line with the DAC definition of ODA in the case of debt relief on bilateral aid loans;
- Debt relief to the poorest countries should be given without policy conditions.

Given that chances for success of the HIPC Initiative are grim as a result of the problems analysed in this chapter, we hope that donors and creditors begin to consider these possible changes seriously.

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