

# **Resource Rich BWIs, 100% Debt**

## **Cancellation and the MDGs**

By

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## **Abstract**

The Millennium Development Goals – a set of time bound targets aimed at reducing poverty & hunger and increasing human development - adopted by the UN general assembly in 2000, are now accepted as guiding principles by most major donor agencies. This paper highlights the costs of reaching these targets-with an emphasis on Malawi, Mozambique, Tanzania and Uganda. It then goes on to estimate the resource gap faced by these countries and shows how total debt cancellation is necessary but not sufficient to plug this gap.

Even the partial debt cancellation promised under the Highly Indebted Poor Countries (HIPC) Initiative is being rendered less effective due to the violation of the central concept of equal burden sharing amongst creditors; the International Monetary Fund (IMF) and the World Bank have refused to contribute their fair share by pleading poverty. In response to calls for additional debt cancellation, they say that any further use of their resources for this purpose would seriously endanger their financial soundness and sustainability. This paper uses rigorous financial analysis to show how both the IMF and the World Bank have ample resources to cancel all the HIPC debt owed to them - hence contribute to the achievement of the MDGs - without compromising their own operations. We also show how the Bank and the Fund can go beyond just debt cancellation and finance higher grants out of their resources.

The paper also seeks to interpret the arguments presented here in the context of the findings of the evaluation of international debt relief by the Operations Evaluation Department (IOB) of the Dutch Ministry of Foreign Affairs. In fact three of the four countries studied in detail here are also used as case studies in the IOB report; so the findings of this paper have an added relevance.

## **Executive Summary**

*This paper makes the case for higher levels of debt cancellation and grant (aid) flows for the Heavily Indebted Poor Countries (HIPCs) and shows how some of the additional resources needed for this can be mobilized by multilateral financial institutions such as the IMF and the World Bank. The paper is in three parts:*

***Part A** uses Malawi, Mozambique, Tanzania and Uganda as case studies to highlight that both additional debt cancellation and higher grant (aid) flows are needed by the HIPCs in order to meet the MDGs; **Part B** shows how the World Bank and the IMF have ample resources not just to finance further debt relief but also to increase grant aid; **Part C** links the findings of Parts A and B to the results of the evaluation of International Debt Relief carried out by the Policy and Operations Evaluation Department (IOB) of the Dutch Ministry of Foreign Affairs*

### **Part A**

The United Nations, the World Bank and the New Economics Foundation have all estimated that massive additional resources (\$45-\$75 billion every year till 2015) are needed globally in order to meet the Millennium Development Goals. This paper takes an in-depth look at Malawi, Mozambique, Tanzania and Uganda – all HIPC countries in Sub Saharan Africa - and finds that they need a total of about \$72 billion between 2000 and 2015. Of this, they can only raise \$12 billion domestically and depend on external sources for the rest.

The international community has rallied behind the Millennium Development Goals, and has widely accepted that debt-servicing capacity should be assessed relative to the country's need for achieving the goals. However, despite this, these four countries will be paying more than \$3 billion in debt service – 25% of the total domestic resources available to spend on meeting the MDGs. So instead of funding basic needs such as health and education, the HIPCs are forced to divert scarce resources for the repayment of debts.

We show that total debt cancellation for HIPCs would release precious resources to fight poverty, hunger and disease. It would also demonstrate that both developed countries and multilateral institutions such as the IMF and the World Bank are fully committed to helping HIPCs meet the MDGs.

However this is by no means enough; it would still leave a resource gap of more than \$57 billion. It is expected that less than half - \$27 billion will be financed by grant flows. The balance \$30 billion would need to be financed through additional grants, concessional loans or through market loans.

We find that out of these three options, additional grants is the only one that is sustainable in the long run; concessional loans would lead to high debt to GDP ratios and defeat the very spirit of the HIPC initiative and market loans would become unsustainable long before they could plug even part of the resource gap.

However, not every dollar given as a grant can be used to finance MDG spending; on current practice as much as 30% of total grants are 'tied' – recipients are forced to buy expensive goods and services from the donor country. A significant proportion of the grant also goes towards administrative costs etc. So only a part of grant aid can be

used for meeting the MDGs. This means that the total amount of grant aid required is much higher than estimated.

The paper finds that for these four countries total debt cancellation accompanied by a near doubling of grant aid is the only way to finance meeting the MDGs in a sustainable way.

We also show how our conclusion of the need for additional debt cancellation and higher grant flows can be generalized to all HIPCs.

### ***Part B***

Of the more than \$26 billion (NPV) of debt owed by the HIPCs to the IMF and the World Bank, these institutions have agreed to cancel less than a third - \$8 billion (NPV) that too funded mostly through bilateral sources. Both have pleaded poverty saying that any additional debt cancellation through the use of their resources would seriously endanger their financial soundness and sustainability.

As a result the HIPC countries will be left with unsustainable levels of debts – debts that can only be repaid at great human cost to their citizens. Altruism and idealism aside, the debt of the HIPCs is also uncollectible; they cannot afford to pay, and the Fund and the Bank must bear some responsibility for the accumulation of unsustainable levels of debts. This would also help reduce the moral hazard that has come about because the multilateral institutions have repeatedly been bailed out by bilateral donors; grants and loans from donor countries have often been used to repay IMF and World Bank loans.

Using rigorous financial analysis this paper shows that both the IMF and the World Bank have ample resources to cancel all of the nearly \$18 billion (NPV) HIPC debt owed to them without in any way jeopardizing their normal operations.

In fact this paper finds that even after writing off all the HIPC debt owed to them, the Fund and the Bank will have resources that can be used to increase grants to HIPC countries

While trying to highlight their self proclaimed paucity of resources, the IMF and the World Bank have sought to underplay their considerable financial strength, which is underpinned by their distinctive political and financial structure and their special role within the international financial system. They have incorrectly made implicit comparisons with the private sector to highlight their 'poverty'.

However, their unique status based on implicit guarantees from donor (mostly G7) countries makes them highly resource rich. By factoring these benefits in, we show that both the IMF and IBRD are overcapitalised and are not using their resources most efficiently.

We recommend that the IMF should sell some of its gold reserves directly into the market over a period of a few years and use the proceeds to bankroll the full cancellation of the HIPC debt owed to itself and that the IBRD mobilize its internal resources by using a combination of retained earnings and future income allocations to fully bankroll the total cancellation of the HIPC debt owed to the World Bank group

In response to the growing call for additional debt cancellation, the IMF and the World Bank have written a joint paper<sup>1</sup> criticising the concept and claiming how it would seriously jeopardize their finances; we also rebut all the arguments presented here.

### ***Part C***

The evaluation of international debt relief carried out by the IOB concludes that debt relief to date has been insufficient and shows how additional debt relief can prove highly beneficial to HIPC's by releasing resources and reducing debt overhang.

Our calculations support these findings by quantifying some of the resources that can be generated through additional debt cancellation. We also highlight the urgent need for total HIPC debt cancellation in order to meet the MDGs.

The IOB also says that the repeated bailout of multilateral creditors by donor countries has created a moral hazard. This moral hazard has resulted in excessive and irresponsible multilateral lending which is at least partly to blame for the current unsustainable levels of HIPC debt. The IOB specifically recommends that the bilateral donors should stop funding the cancellation of multilateral HIPC debt.

Our analysis of the financial position of the IMF and the World Bank shows that the IOB recommendations can immediately be implemented by making these institutions fund their own share of HIPC debt cancellation. Moreover, by making a case for total debt cancellation we show how the moral hazard problem highlighted by the IOB can be mitigated further.

The IOB further suggests that future aid flows should be skewed in the favour of grants over concessional loans.

We support the IOB findings by showing how concessional loans can lead to unsustainable levels of debt and in fact go a step further in recommending that all future aid flows to HIPC's be in the form of grants not loans.

The IOB argues against the usefulness of ex-ante conditions on debt relief.

We agree with the IOB and suggest in common with many others that debt relief be contingent only on an assessment of need to meet the MDGs. We then make a case that all HIPC's face a resource shortfall in financing the MDGs and hence already fulfil this condition. We conclude that further HIPC debt relief should be totally unconditional.

On many other points too, our conclusions and IOB findings reinforce each other and enhance the credibility of the analyses in both the papers.

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<sup>1</sup> 100 Percent Debt Cancellation? A Response from the IMF and the World Bank By IMF and World Bank Staffs, July 2001 <http://www.imf.org/external/np/exr/ib/2001/071001.htm>

## **Part A**

### **MDGs and HIPC Debt Cancellation**

#### **What are the Millennium Development Goals<sup>2</sup> and why they are vital to HIPCs?**

In the year 2000, the world's leaders met in the United Nations General Assembly to set out a new global vision for humanity. They agreed to admirable goals, subsequently known as the Millennium Development Goals - to halve world poverty and hunger by the year 2015; to achieve universal primary education; to promote gender equality and empower women; to reduce child mortality; improve maternal health; to combat HIV/AIDS and other diseases; and to ensure environmental sustainability.

Since then, these goals have been adopted by all major donor agencies as guiding principles for their strategies for poverty eradication. The OECD 'confirmed their commitment' to reducing poverty in all its dimensions and to achieving the International Development Goals.<sup>3</sup> The IMF and World Bank too claim to have coordinated their efforts behind this set of goals. More importantly, the adoption of the targets has motivated a fundamental shift within development thinking – away from a narrow focus on inputs, towards a fundamental concern with outcomes for the poor of the world.

Amongst the countries of the world farthest away from meeting these goals are the 42 HIPCs (heavily indebted poor countries), concentrated mostly in sub-Saharan Africa. They are abjectly poor and are becoming worse off; average per capita real income is about \$300 a year, down from about \$400 in 1980. Unwholesome debt-to-export ratios are matched by an unhealthy life expectancy of 51 years.

The possibility of collective action by the global community in the form of helping mobilize resources to help meet the MDGs is the only ray of hope in this bleak situation.

#### **Why it is important to cost the MDGs and how much it would take to achieve them?**

Costing the MDGs is the first step towards achieving them. Global cost estimates help identify the large gap, that exists between the resources available to developing countries and the resources needed to achieve the MDGs. These estimates provide both the donor community and developing country governments a guideline for the increase in the levels of development aid needed to meet the MDGs. They also allow aid allocations to be based on the MDGs, rather than the current practice of basing them on geopolitical priorities, ad-hoc decisions, favoured countries, or other opaque criteria.

The Monterrey Conference on Financing for Development emphasized the dramatic shortfalls in resources required to achieve the internationally agreed development

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<sup>2</sup> <http://www.un.org/millenniumgoals/>

<sup>3</sup> OECD/DAC Guidelines on Poverty Reduction: In the Face of Poverty

goals, including those contained in the Millennium Declaration. In fact, MDG costing has recently gained a lot of interest from the donor community, the UN system and other development agencies.

The development of MDG costing models has first focused on global sector estimates before turning to country level studies, which allow more accurate evaluation. In the Technical section of the Report of the High Panel on Financing for Development, also called "Zedillo Report", it is suggested that "the cost of achieving the 2015 goals would probably be on the order of an extra \$50 billion a year"<sup>4</sup>. However, the figures provided in the Zedillo Report are only meant to indicate "an order of magnitude" of the incremental funds required to reach the Millennium Development Goals.

Using two different approaches the World Bank figures range between \$54 and 62 billion a year, and from \$35 to 76 billion per year. The background paper for the Human Development Report 2003 takes a similar but different approach as the "Zedillo Report" and reaches an estimate of about \$76 billion.

At a national level, UNDP country offices have taken part in a pilot project trying to estimate the cost of attaining the MDGs in six countries<sup>5</sup>. Both, the Millennium Project directed by Jeffrey Sachs and the World Bank have also launched important projects to estimate the cost of achieving the goals at the national level. The New Economics Foundation (**nef**)<sup>6</sup> has already done some top down country level costings for the MDGs.

### **How can debt relief help?**

The HIPC initiative is predicated on the fact that money released from debt repayments can and should be used in an effective manner to reduce poverty. It is difficult to understand, especially given the obvious needs of the HIPC countries, why the amount of debt cancellation on offer is limited. The OECD and multilateral institutions should try and reduce poverty by as much as possible by releasing more resources through total debt cancellation. In the four countries under study, more than \$3 billion, or a full quarter of the domestic resources available to spend towards meeting the MDGs, can be freed up for use in reducing infant mortality and fighting hunger and poverty.

It is clear the benefits from total HIPC debt cancellation would be enormous, given the poverty reduction that has already occurred as a result of the limited relief given to date. For example, a study<sup>7</sup> of the ten HIPC countries has shown that:

- In 1998, education spending was only \$929m, less than the amount spent on debt service. In 2002, it was \$1,306m – more than twice what is being spent on debt service.

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<sup>4</sup> United Nations "Report of the High Level Panel on Financing for Development" (Zedillo Report) (2001). Technical Report, p.16. <http://www.un.org/reports/financing/>

<sup>5</sup> UNDP: 'Financing the Development Goals: An Analysis of Tanzania, Cameroon, Malawi, Uganda, and the Philippines', March 2002 <http://www.undg.org/content.cfm?id=573> . Another study was developed in Egypt.

<sup>6</sup> The Unbreakable Link: Debt Relief & the Millennium Development Goals - Jubilee Research/JDC, 2002.

<sup>7</sup> Relief Works, Jubilee Research, 2002.

- In 1998, debt service took up twice as much, in terms of resources, as spending on health. Since then, spending on health has risen by 70% and in 2002 was one third higher than debt repayments.

Another more recent study<sup>8</sup> undertaken in 2003 highlights that as a direct result of assistance with their debts:

- Social spending across all HIPCs is estimated to have risen by about 20%.
- Mozambique has introduced a free immunisation programme for children.
- School fees for primary education have been abolished in Uganda, Malawi, Zambia and Tanzania, as have fees in rural areas of Benin.
- Mali, Mozambique and Senegal are due to increase spending on HIV/AIDS prevention.

These real outcomes, saving and improving the lives of millions of people, have been achieved with relatively limited resources. Even greater benefits would accrue from deeper debt relief.

### **But is increased aid not the answer?**

What is needed is an effective delivery of the financial resources needed to meet development aims and objectives. Debt cancellation and increased aid provide necessary and complementary financial flows. In fact, both 100% debt cancellation and a doubling of aid will be needed if the Millennium Development Goals are to be met, especially in sub-Saharan Africa.<sup>9</sup>

We therefore believe that writing off multilateral debt should be additional to meeting the UN target that aid levels should be at least 0.7% of GDP of donor countries. In general, debt cancellation is a highly effective means to deliver new resources because<sup>10</sup>:

- Debt cancellation provides direct budgetary support to debtor countries. It largely bypasses the considerable administrative overheads that attend the application for, granting and monitoring of overseas aid.
- Debt cancellation is a durable source of income: debtor countries can budget for years into the future in the knowledge that planned debt repayments can now be diverted, without loss, into social programmes. By contrast, aid delivery is often highly variable, being subject to the ebb and flow of political will in donor countries.
- High levels of debt (debt overhang) deter future private investment. There is ample evidence to suggest that poor/indebted countries, with their rock-bottom credit ratings, are actively avoided by private investors (unless there are large

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<sup>8</sup> Did the G8 Drop the Debt?, Jubilee Research, CAFOD and Jubilee Debt Campaign 2003.

<sup>9</sup> The Unbreakable Link: Debt Relief & the Millennium Development Goals - Jubilee Research/JDC, 2002.

<sup>10</sup> Call for Change, Jubilee debt campaign and World Development Movement, 2004

official inducements). Eliminating unpayable debt – and moving towards a grants-based approach to development assistance - would, by contrast, create an improved climate for investors.

- Debt relief is anti-inflationary. A recent IMF paper points to a correlation between higher levels of indebtedness and increased inflationary pressures.<sup>11</sup>
- Debt relief helps keep domestic interest rates low. Poor countries are currently being driven to increasing levels of internal borrowing to service their external debts (which are sometimes simply external debt in disguise, since many internal banks have parent companies overseas). This also leads to higher interest rates, making loans unaffordable for local businesses.

Full debt cancellation is a fundamental component of the package of measures needed to finance development; it can be delivered early, and must be purely additional to agreed targets for increasing aid as a proportion of national income. Moreover where the loans have clearly been badly made, the creditor must also share the responsibility for the financial consequences.

### **How much HIPC debt is already being cancelled and who is paying for it?**

Total HIPC debt has now spiralled to more than \$200 billion in nominal terms, but the cost of a write-off is less demanding than it appears. As the majority of the loans carry a concessionary interest rate, a cash offset equal to the net present value (NPV) - roughly 70% of the nominal amount of the debt is all that is required.

The nominal \$176 billion of official loans, which represents 82% of the total due, translates into some \$80 billion (NPV) in effective bilateral (mostly G7) obligations and \$45 billion (NPV) owed to the multilateral agencies, of which the World Bank and the IMF largest hold a dominant 60% share.

Many OECD creditor nations have already promised a write-off of most HIPC debts owed to them. Meanwhile, the IMF and the World Bank are cancelling a much smaller part of their debt; most of this write-off also being paid for by the creditor nations.

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<sup>11</sup> FDI to Africa: The Role of Price Stability and Currency Instability - Carmen M. Reinhart & Kenneth S. Rogoff, International Monetary Fund.

## **Malawi, Mozambique, Tanzania and Uganda Case Studies**

In this section we have used Malawi, Mozambique, Tanzania and Uganda as case studies to study the future financing needs of HIPC. We have tried to find the most up-to-date information on both domestic and foreign resources available to each of these countries; analysed each of their budgets and current expenditure commitments; and made estimates of the external resources needed by each of these countries to attain the MDGs.

We then analyse various sources of funds including debt cancellation, grants, concessional and non concessional loans that these countries can use in order to plug this financing gap. Finally, we show how the findings of these case studies can be generalized to the HIPCs as a group.

A brief background of the assumptions and methodology used for the country case studies is presented first; it also includes important comments and caveats. The source data and detailed calculations are available from the author on request.

### **Assumptions and Methodology**

#### ***Sources of data***

In writing this paper we have used inputs from the World Bank (HIPC Decision Point and Completion point documents, MDG related papers, Global Development Finance, World Development Indicators), UNDP (MDG papers and country level costing analysis), New Economics Foundation (MDG related papers) and the Economist Intelligence Unit.

#### ***Time period used***

Throughout, we have used the period 2000-2015 for consistency. The year 2000 is important as the year when the MDGs were adopted. It is also significant from a methodological perspective as many of the World Bank projections (from completion and decision point perspectives) date back to 2000. The ensuing period also gives us a chance to evaluate and try and eliminate any biases in these projections.

#### ***Annual resources***

Over the last three year period, none of these countries have been able to mobilize the resources they need in order to meet the MDGs. On current trends, barring a significant additional external injection of resources, none of these countries would be able to meet the MDGs. The fact that we now need to look at resources going forward from 2004 does not change the actual amount of resources required significantly. (Even though they are listed as an annual flows) This is because the annual investment needed to achieve the MDGs under a tighter time constraint (as we have now) increases at least proportionately. This method perhaps leads to a slight underestimation of the total resources required.

#### ***Currency***

We have denominated all costs and revenue estimates and projections in millions of US dollars for both consistency and comparability.

## ***GDP growth***

For the years that they are available, we have used actual GDP estimates from the online version of the World Development Indices. For GDP growth projections going out to 2015, we have taken data from the UNDP country studies (where available), the Economist Intelligence Unit (mostly till 2007) and most important the World Bank (Country completion and decision point documents). Where none of these estimates have appeared to be realistic (given recent history and structural constraints), we have made our own projections.

## ***Domestic Revenue***

For domestic revenue, we have used actual figures where available. (Mostly from UNDP and World Bank documents) For domestic revenue projections going out to 2015, we have taken data from the UNDP country studies (where available), the Economist Intelligence Unit and most important the World Bank (Country completion and decision point documents). Where, none of these estimates have appeared to be realistic (given recent history and structural constraints), we have made our own projections.

Year	Malawi		Mozambique		Tanzania		Uganda	
	GDP	Revenue	GDP	Revenue	GDP	Revenue	GDP	Revenue
2005	1,964	393	4,734	625	11,768	1,483	7,232	911
2010	2,229	446	6,486	921	15,748	2,142	9,363	1,273
2015	2,509	502	8,886	1,351	21,074	3,077	12,306	1,797

## ***Costs of meeting MDGs***

Most existing estimates for the costs of the MDGs look at global costs of achieving the MDGs. The Zedillo report, the World Bank and the New Economics Foundation have all estimated these global costs to be in the range of \$45- \$76 billion.

However, for the purpose of this report, we need to look at country level costings. The UNDP has done some MDG costings for Malawi, Tanzania and Uganda as a part of a pilot project. Both the Millennium Commission and the World Bank are also working on country level MDG costings but have not completed or published most of their estimates yet. In the event, the only country level estimates that exist for Mozambique are the estimates made by the New Economics Foundation (**nef**) in 'The Unbreakable-Debt Relief and the Millennium Development Goals', 2002. For Tanzania, the UNDP, nef, and the World Bank have all estimated the costs of meeting the MDGs.

The UNDP country models focus on six MDG targets: income poverty, primary education, child mortality, maternal health, HIV/AIDS and water. They do not cover all sectors and deliver only a partial idea of the interventions needed to achieve the MDGs. The country studies did not aim at estimating the total cost of achieving the MDGs and hence do not reflect the total costs. Also, the methodology used was not standard and differed between targets and countries.

The UNDP estimates of the total costs are on average about 20% less than nef estimates. However early indications from the detailed MDG costing work in progress under the Millennium Project points to estimates that are significantly higher than the **nef** estimates.

Hence, while the estimates made in 'The Unbreakable- Debt Relief and the Millennium Development Goals', New Economics Foundation 2002 also suffer from serious limitations, we use them as they provide both consistency and a 'balance of opinion' between the UNDP and the Millennium Project.

The table shows the total costs of meeting the MDGs between 2000 and 2015

<i>In US\$ million</i>	<b>Malawi</b>	<b>Mozambique</b>	<b>Tanzania</b>	<b>Uganda</b>	<b>Total</b>
MDG Costs	8,864	15,632	29,440	18,448	72,384

### ***Non MDG Spending***

Next we calculate the Non MDG related public expenditure needed for each country. This includes statutory and state functions other than debt servicing. Where an estimate of the current and future expected levels of such expenditure is possible by looking at recent budgetary allocations, we make our own projections. The data for this is mainly derived from various documents including UNDP country studies, World Bank Decision point & Completion point documents and Poverty Reduction Strategy Papers.

Where such data is not available, we follow Jeffrey Sachs in arguing that the HIPCs need to spend at least 10% of GDP on other essential expenditures. (This is broken down into 2% on public administration; 3% on police and defence; and 5% on essential infrastructures such as roads.)

### ***Debt Servicing***

As we are looking to the future, we look at the debt servicing numbers after maximum debt relief under the Enhanced HIPC initiative and any additional bilateral debt relief pledged by donor nations. We are hopeful (though not necessarily optimistic), that all the HIPC countries would get to the point where they will be able to get this debt relief. However, we need to look beyond this and towards mobilizing resources needed to meet the MDGs.

From a methodological perspective, we wanted to establish the total amount of external resources (irrespective of source) that the countries in question would need in order to meet the MDGs. For this purpose, in our calculations we have systematically removed any resources already mobilized though additional (post 2000) borrowing. We then take a fresh look at the various sources of funds (of which new debt is one) that can be used to plug the MDG resource gap.

The data for this is derived mostly from the World Bank HIPC Completion and Decision point documents for the respective countries. The table shows the total debt service between 2000 and 2015 on debt that was contracted before the cut off dates. This does not include the debt service due on more recent debt.

<i>In US\$ million</i>	<b>Malawi</b>	<b>Mozambique</b>	<b>Tanzania</b>	<b>Uganda</b>	<b>Total</b>
Debt Service	587	615	718	1,059	2,979

### ***Expected grant flows***

These projections of grants are taken from the World Bank Completion point and Decision point documents. They are critical as they provide one very important source of funds to plug the resource gap to meet the MDGs. Once these are factored in, it allows us to calculate the additional commitments needed from donor countries towards meeting the MDGs.

It is important here to point out that these projected grant flows may not materialize in full. This is so because grant flows are notoriously volatile and hence difficult to predict with any accuracy. The amount of grant flows are sometimes influenced more by the geopolitical priorities and the domestic situation of the donor country (institution) rather than by the needs of the recipient country.

<i>In US\$ million</i>	<b>Malawi</b>	<b>Mozambique</b>	<b>Tanzania</b>	<b>Uganda</b>	<b>Total</b>
Expected Grants	2,032	6,652	13,139	5,637	27,460

### ***Model***

We follow a very simple model where we calculate the resources available to countries to spend on achieving the MDGs and compare these with the estimates of the approximate costs of achieving these MDGs to highlight the resource gap.

For this purpose, we first project the GDP out to 2015 and then estimate the revenues that can be mobilized domestically (mostly as a percentage of GDP). From these revenues we then deduct the debt service (on existing debt after E-HIPC and additional bilateral debt relief), the Non MDG spending (actual projections from documents or calculated as a percentage of GDP) and then finally the required MDG spending to arrive at the total financing gap.

We then assume a 100% debt cancellation scenario (hence we add back the debt service we deducted previously) and also add expected grant flows to arrive at a financing gap that needs to be financed through additional external grants or loans.

In order to plug the resource gap, we examine the relative merits of the different sources of funds.

## **Results, Discussion and Caveats**

It is important to interpret the country numbers in the context of the assumptions and methodology used in this paper.

### ***Economic Shocks***

We do not account for any shocks to the economies. However, these and other Sub Saharan African countries are especially vulnerable to both weather (mostly drought and sometimes flooding) as well as commodity price shocks. Such shocks can undo what it has taken years of steady economic growth to achieve. There would need to be significant additional external support in terms of emergency relief and additional grants and aid in order to help these countries tide over such shocks without derailing their progress towards the MDGs.

Given the past frequency of shocks experienced by these countries, it is highly unlikely that they would not suffer any more such shocks now till 2015. Yet, due to the uncertainties involved and limitations in modelling, this is the assumption we have based our analysis on. Such shocks would serve to increase the resources these countries need to meet the MDGs.

### ***Additional resources***

There are additional channels other than just debt cancellation through which the domestic resources available for MDG spending can be increased significantly. However, most of these are beyond the control of the HIPC countries and hence almost impossible to predict accurately. So these do not form a part of our simple model and any additional resources arising would reduce the need for additional grants and loans. Some of these channels are:

- Higher domestic reinvestment and lower remittances by foreign companies
- Lower patent and copyright fees charged by multinational corporations for using technology and medicines
- Repatriation of the overseas savings of wealthy residents
- Improved terms of trade and higher export revenues as a result of reduced protectionism and lowering of subsidies in the developed world.
- Increased inward remittances due to lowering of barriers to the free movement of people.

### ***Debt cancellation, Concessional and Non Concessional Loans***

Concessional loans from the IDA typically have zero interest rates, forty years maturity; and a grace period of ten years. There is however a small upfront commitment fee. PRGF loans from the IMF typically have much less generous terms.

For our model, we assume that all concessional borrowing undertaken to fill the resource gap happens at these terms. However, this assumption is highly optimistic as non IDA concessional loans have less generous terms and the amount of concessional

loans available to these countries currently is limited. So this underestimates the amount of debt service and overestimates the amount of concessional loans available.

However, under the assumption that such loans are available as needed, the cash flows from these would be nearly indistinguishable from grants for the period till 2015 (because of the ten year grace period on repayment) However, given that the countries in question would still have significant resource gaps in 2015 and that they should be expected to stay on course (in terms of improving the targets set under the MDGs) even after they meet the MDGs in 2015, this would lead to a serious external debt burden.

In case all the additional resources needed to meet the MDGs are raised in the form of concessional loans, the debt burden of all the countries would quickly go to unsustainable levels. The following table illustrates this scenario and the 'Minimum debt to GDP Ratio' does not include existing (both pre HIPC and post HIPC) debt.

<i>In US\$ million</i>	Malawi	Mozambique	Tanzania	Uganda
<b>Total MDG Resource Gap</b>	<b>6,935</b>	<b>11,966</b>	<b>21,908</b>	<b>16,702</b>
<b>Expected GDP in 2015</b>	<b>2,509</b>	<b>8,886</b>	<b>21,074</b>	<b>12,306</b>
<b>Minimum Debt to GDP Ratio</b>	<b>276.4%</b>	<b>134.7%</b>	<b>104.0%</b>	<b>135.7%</b>

Malawi would then already have a debt burden of at least 276% of GDP in 2015. In other countries too this debt burden would go on increasing after 2015 at least for the foreseeable future. This would in essence defeat the very spirit of the HIPC initiative which was to reduce the debt burden of these countries to sustainable levels.

Such levels of indebtedness would cause serious problems even to the most advanced economies even though they have access to substantial domestic resources and export revenues. It is well known that HIPCs have a much lower level of sustainable debt burden. We do not want to use a single cut off point, but firmly believe that HIPCs should only build up debt as a very last resort and even then keep the debt stock levels as a fraction of GDP.

Due to the very low creditworthiness of these countries (they have all restructured debt under the HIPC initiative); they would find it next to impossible to raise any money in the markets. This is especially true given the recent defaults by other large sovereign states (Argentina, Russia).

To illustrate the unsuitability of market borrowing for financing the MDGs we use the example of Malawi. We assume that Malawi is able to get the terms on private credit that it had in the past (average of 1970,1980,1990,1996); 10% interest, a maturity of 7 years, and a grace period of 2 years.

If Malawi financed the MDG cost gap through such borrowing, it would be completely unsustainable. Our calculations show that on these terms Malawi would already be borrowing \$1 billion by 2007 (50% GDP) of which less than a fifth would go towards financing the MDGs and the rest would be used for debt servicing. Clearly, such a scenario is completely unaffordable.

In case we consider a more realistic possibility of the net resource gap (after factoring in expected aid flows) being financed exclusively through concessional lending, we find that both Malawi and Uganda will still have very high debt burdens in 2015. The following table illustrates this point.

<i>In US\$ million</i>	Malawi	Mozambique	Tanzania	Uganda
<b>Net MDG Resource Gap</b>	5,490	5,928	9,488	12,124
<b>Expected GDP in 2015</b>	2,509	8,886	21,074	12,306
<b>Minimum Debt to GDP Ratio</b>	218.8%	66.7%	45.0%	98.5%

Given the potential problems posed by both concessional and non concessional debt discussed above, we believe that the resource gap should be plugged mainly through 100% debt cancellation and additional grant flows.

### ***Debt cancellation and grant flows***

Throughout the paper, we have based our calculations on debt service on the assumption that all debt relief promised under the enhanced HIPC initiative and additional bilateral debt relief will be forthcoming; however given the slow progress of the HIPC initiative this can by no means be taken for granted. We have looked beyond that to the financing need for the MDGs and firmly establish that as a first step, total debt cancellation is urgently needed.

Debt cancellation is the most efficient form of aid delivery as it has minimal administrative costs and provides direct budget support (that may be ring fenced for social and health related expenditure) so the government can target the funds as per local priorities.

However, as we have established, this is by no means sufficient. A multiple of the resources released by debt relief would actually be required to achieve the MDGs. We have shown in the last section, debt is not a good way to finance the MDGs. So we are just left with grants.

As we show in the country section, the donor community is already expected to give significant (though by no means enough) grants in the run up to 2015. However, historically up to 30% of all grant revenues are used for tied aid, administration, foreign consultants etc. Given this, grants are not the most efficient way of mobilizing resources for the MDGs. However, there is now an increased recognition of these limitations of current donor financing and we are optimistic that future grants would be less 'tied' and would increasingly be given in the form of direct budgetary support.

To the extent that this does not happen over the next ten years or so, our calculations underestimate the actual amounts of grants needed to achieve the MDGs.

### ***Domestic Resources***

Most of the HIPCs are faced with serious constraints on domestic resource mobilization. These result from the combined existence of (usually) low savings and investment rates and a mainly subsistence based, highly informal economy. This and the fact that income levels in HIPCs are so low that a significant part (more than 50% in many countries) of the population lives below the poverty line means that personal income tax revenues are abysmally low.

The lack of a well organized corporate sector (most firms are run by small family entrepreneurs as a part of the informal economy) severely constrains the amount of corporate tax revenue that these countries can raise. Multinationals firms, where they

operate, have sometimes been attracted through tax breaks and in some other instances have used transfer pricing to minimise tax liabilities.

As a part of the structural reforms package being pushed by the IMF and the World Bank, a number of these countries are being asked to introduce consumption based taxes such as value added taxes. Given that aggregate consumption levels are so low and that the government has severely limited resources to enforce and collect such as tax, the total revenues raised from this are also low.

Customs duties are one of the easier taxes to administer. However, under the WTO agreements and structural reforms being pushed through by the Bank and the Fund, most HIPC's are being forced to lower these tariffs. This is another reason why domestic revenue growth is expected to be low.

User based fees for essential services are yet another potential source of revenue. However, this can only be applied in a very limited number of cases on a 'capacity to pay' basis and is not expected to bring in large revenues due to the low prevailing income levels.

Finally, there exist other more unconventional non-monetary ways of mobilising resources domestically. Community based initiatives is one such example that seems to be promising. However, these measures will take time to develop roots and are complementary to rather than substitutes for increased monetary financing. Such initiatives could prove very effective in increasing the efficiency of monetary investments.

## **Conclusion**

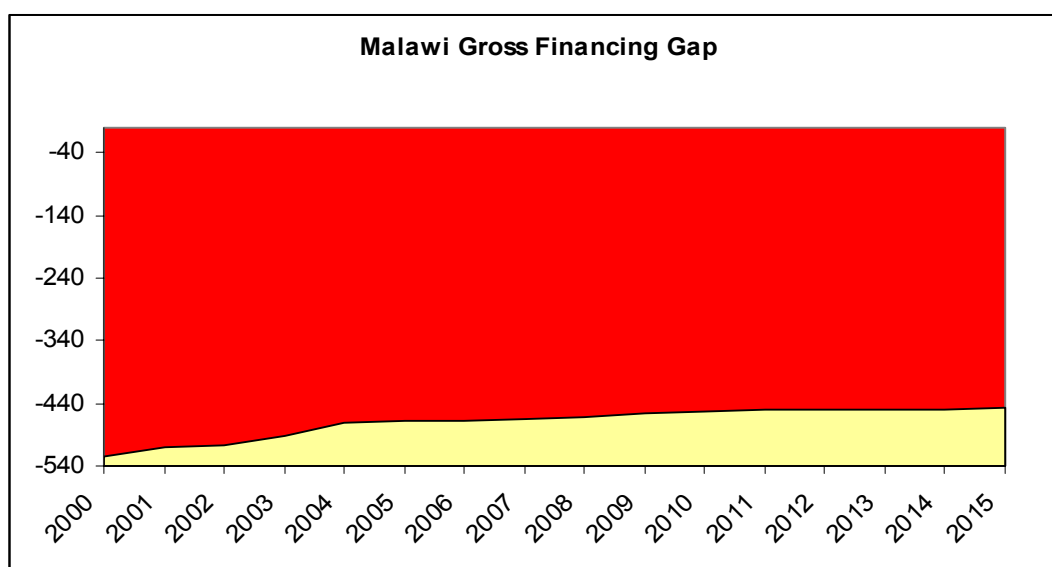
We have established that Malawi, Mozambique, Uganda and Tanzania all suffer from an acute shortage of resources required to meet the MDGs. While total debt cancellation will release additional resources, it is by no means enough. The deficit could be financed either through additional grants or loans.

We have also shown how loans are unsuitable and would result in unsustainable levels of debt. We conclude that the only realistic option left to finance the MDG resource gap is to cancel all HIPC debt and significantly increase the level of grants flowing to these countries.

## Country Snapshots

### Malawi

- Malawi faces a \$7.5 billion shortfall of funds to meet the MDGs
- Of this it can raise almost \$600 million through 100% debt cancellation
- This still leaves a gap of about \$7 billion that needs to be plugged
- This could come from additional grant flows (assuming direct budgetary support) of \$5 billion (current expected levels of \$2 billion)
- Alternatively, Malawi needs \$7 billion in IDA terms concessional loans to plug this gap
- However, this would leave it saddled with an unsustainable external debt stock of 280% of GDP in 2015
- Due to its poor creditworthiness, Malawi would be unable to borrow significant amounts of private capital. Even if it did, the interest rates would be so high that the debt burden would quickly become unsustainable.
- In conclusion, Malawi would perhaps need to finance its resource gap solely through additional grants (our preferred option) or through a combination of (primarily) grants and some concessional loans at levels significantly higher than those available to it currently.



We use the low end UNDP estimates of about 2.5% per annum for expected GDP growth in Malawi. Given the severe drought that Malawi faced in 2003, the low price of Tobacco (its main export) and the economic impact of a HIV/AIDS epidemic, this seems to be a prudent projection.

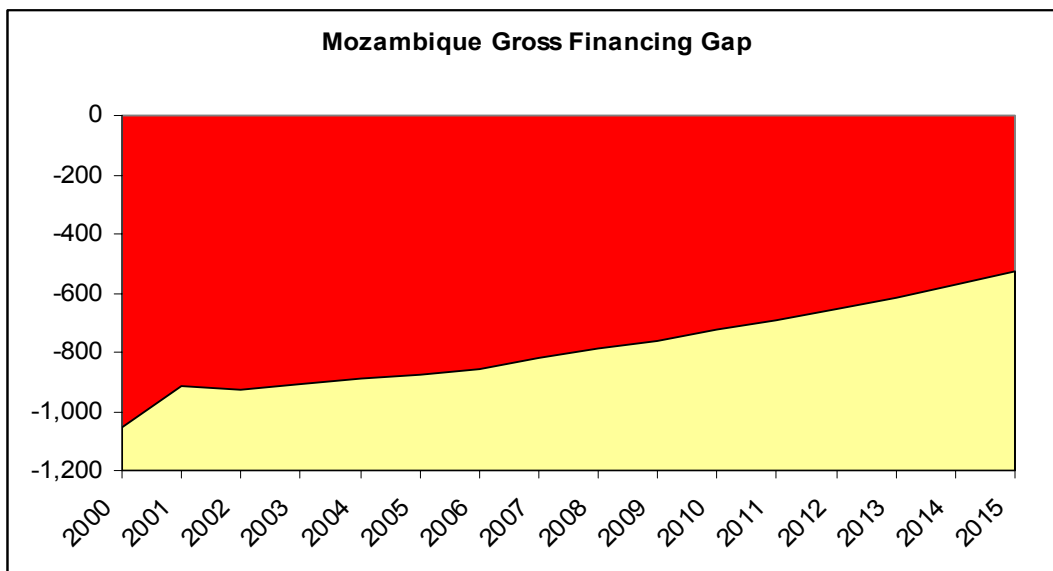
For domestic revenues we use reasonable World Bank projections of about 20% of GDP.

Malawi is one of the few countries to have a detailed UNDP country level MDG costing study. The estimates for this are in the same range as the **nef** estimates. For reasons detailed in the methodological section we use the **nef** numbers.

We calculate the statutory and state expenditure incurred in the recent past and assume that the same (as a percentage of GDP) would be necessary in the future.

### **Mozambique**

- Mozambique has a \$12.5 billion shortfall of funds to meet the MDGs
- Of this it can raise almost \$600 million through 100% debt cancellation
- This still leaves a gap of about \$12 billion that needs to be plugged
- This could come from additional grant flows (assuming direct budgetary support) of \$5.5 billion (current expected levels of \$6.5 billion)
- Alternatively, Mozambique needs \$12 billion in IDA terms concessional loans to plug this gap
- However, this would leave it saddled with a very high external debt stock of 136% of GDP in 2015
- Due to its poor creditworthiness, Mozambique would be unable to borrow significant amounts of private capital. Even if it did, the interest rates would be so high that the debt burden would quickly become unsustainable.
- In conclusion, Mozambique would perhaps need to finance its resource gap solely through additional grants (our preferred option) or through a combination of (primarily) grants and some concessional loans at levels significantly higher than those available to it currently.



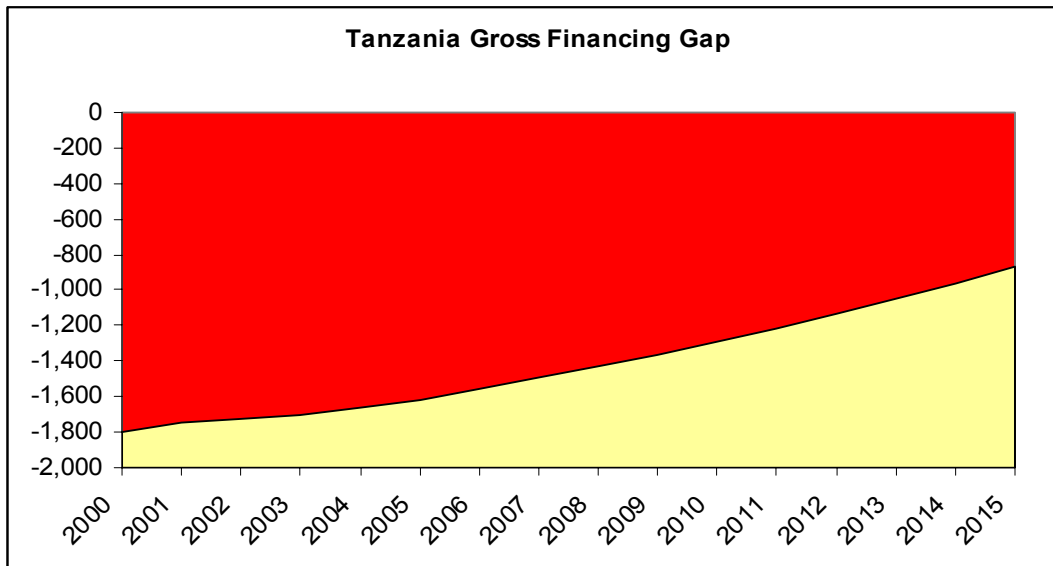
Mozambique has grown impressively since the end of conflict there in the late 1980s. We use the World Bank projections of a 6.5 % growth driven by mega industrial projects that are coming upstream as well as investment in many other sectors.

Based on recent history and structural issues, we have made our own projections for domestic revenue to grow from 12% of GDP in 2000 to about 15% of GDP in 2015

In the absence of other estimates, we use nef estimates for both MDG and non MDG costs

## Tanzania

- Tanzania has a \$22.5 billion shortfall of funds to meet the MDGs
- Of this it can raise about \$700 million through 100% debt cancellation
- This still leaves a gap of about \$21.8 billion that needs to be plugged
- This could come from additional grant flows (assuming direct budgetary support) of \$8.8 billion (current expected levels of \$13 billion)
- Alternatively, Tanzania needs \$21.8 billion in IDA terms concessional loans to plug this gap
- However, this would leave it saddled with a very high external debt stock of 104% of GDP in 2015
- Due to its poor creditworthiness, Tanzania would be unable to borrow significant amounts of private capital. Even if it did, the interest rates would be so high that the debt burden would quickly become unsustainable.
- In conclusion, Tanzania would perhaps need to finance its resource gap solely through additional grants (our preferred option) or through a combination of (primarily) grants and some concessional loans at levels significantly higher than those available to it currently.



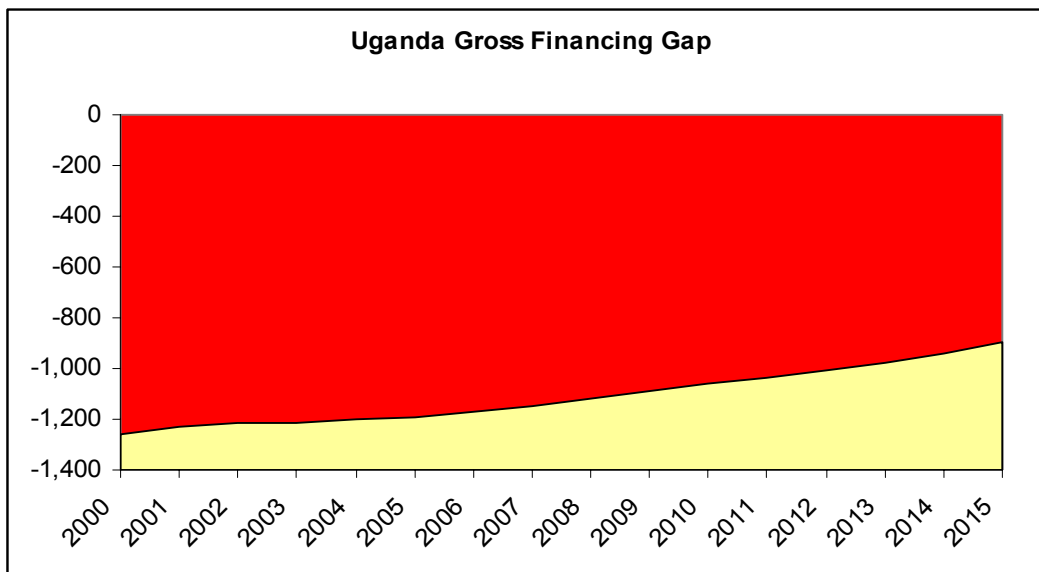
Tanzania is expected to register good economic growth over the next few years. However, an overdependence on rain fed agriculture makes it very vulnerable to weather related shocks. We have used World Bank projections of 6% GDP growth in the medium term.

We have taken a more conservative estimate of revenue (12% of GDP in 2002-14.6% of GDP in 2015) than the World Bank, given the serious structural constraints.

Tanzania is one of the countries to have a detailed UNDP country level MDG costing study. There are also some estimates from the World Bank. These estimates grow (by 2015) to be in the same range as the **nef** estimates. For reasons detailed in the methodological section we use the **nef** numbers.

## Uganda

- Uganda has a \$17.7 billion shortfall of funds to meet the MDGs
- Of this it can raise about \$1 billion through 100% debt cancellation
- This still leaves a gap of about \$16.7 billion that needs to be plugged
- This could come from additional grant flows (assuming direct budgetary support) of \$11 billion (current expected levels of \$5.7 billion)
- Alternatively, Uganda needs \$16.7 billion in IDA terms concessional loans to plug this gap
- However, this would leave it saddled with a very high external debt stock of 136% of GDP in 2015
- Due to its poor creditworthiness, Uganda would be unable to borrow significant amounts of private capital. Even if it did, the interest rates would be so high that the debt burden would quickly become unsustainable.
- In conclusion, Uganda would perhaps need to finance its resource gap solely through additional grants (our preferred option) or through a combination of (primarily) grants and some concessional loans at levels significantly higher than those available to it currently.



Uganda is expected to register good economic growth over the next few years. However, poor rainfall and low prices for key commodities could make this growth vulnerable. We have used UNDP projections of about 5.3% GDP growth.

We have taken a more conservative estimate of revenue (12% of GDP in 2002-14.6% of GDP in 2015) than the World Bank, given the serious structural constraints.

Uganda is one of the countries to have a detailed UNDP country level MDG costing study. These estimates grow (by 2015) to be in the same range as the **nef** estimates. For reasons detailed in the methodological section we use the **nef** numbers.

We calculate the statutory and state expenditure incurred in the recent past and assume that the same (as a percentage of GDP) would be necessary in the future.

## **How do these results apply to other HIPCs?**

Of the four countries used as case studies three (Mozambique, Tanzania and Uganda) have shown a high rate of GDP growth in recent years. These are also expected to keep growing at an annual rate of between 5% and 7% till 2015. It is important to note that this high rate of growth is an exception rather than a rule in HIPCs. Most HIPCs have grown much more slowly or not at all. The GDP of Burundi for instance contracted at an annual rate of 8% between 1998 and 2002.

Uganda was the first HIPC to reach completion point. Tanzania and Mozambique have also reached completion point. This again is far from typical for HIPCs; less than a fourth have reached completion point. The countries used in these case studies are in fact the 'performers' amongst the HIPC group. Uganda, for instance is often held up as role model for other HIPCs to follow.

Given that grant flows are at least partially contingent on performance - so donor country agencies and multilateral institutions can demonstrate successes and results - this group of countries is also expected to receive a higher proportion of grants than the other 'non performing' HIPCs.

We have shown that even this 'model' group of HIPCs with good policies, high grant inflows and most important high expected growth rates falls far short of mobilizing resources needed to meet the MDGs.

While total debt cancellation is a critical first step in releasing additional resources that can be used to meet the MDGs, it is by no means enough. These countries as a group also need a doubling of current grant levels.

Based on this conclusion, and the fact that other HIPCs are generally worse off, it is then possible to generalize that other HIPCs would need at least the same level (proportionately) of additional resources.

This strengthens the findings of 'The Unbreakable- Debt Relief and the Millennium Development Goals', 2002 which concludes that in order to meet the MDGs, HIPCs need total debt cancellation and a doubling of current ODA (overseas development assistance) levels.

We have also established that net country level costings, though by no means completely rigorous, are credible since UNDP and World Bank costings (where they exist) fall in the same range. Our costings reflect the balance of opinion that ranges from somewhat lower estimates (UNDP and World Bank) to somewhat higher estimates (Millennium Project). As the conclusion of the 'Unbreakable Link' paper, that higher ODA flows and debt cancellation are both needed, depends on these estimates, it is further strengthened by this finding.

Moreover, our analysis does not account for any 'economic shocks' even though it is very likely that the HIPC group would see many shocks over the next few years. Such occurrences would serve to further increase the resources needed for the MDGs.

In conclusion, we suggest that total debt cancellation and additional grant financing be contingent only on MDG financing needs. As we have established these needs, we

recommend total HIPC debt cancellation, a significant increase in ODA levels and a total switch from concessional loans to grants.

## Part B

### How the IMF and the World Bank can afford to cancel all of the HIPC debt owed to them?<sup>12</sup>

#### Are the IMF and the World Bank committed to debt cancellation under the HIPC Initiative?

As early as 1996, the Committee of the Board of Governors of the IMF

"warmly endorsed the program of action proposed by the Fund and the Bank to ensure that the heavily indebted poor countries (HIPCs) that have shown a sound track record of economic adjustment *can attain a sustainable debt situation* over the medium term. It endorsed the conclusions by the Executive Board on financing the continuation of ESAF (the Enhanced Structural Adjustment Facility) and the Fund's participation in the Initiative to assist the HIPCs to which all members are committed...It also reaffirmed the importance of the Fund's preferred creditor status". (Our italics)

"The HIPC debt initiative was proposed by the World Bank and IMF and agreed by governments around the world in the autumn of 1996. It was the first *comprehensive* approach to reduce the external debt of the world's poorest, most heavily indebted countries, and represented an important step forward in placing debt cancellation within an overall framework of poverty reduction." (Our italics)<sup>13</sup>

Both the IMF and the World Bank are at the forefront of the HIPC initiative and are the primary institutions involved in the execution of the actions required by the initiative. They have kept a tight control over the HIPC debt cancellation mechanisms and implicitly profess ownership of the Initiative.

The World Bank and the IMF are also the HIPCs' main creditors among multilateral institutions and significant contributors to the HIPC Initiative in terms of intellectual and technical resources. However, they both have been very wary of cancelling any HIPC debts.

We believe that both the Bank and the Fund should cancel all the HIPC debt owed to them; however, they have reacted negatively to this suggestion and have sought to argue that any further mobilization of their own resources towards the debt cancellation effort would seriously jeopardize their financial soundness and curtail their ability to undertake their normal operations.

#### Are the IMF and the World Bank contributing to the HIPC initiative?

"It now seems that those who sought the spotlight are now retreating to the end of the queue when the costs of the HIPC initiative need to be paid. The IMF and the

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<sup>12</sup> See 'Can the IMF and the World Bank cancel 100% HIPC debt?' by Sony Kapoor, Jubilee Research at nef, 2003 for a comprehensive treatment of the subject.

<sup>13</sup> Taken from the World Bank's website on HIPC [www.worldbank.org/hipc/about/hipcbr/hipcbr.htm](http://www.worldbank.org/hipc/about/hipcbr/hipcbr.htm)

World Bank are saying: not relief for all 42 countries, not total relief for any country, not now, and, certainly, not us."<sup>14</sup>

Pleading scarcity of resources, the Bank and the Fund plan to write off a miserly \$8.4 billion (NPV), less than one-third of the amount owed to them, and that too only after every other avenue has been exhausted, and even then mostly with funds from donor countries. Under current plans, donor country taxpayers are financing the lion's share of debt cancellation and the illusion of equal burden sharing among creditors, the centrepiece of the HIPC initiative, has been shattered by the refusal on the part of the Bank and the Fund to contribute their fair share. They have committed only limited amounts from their own resources for the funding of these cancellations. They will still be the two biggest creditors of HIPCs even after all cancellation has been provided through the original and enhanced HIPC initiatives.

### **But do the IMF and the World Bank have enough resources?**

Sitting on billions of dollars of untapped resources, the IMF and the World Bank are amongst the most prosperous financial institutions in the world. The IMF and the World Bank hold a wealth of resources on their own balance sheets – about \$500 billion in effective capital and \$40 billion in provisions for loan losses and reserves.

They can easily marshal internal resources for total debt cancellation as it represents just 5% of their effective capital and 65% of provisions for losses and reserves. These are accumulated for the day when borrowers cannot pay and they would not be disabled by such an insignificant drop in equity. Contrary to their claims, the viability of the IMF and the World Bank is not threatened.

As HIPC debt has mounted so have IMF and World Bank reserves. These have accumulated on account of the special structure of the IMF and the World Bank, which offers large capital and credit guarantees. The World Bank, for instance, generates upwards of \$2 billion each year by investing its equity capital and through arbitrage between the favourable borrowing rates it enjoys (owing to guarantees of its donor members) and the higher yields on the market instruments in which it reinvests.

In this report, using rigorous financial analysis, we show that the Bank and the Fund are richly endowed with resources. They hold a pre-eminent position in the international capital markets, which will in no way be compromised by the allocation of a part of their ample resources to total debt cancellation.

### **Are there any other reasons that the Fund and the Bank should cancel more debt?**

It is widely accepted that the lending practices of the Fund and the Bank have been plagued by 'Moral Hazard'. Grants from donor countries have often been used to repay poor country debt owed to the Bank and the Fund. This has engendered unsound practices and sometimes encouraged lending to 'white elephant' projects as the institutions have had a de facto guarantee that their loans will be repaid; they would be bailed of situations where the borrowing country can not repay.

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<sup>14</sup> The Initiative is lacking, Adam Lerrick, September 2000. Euromoney

The IMF and the World Bank have for years written a self-delusional record of never making a bad loan by refusing to ever recognize a formal loss. They have a deep-rooted system of masking default by rolling over bad debts each year, with enough added to cover new interest costs. These are financially unsound practices that would invite regulatory reprimand in any private sector environment.

By making the Fund and the Bank use own resources to cancel debt, we can significantly reduce the 'Moral Hazard'. As they are forced to face the consequences of their irresponsible lending practices, these institutions will realize that they can not always rely on being bailed out by donor countries; this will encourage more sound lending practices.

We also are against giving loans to countries that cannot afford to repay them; they should get grants instead.

### **What is the next step?**

In this section, we demonstrate how significant additional resources could be mobilized in an efficient and financially prudent way by both the institutions. We begin by offering concrete proposals on how these resources could be mobilised to meet the commitment to sustainability to cancel debt and give more grants.

Next, we rebut, point by point, the IMF's and the World Bank's opposition to total debt cancellation, outlined in a recent paper.<sup>15</sup> Finally, in the appendices we back up these claims mainly through the use of prudential comparisons with the private sector as appropriate.

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<sup>15</sup> 100 Percent Debt Cancellation? A Response from the IMF and the World Bank By IMF and World Bank Staffs July 2001 <http://www.imf.org/external/np/exr/ib/2001/071001.htm>

## **International Monetary Fund**

### ***Background***

The HIPC countries owe the IMF a total of about \$7 billion (NPV) of debt, of which the Fund has already cancelled or promised to cancel about \$2 billion (NPV). This means that for all of the HIPC IMF debt to be cancelled another \$5 billion (NPV) must be mobilized. The IMF, like other multilateral creditors, is not writing off debt outright. Instead, in efforts to preserve its "preferred creditor" status, it is keeping the HIPC loans on its balance sheet. However, the HIPC countries are not expected to repay; non-repayment on these loans will be substituted for by payments from the 'HIPC trust account' as and when the repayments become due.

The IMF has already identified financing to meet most of its current share of debt cancellation from internal resources. This includes

- Earnings on investment profits from the off-market gold transactions undertaken especially for this purpose
- Contributions from its members and other sources<sup>16</sup>

### ***How can the IMF finance the total cancellation of HIPC debt?***

The IMF holds the largest reserves of gold in the world after the United States and Germany; its gold reserves amount to 103.4 million ounces and the IMF holds them at a book value of only about \$8 billion when the market value is closer to \$38 billion. Most gold is held at SDR<sup>17</sup> 35(\$51) per ounce as compared to the current market price of \$384<sup>18</sup> per ounce. Hence, there is a lot of latent value locked up in the IMF's gold reserves. We believe that unlocking this value by selling the gold at market rates can generate substantial resources (up to \$30 billion) that can be put to productive use; such as financing total debt cancellation and additional grants for HIPCs.

The IMF has no real use for this gold; it is small as compared to its total \$350 billion in resources<sup>19</sup> (\$228 billion is in usable currencies).

### ***How to sell the gold?***

As a first step the IMF would need to estimate the amount of gold it would need to sell to raise enough resources for HIPC debt cancellation. It would be prudent to take a conservative estimate for the price at which it can sell the gold. The current market price of gold is \$384 per ounce and the average price since 1980 has been \$370 per

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<sup>16</sup> These contributions are primarily the promised repayments from the resources refunded by the termination of the \$1.4 billion SCA-2 account in 1999. There have also been additional payments by individual members over and above their share of the SCA-2 account. Additionally, the IMF has also generated resources through the non-reimbursement of the fees that the Poverty Reduction and Growth Facility (PRGF) owes to the General Reserve Account from 1999-2004.

<sup>17</sup> SDR is a special IMF currency. For this paper we use the 10<sup>th</sup> June 2004 rate of 1.462 US dollar per SDR.

<sup>18</sup> On the 10<sup>th</sup> of June 2004

<sup>19</sup> <http://www.imf.org/external/np/tre/liquid/2004/0304.htm>

ounce. The IMF being one of the most financially astute institutions in the world should be able to lock in a good price for its gold through the use of derivative<sup>20</sup> transactions.

Even so, this price would almost certainly be somewhat lower than current levels as the IMF unloads more gold into the market. Hence, the IMF can take a conservative estimate, say at a 15%<sup>21</sup> discount to the current market price and assume that it will be able to get a price of \$326 per ounce for its gold. Of the money that the IMF gets from the gold sales, the book value of SDR 35(\$51) per ounce will go to the General Resources Account (Reserves) and the excess of \$275 per ounce will be allocated to the Special Disbursement Account from where it can be allocated to HIPC debt cancellation. For a current financing need (net present value)<sup>22</sup> of \$5 billion, this would mean that the IMF would need to sell less than 20 million ounces of gold (or less than a fifth of its total gold holdings) into the market.

We suggest that the IMF sell 20 million ounces of its gold in the open market or through private transactions indexed to the market price. In order to at once get the best price and minimize the impact on the gold market, the Fund should spread the sale of this gold over a period of time. We believe that a period of 3-4 years would be a judicious compromise between timeliness and minimizing market impact. This can be achieved either through opportunistic sales in the spot market or through an appropriate use of the futures (or other derivatives) available in the market. As discussed later in this section, an additional annual supply of about 5 million ounces of gold in the existing market would not dramatically impact the supply demand dynamics and hence would have a relatively small impact on the price.

### ***Using the investment income generated from the proceeds of gold sales***

Alternatively, we suggest that the IMF gradually sell all of its gold reserves, and invest the proceeds in income generating assets. Spread over a sufficient number of years, this is unlikely to have any significant impact on the price of gold. This sale would yield additional resources of the order of \$30 billion, which when invested in assets yielding an average of 5%-6% would generate an annual income stream of \$1.5 - \$1.8 billion. Part of this could then be used to finance total HIPC debt cancellation.

### ***Gold sale would not depress gold prices by much***

The annual production of gold in the world has averaged around 80 million ounces over 1997-2002 and the demand has averaged well above 125 million ounces during the same period. Central bankers have been decreasing their stocks of gold for some time now (especially under the 1999 Washington agreement) and have sold an average of 13.4 million ounces annually over the past four years. The IMF's annual sale of 5 million ounces would then only be incremental to the current level of gold reserve sales. Canada, Switzerland, UK, Australia and other OECD countries have been major seller of late; if these countries can go ahead and sell gold for their own domestic ends surely a strong case can be made to sell IMF gold in order to benefit HIPC countries which receive aid from these very same OECD countries.

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<sup>20</sup> The IMF is not allowed to enter into derivative transactions involving gold. However, once there is enough political will (85 % vote share) to sell the gold, this situation should be relatively easy to rectify by amending the relevant article.

<sup>21</sup> Private conversations with gold analysts have indicated that the price impact would actually be much lower

<sup>22</sup> Using a discount rate of 3%

Even as the OECD group is decreasing its gold reserves, many other countries such as China, the Philippines and Russia are actually increasing their gold reserve holdings. China for instance bought about 6.6 million ounces of Gold in 2001-2002. This gives rise to another possibility for minimising the price impact of IMF gold sales.

The IMF could enter into agreements with central banks that are planning to increase their gold holdings to sell them the gold at a small discount (say up to 5%) to the market price in return for an agreement for them not to sell gold into the market for say a period of 5-10 years. The IMF would benefit as it would be able to liquidate its gold reserves; the countries would benefit as they would make an immediate effective financial gain. Such an offer might even induce central banks that were not planning to buy gold to do so and hence would not necessarily come at the expense of potential central bank demand in the market.

In case the IMF did engage in open market sales, the gold market, being one of the most liquid markets in the world would not be disrupted; it had a turnover of almost \$4.5 trillion (45% of the turnover of the NYSE) in the year up to March 2003.

We have shown that there is ample room to bring new gold to the market without tipping the supply demand balance. The IMF's fears of seriously disrupting the gold market are unfounded, especially if it follows the suggestions made above<sup>23</sup>.

### ***Precedents for the sale of gold***

Our suggestion that the IMF sell gold is not new; the fund has already engaged in several transactions<sup>24</sup> where it sold gold.

From 1976-1980, the IMF sold approximately one third (50 million ounces) of its then-existing gold holdings following an agreement by its members to reduce the role of gold in the international monetary system<sup>25</sup> and to finance concessional lending to poor countries.

In 1999-2000, the IMF once again carried out transactions involving 12.9 million ounces of gold in order to generate resources for HIPC debt cancellation. These precedents indicate that when the political will is there, resources can be found for debt cancellation. There is now a growing recognition of the need to transfer additional resources to HIPC countries.

IMF members having long since agreed to reduce the role of gold in the international monetary system should now put their votes behind the sale of IMF gold.

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<sup>23</sup> Our opinion has been seconded by gold analysts who prefer to remain unnamed

<sup>24</sup> "Financing the Fund's Operations—Review of Issues." 2001, IMF. "In the late 1950s and in the 1960s, the IMF sold gold on several occasions to replenish its holdings of currencies." " In order to generate income to offset operational deficits, some gold was sold to the United States and the proceeds invested in U.S. government securities. A significant build-up of reserves through income from charges prompted the IMF to reacquire this gold from the U.S. government in the early 1970s."

<sup>25</sup> "Financing the Fund's Operations—Review of Issues." 2001, IMF. "Auctions and restitution sales (1976-80). The IMF sold approximately one third (50 million ounces) of its then-existing gold holdings following an agreement by its members to reduce the role of gold in the international monetary system. Half of this amount was sold in restitution to members at the then-official price of SDR 35 per ounce; the other half was auctioned to the market to finance the Trust Fund, which supported concessional lending by the IMF to low-income countries".

Again there is a precedent here. In 1979-80, staff discussions took place regarding the establishment of a Substitution Account<sup>26</sup> in lieu of gold reserves. However, the question of a Substitution Account was later dropped, as was the issue of gold sale for the purpose of deriving income for the Fund. Sale of gold by the Fund was then seen to be problematic because of its possible adverse impact on the gold price and the value of central bank gold holdings.

Things have moved on since then and a sale now would just be belated recognition of the relatively insignificant role that gold now plays in the in monetary system. The gold market has become bigger, more liquid and diverse and central banks themselves have been off loading their reserves in the market for years.<sup>27</sup>

For all these reasons, we believe that this is the right time to re-consider the sale of IMF gold to fund total HIPC debt cancellation.

### ***Rebutting the IMF's opposition to total HIPC debt cancellation***

In response to repeated calls for additional (total) debt cancellation for the HIPC countries amounting to about \$5 billion (NPV), the IMF has responded with an official position in the form of a joint paper with the World Bank entitled "100 Percent Debt Cancellation?"

*The IMF claims that any additional debt cancellation would necessarily come at the cost of other developing countries. The IMF says that the PRGF, which is close to being a permanent facility, will in future be financed purely by reflows. Additional debt cancellation, says the IMF, would deplete the resources of the PRGF and force the closure of the facility leading to the withdrawal of the IMF from concessional lending.*

We contest this view. We strongly believe in the principle of additionality in the context of debt cancellation and do not believe that HIPC debt cancellation should come at the expense of other developing countries. The main recommendations of this report provide clearly defined ways of mobilizing *additional* Fund resources for the purpose of debt cancellation without either using PRGF resources or at the expense of other developing countries. Gold sales to the tune of 20 million ounces spread over a number of years would generate enough additional resources for HIPC debt cancellation without a significant impact on gold prices. (And hence on gold producing developing nations)

*The IMF argues that total debt cancellation would do serious damage by fundamentally changing its present character as a co-operative monetary institution designed to promote the stability of the international financial system and provide temporary balance of payments support for members in need.*

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<sup>26</sup> "Financing the Fund's Operations—Review of Issues." 2001, IMF. "In 1979-80, discussions took place regarding the establishment of a Substitution Account. Fund management supported the use of a (substantial) part of the Fund's gold holdings to ensure the viability of the Account, and also the sale of a small portion of the Fund's gold and use of the profits to create an investment fund and thereby strengthen the Fund's income position. The question of a Substitution Account was later dropped, as was the issue of gold sale for the purpose of deriving income for the Fund. This was done primarily because of the lack of a political consensus and concerns about the impact on the still nascent post gold standard international gold market.

<sup>27</sup> [http://www.gold.org/value/reserve\\_asset/](http://www.gold.org/value/reserve_asset/)

We are puzzled by this statement especially since the IMF's charter was constituted under an exchange rate system based on the gold standard which has long since been abandoned. The IMF is diverging from its institutional purpose, and is currently involved in development and poverty reduction (regarded as the domain of the World Bank) and in detailed, prescriptive, long lasting structural adjustment programs. This is in contrast to its original purpose: to act as a "fire-fighter" for the global economy and to provide temporary balance of payments support to members facing difficulty. Given this context, the IMF's argument is completely irrelevant.

*The IMF asserts that debt cancellation would impair the Fund's financial integrity and argues that its gold reserves constitute an integral part of its financial position; that the exceptional decision to use the income from investments of the profits from limited off market gold sales to finance part of its contribution to the HIPC Initiative has already proven to be a substantial cost to the institution and its members.*

We rebut this statement. Even the Fund does not believe that gold reserves are indispensable<sup>28</sup>. We discuss this point in greater detail below.

Having analysed the Fund's financial statements, we conclude that the off market gold sales did not have a substantial cost for the IMF. The transaction and the subsequent commitment of the investment income towards HIPC debt cancellation did lead to a decrease in the level of interest free assets<sup>29</sup>. However this decrease could not only have been avoided; but could have been converted into an *increase* if the Fund had sold the gold *outright* rather than using off market transactions<sup>30</sup>.

*The IMF claims that holding undervalued gold provides fundamental strength to its balance sheet. It also claims that any transaction involving gold should avoid weakening the IMF's overall financial position.*

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<sup>28</sup> "Financing the Fund's Operations—Review of Issues." 2001, IMF. "In 1979-80, discussions took place regarding the establishment of a Substitution Account. Fund management supported the use of a (substantial) part of the Fund's gold holdings to ensure the viability of the Account, and also the sale of a small portion of the Fund's gold and use of the profits to create an investment fund and thereby strengthen the Fund's income position. The question of a Substitution Account was later dropped, as was the issue of gold sale for the purpose of deriving income for the Fund. This was done primarily because of the lack of a political consensus and concerns about the impact on the still nascent post gold standard international gold market."

<sup>29</sup> "Financing the Fund's Operations—Review of Issues." 2001, IMF. "The sale of gold to the market adds to the Fund's interest-free resources, but acceptance of gold in lieu of payments in currency or SDRs by a member satisfying its obligations to the Fund has the opposite effect. A sale of gold to the market provides interest-free resources equal to SDR 35 per fine ounce, and the excess also provides interest-free resources in the SDA, which, among other uses, could be transferred to the GRA or invested to generate income. Acceptance of gold in lieu of currency (or SDRs) would reduce outstanding Fund credit without a corresponding reduction in members' reserve tranche positions (or increase in SDR holdings of the Fund), and consequently would reduce the Fund's net income. Combining a sale of gold and its acceptance results in a loss of income in the GRA that is offset by investment earnings in the SDA."

<sup>30</sup> For illustrative purposes, let us assume that the IMF is able to sell all its gold reserves in a single financial year at SDR 200/ ounce for a total of SDR 20.6 billion.

The articles of the IMF mandate that of this amount, a total of SDR 35/ounce \* 103 million ounces = SDR 3.605 billion be transferred immediately into the General Resources Account. This would constitute an immediate and equal increase in the interest free assets. This increase would exactly offset the extent to which gold holdings had been decreasing the net available interest free assets and effectively free up all of them for use. The balance amount of SDR 16.995 billion would go into the Special disbursement account. This too would cause an immediate and equal increase in interest free assets, which would be additional to the levels before. Looking at the IMF balance sheet for 2002, this would actually increase the availability of interest free resources manifold.

The SDR 16.995 billion could be moved wholly or in part to the investment account to be invested in order to generate a regular income stream. This income stream can then be used partially to augment the General Reserves, fund concessional lending and debt cancellation or for any purpose that the Fund may deem suitable.

We contend that the sale of IMF gold would strengthen rather than weaken its position. The gold on the IMF's books is currently held at SDR 35(\$51) per ounce. If the IMF were to sell the gold in the market it would be able to retain a substantial part (more than three fourths) of the profits on its balance sheet even after providing for total HIPC debt cancellation. These added reserves estimated at well over \$20 billion would be much more substantial than the current book value of the gold and thus provide the IMF balance sheet with more fundamental strength.

*The IMF claims that gold holdings provide the IMF with operational manoeuvrability both as regards the use of its resources and through adding credibility to its precautionary balances. It also claims that in these respects, the benefits of the IMF's gold holdings are passed on to the membership at large, to both creditors and debtors. More specifically, it argues that its gold reserves allow even conservative central bankers to treat quota increases as asset swaps<sup>31</sup> rather than a donation because they know that the IMF could, in the event of non-payment of some of its loans, sell the gold to make up for the loss.*

We assert that this is not only inaccurate, but also misleading.

Due to the preferred creditor status of the IMF and its pre-eminent role in international finance as the central banker's central banker, there has been no default on IMF obligations in the past. There have been several very severe currency and debt crises in the past two decades and the IMF has had enough resources to cope with room to spare. There is no evidence that it will not be able to cope with future crises without dipping into gold reserves especially after the most recent quota increase in 2000.

Unlike the Multilateral Development Banks the IMF does not need reserves to reassure lenders and to permit it to borrow cheaply. The only function is to reassure central bankers that their funds are safe with the IMF. The IMF's balance sheet is perfectly sound for central bankers to treat quota increases as asset swaps, gold reserves or not.

We believe that the claim about the benefits of gold holdings being passed on to members is especially misleading as these stated benefits are intangible and insignificant compared to the significant opportunity cost of holding undervalued gold reserves. According to our calculations<sup>32</sup>, if the IMF had sold its gold holdings into the market gradually over a period of say twenty years from 1980, it would have had current reserves of more than \$65 billion; almost twice the current value of its gold holdings. If anything, IMF members have lost rather than gained because of the conservative approach to gold reserves.

It is important to recollect, that Fund staff in 1979-1980 wanted to sell the gold and invest proceeds in income generating assets but were thwarted by lack of political will and shallow markets. Given this earlier position and taking note that both the political

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<sup>31</sup> Asset swaps are an exchange of equivalent assets. In this case the amount of the quota increase by the central bank will be balanced by an increase in the share (claim) that the central bank has on IMF resources

<sup>32</sup> We assume that the IMF sold 5 million ounces of gold in the market every year from 1980-1999 at a 10% discount to the market price and the proceeds from such sales in excess of SDR 35 per ounce were invested in securities yielding 5% per annum. A simple calculation shows that the IMF would now have more than \$65 billion.

will to put the Fund's gold to productive use and deep and liquid gold markets to facilitate this exist now, we are baffled by the current position of the IMF on the issue.

*The IMF further states in its policy on gold<sup>33</sup> that it should continue to hold large quantities of gold among its assets, not only for prudential reasons, but also to meet contingencies.*

Once again, we assert that the IMF position on this goes contrary to good financial practice. The IMF has long sacrificed efficiency in its bid to be 'prudential'. However, had the IMF monetized its gold reserves through outright sales in the market, it would have had reserves that were twice the current market value of its gold reserves. So not only is holding gold inefficient, but it is also not 'prudential' as a higher level of reserves implied by the sale of gold would be more 'prudential' than a lower level of reserves implied by gold holdings.

Additionally, the IMF claims that it holds on to its gold to meet contingencies. Given its much-touted concern about disrupting gold markets, this is a strange claim. One would assume that in the event of the occurrence of a 'contingency', the IMF would need to sell some of its gold holdings. The very occurrence of a contingency would imply the existence of some form of global macroeconomic stress. Any way one looks at it, selling huge quantities of gold in such a stressed global environment would be a bad idea.

In order to meet with any contingency that the IMF wants to guard against, the sensible defence would be the existence of a well-diversified portfolio of highly rated liquid assets, which can be liquidated at relatively short notice to generate resources. This portfolio could be built up from the income generated by the sale of gold proposed in this paper.

*Finally, the IMF states that profits from the sale of any gold should be used, whenever feasible, to create an investment account from which only the income should be used.*

We sympathise with this position and believe it to be prudent. However, we insist that the HIPC Initiative and the request for total debt cancellation is an exceptional circumstance and creates sufficient justification for a possible violation of this prudence principle especially given that the IMF would still have more than three quarters of its gold intact after having met its enhanced obligations under a program of total HIPC debt cancellation.

Alternatively, if the IMF sells a sufficient amount of gold, the investment income from the proceeds of the sale of gold would be enough to meet the Funds' obligation for total HIPC debt cancellation. Under such a scenario, all the profits from the sale of gold could be invested in income generating assets.

***Does the IMF have any excess resources left over after total HIPC debt cancellation? How can these be used?***

We have shown that the IMF can easily afford to cancel all of the \$5 billion (NPV) HIPC debt that it is owed. However, we believe that the IMF has enough resources to go beyond total cancellation of its own debt to either cancel the HIPC debt of other less

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<sup>33</sup> <http://www.imf.org/external/np/exr/facts/gold.htm>

generously endowed multilateral financial institutions or to increase grants to HIPC countries. We have shown that if the IMF sells all the gold it owns, it can generate almost \$30 billion. This amount can easily be invested at between 5% and 6% in safe OECD government bonds<sup>34</sup> to generate between \$1.5 billion and \$1.8 billion in additional income every year in the long run. Of this the IMF needs only about \$150million-\$200 million every year to cancel all HIPC debt and can spare the rest.

The PRGF (Poverty Reduction and Growth Facility) loans that the IMF gives to HIPCs typically have less generous terms (0.5% interest, 5.5 year grace, 10 year repayment) than IDA loans (0% interest, 10 year grace, 40 year repayment); this means they have an effective grant element below the IMF's own criteria of 35%. If the program of PRGF lending continues (though we advocate that concessional lending be replaced by pure grant financing) the IMF could use some of this income stream to help subsidize more generous terms on the loans so they have an effective grant element of at least 35%.

However we suggest that the excess income be used wither to write off the HIPC debt owed to other multilateral financial institutions, such as the African Development Bank, that have fewer resources to spare; or be used to increase the grant aid flowing to HIPCs in order to help them meet the Millennium Development Goals.

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<sup>34</sup> "Financing the Fund's Operations—Review of Issues." 2001, IMF. "In order to generate income to offset operational deficits, some gold was sold to the United States and the proceeds invested in U.S. government securities. A significant build-up of reserves through income from charges prompted the IMF to reacquire this gold from the U.S. government in the early 1970s."

## **The World Bank**

### ***Background***

The HIPC's owe the World Bank a total of about \$19.2 billion (NPV) of debt, of which the Bank has already cancelled or promised to cancel about \$6.4 billion (NPV). Most of this debt is owed to the International Development Association (IDA).

The World Bank is using the 'HIPC trust fund' operating under the trusteeship of the IDA as the vehicle for debt cancellation. The fund gets its resources through International Bank for Reconstruction and Development (IBRD) net income allocations and voluntary bilateral contributions. Neither the IBRD, nor the IDA has written off the HIPC loans from their books. Instead, as and when a HIPC debt falls due, equivalent funds are transferred from the 'HIPC trust fund' onto their respective balance sheets.

To date, donor countries have committed about \$2.5 billion and the IBRD about \$1.5 billion to the trust. However, this is less than half the amount even for the part of debt cancellation that the World Bank has already agreed to. In addition, about another \$13 billion (NPV) must be mobilized to cancel all the debt owed to the IBRD by HIPC's.

### ***How can the World Bank finance the total cancellation of HIPC debt?***

Both the IBRD and the IDA are parts of the World Bank group. The IBRD, which is responsible for the non concessional lending by the World Bank, is one of the most resource rich financial institutions in the world. The IBRD has more than \$236 billion of effective capital of which about \$37 billion is in the form of reserves and paid in equity and the rest can be drawn in case of need to pay liabilities arising out of borrowings.

The IBRD has accumulated more than \$11 billion of reserves since 1998 while the level of borrowing and lending has remained roughly constant. Concurrently, its net income has gone up from \$1.2 billion in 1998 to \$3.4 billion in 2003. The equity to loans ratio, the bank's own measure of financial prudence has climbed steadily from 20.7% in 1999 to 28.2% in 2004.

Every way one looks at it, the IBRD is in an enviable financial situation and currently using only about 50% of its lending capacity. We firmly believe that the IBRD has enough resources not just to fund total World Bank HIPC debt cancellation but also to help increase grant flows to HIPC countries in the future.

The Bank's own assessment<sup>35</sup> of its financial situation presented below seems to agree with ours

"The World Bank has been rated AAA, the highest possible rating available, for more than 40 years by the major credit rating agencies. This quality assessment is confirmed by the capital markets which have been welcoming World Bank debt instruments since the issuance of the first World Bank bond in 1947.

There are six main reasons for the high degree of quality of World Bank debt instruments. First, World Bank debt is backed by the Bank's 184 sovereign shareholders. Second, the World Bank follows highly prudent financial policies that

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<sup>35</sup> <http://www.worldbank.org/debtsecurities/faqs.htm>

restrict its lending to a maximum of one dollar in loans per one dollar of total capital - the current ratio is as low as 53 cents in loans per one dollar of capital. The financial leverage is equally low as the World Bank's borrowings currently account for less than 60% of its total capital. Third, the World Bank has been consistently profitable with a net annual income exceeding USD 1 billion for over 15 years. Fourth, the World Bank maintains a highly liquid asset base in order to be flexible in the timing of its new debt issuance. Fifth, the World Bank's prudent lending policies, loan concentration limits ensure the high quality of the World Bank's loan portfolio. And finally, the World Bank only lends to sovereigns and sovereign-guaranteed projects and is recognized by the major rating agencies to enjoy a preferred creditor status with its borrower shareholders."

Below we consider three possible sources of funding for World Bank debt cancellation and show how these do not have any significant impact on any of the six factors, behind the AAA rating, that the World Bank has listed above.

### ***Through transfers from its retained earnings and net income***

We believe that the IBRD could transfer up to \$10 billion to the HIPC trust from its retained earnings, which currently stand at \$25.7 billion (total equity \$37 billion). These include the past profits, which are yet unallocated or have already been allocated to the reserves. Such a transfer would merely take the IBRD's retained earnings to the level they were at in 1997 at which point the Bank was active and successful (and rated AAA) as it is now.

Such a transfer would be worth \$10 billion in NPV terms.

We also argue that the IBRD could transfer up to \$800 million annually from its net income to the HIPC trust over the next 25 years. The IBRD's net income (profit) has been more than \$1 billion annually for more than 15 years in a row. Moreover it has been increasing sharply over the last few years, up from just \$1.2 billion in 1998 to more than \$3.4 billion in 2003.

Such a transfer of \$800 million every year over the next 25 years would generate<sup>36</sup> in excess of \$14 billion in NPV terms.

Hence we maintain that the IBRD could afford to mobilize up to \$24 billion in NPV terms part of which should be used to fund total HIPC debt cancellation. The balance can then be transferred to IDA to help increase the levels of grants to HIPCs and other poor countries. In the past, the IBRD has already transferred more than \$7 billion to IDA from its annual earnings.

### ***How this would not jeopardize the financial strength of the IBRD***

We now assess the affects of these resource transfers on the major sources of strength for the IBRD balance sheet as listed by the IBRD itself.

*First, World Bank debt is backed by the Bank's 184 sovereign shareholders.*

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<sup>36</sup> Using a discount rate of 3%

Our proposal for resource transfers from the IBRD has no effect on the support from the 184 sovereign shareholders

*Second, the World Bank follows highly prudent financial policies that restrict its lending to a maximum of one dollar in loans per one dollar of total capital - the current ratio is as low as 53 cents in loans per one dollar of capital. The financial leverage is equally low as the World Bank's borrowings currently account for less than 60% of its total capital.*

Our suggestions would have no impact on the Bank's policy of restricting its lending to a maximum of one dollar in loans per dollar of capital. It would, in the unlikely and extreme event of the Bank being stretched to its lending limit, decrease the lending capacity by 4.5%. However, given this small decrease and the fact that the Bank has never come close to reaching its lending limit, such an effect has no bearing on the Bank's financial strength or day to day operations.

In fact, as the Bank itself says, it is lending only at 53% capacity. As a result of the suggested transfer of resources, this capacity utilization would go up to 55%, a completely insignificant change. The Bank's borrowing is as it says, less than 60% of its capital; our suggestion would change it to about 62% - again an insignificant change.

*Third, the World Bank has been consistently profitable with a net annual income exceeding \$1 billion for over 15 years.*

The immediate transfer of \$10 billion would have a small impact<sup>37</sup> on the Bank's income generating capacity but given the high levels of income the Bank has been generating in recent years (\$3.4 billion in 2003) this would not materially affect its ability to consistently earn much more than \$1 billion every year.

*Fourth, the World Bank maintains a highly liquid asset base in order to be flexible in the timing of its new debt issuance.*

Given that this transfer of retained earnings can be done over a period of a year or more it gives the Bank ample time to manage its liquidity which is usually administered on a much shorter horizon. So the Bank can easily plan and time the transfer of the retained earnings so this has no discernable impact on liquidity. The regular income transfer of \$800 million that we have proposed would be known months and years in advance and hence can be factored into managing the liquidity position of the Bank. Also, \$800 million is only about 3% of the Bank's normal liquid assets of \$25 billion.

*Fifth, the World Bank's prudent lending policies, loan concentration limits ensure the high quality of the World Bank's loan portfolio.*

The transfer of income and retained earnings has no impact on the Bank's prudent lending policy or the quality of the loan portfolio.

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<sup>37</sup> The Bank has earned between 1% and 2% margin on its lending (between its lending income and lower borrowing costs). Presumably the Bank passes on the benefits of zero borrowing costs of retained earnings to the borrowing countries; this means the loss of \$10 billion in retained earnings would only diminish the Bank's annual income by about 1%-2% of that \$10 billion or \$100 million - \$ 200 million every year.

*Finally, the World Bank only lends to sovereigns and sovereign-guaranteed projects and is recognized by the major rating agencies to enjoy a preferred creditor status with its borrower shareholders.*

The preferred creditor status of the IBRD would not be in question as the HIPC debts to be cancelled are IDA debts. The IDA is legally a distinct entity.

Standard & Poors, a well regarded credit rating agency, in according the IBRD its highest rating of AAA says that this is based on

- Very strong capital adequacy and liquidity;
- Prudent financial management and policies;
- Excellent franchise value; and
- Strong membership support, including expected continued treatment as a preferred creditor.

We have already shown above that the suggested transfer of resources would not have any material impact on either the Bank's capital adequacy & liquidity or its financial policies. The IBRD's franchise value, membership support and preferred creditor status also remain unaffected.

Moody's, another prominent credit rating agency lists

- The Bank's solid capital structure;
- Its preferred creditor status;
- Financial policies that greatly reduce the Bank's exposure to financial risk while achieving adequate profitability; and
- Strong support from Aaa/Aa member countries

as the reasons behind assigning the IBRD its highest Aaa credit rating. Our proposal does not have any material affect on the factors listed above.

The African Development Bank (AfDB), another similar multilateral financial institution which is financially weaker than the IBRD faced serious financial and management problems in the mid 1990s. "Morale is as low as I have ever known it to be," said one insider. "The bank has lost direction, it is demoralized, and the entire lending machinery has come to a grinding halt."

Percy Mistry, putting together a report on the African Development Bank in 1993 said "The bank kept lending very large dollops of hard money to countries which simply could not afford its terms. I have still not got a satisfactory explanation for why this has happened." Another report on the AfDB said that "it (the AfDB) may end up destroying itself".

However, despite these very serious problems that would have bankrupted a private sector financial institution, the AfDB was given top credit ratings and its borrowing costs in the market stayed amongst the lowest. Uwe Bott, an analyst with Moody's in New York, said that the bank remained fundamentally sound. He pointed out that, although the quality of the loan portfolio had deteriorated, net income in 1993 was still positive, at just under \$72 million. "For there to be a capital call, the bank's assets must deteriorate sufficiently to absorb all net income," said Bott. "Then the bank must

draw on its reserves to pay its creditors. Only when reserves are depleted must the bank draw on its capital base, and it is backed by a large pool of triple-A-rated capital. This could only happen after a number of years of the bank making losses."

Clearly the IBRD, which will be in a much stronger position than the AfDB was in the early 1990s even after the implementation of our proposals, is under no threat of losing its AAA credit rating; its borrowing costs too, are expected to stay at the low levels they are.

### ***Rebutting the World Bank's opposition to total HIPC debt cancellation***

*The IBRD claims that its equity capital is leveraged at a ratio of about 5 through the issuance of AAA-rated debt. Therefore, its capacity to lend would be reduced by \$5 for every \$1 distributed to debt cancellation in respect of the concessional lenders' balance sheets.*

We rebut this claim as inaccurate, irrelevant and misleading. The following points explain why:

- First, the Bank is actually leveraged at a much lower level than stated. Conservatively estimated, the rate at which the Bank's equity capital is leveraged has declined steadily from 4.7 to less than 3.49<sup>38</sup> in the period 1998-2004. However, using a more accurate measure of equity similar to one used by credit rating agencies the actual leverage is only 0.81
- Second, there is no prudential justification for capping the Bank's equity leverage at 5. Historically, the Bank has had much higher equity leverage<sup>39</sup>. In the late 1980's and the early 1990's the Bank's equity was leveraged almost 6 times. Given that the Bank was healthy and functioning in good shape through most of those times, the current leverage of 3.49 seems excessively prudent and inefficient. In fact the Bank's equity leverage ratio would increase only to 5.1 after the transfer of \$10 billion to the HIPC trust. Using a (more accurate) definition of equity that includes callable capital (see footnote) the Bank's leverage ratio would in fact increase from 0.81 to 0.88 an extremely prudential and conservative level.
- Third, it is misleading when the Bank says that its lending capacity would be reduced by \$5 for every \$1 appropriated towards debt cancellation. The Bank is currently lending only at 47% of its nearly \$236 billion capacity. In fact, our debt cancellation proposal would just have the effect of reduce the Bank's total lending capacity only by 4.2% to about \$226 billion. The Bank's lending capacity would actually be reduced only by \$1 for every \$1 appropriated to debt cancellation.

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<sup>38</sup> On March 31<sup>st</sup> 2004, the Bank's borrowing stood at \$110.9 billion and the equity value used in the Bank's own calculations at \$31.7 billion giving a leverage of 3.49. However, this calculation does not reflect an accurate picture. As seen from the discussion above, the relevant equity figure here includes the Bank's capital that is callable from Aaa and Aa rated countries (\$103.7 billion) and can be used to repay the AAA bond investors- giving an equity of \$135.4 billion. So the real leverage ratio is actually only 0.81 – less than 1

<sup>39</sup> World Bank Annual Reports

*The Bank claims that it is likely that the write-off would result in a weaker equity capital position for the Bank and therefore an increased cost of lending to its borrowers. Debt cancellation, with substantially reduced borrowing, at higher cost, would have a serious impact on IBRD-eligible borrowers, which are home to 80% of the world's poorest people.*

We disagree with the position of the Bank. We believe that the fundamental financial strength of the Bank derives from a number of factors of which capital reserves are only one. According to credit rating agencies such as S&P and Moody's and the Bank itself<sup>40</sup> its financial strength derives from:

- Shareholder support
- Consistent profitability
- Large liquidity
- Quality loan portfolio
- Prudent Financial Policy

To illustrate the point, we assume that the Bank decides to follow our recommendation and decides to write off \$10 billion from its balance sheet. It then uses the amount for debt cancellation. This would mean that the equity of the IBRD would go back to the 1997-1998 level. The Bank was financially sound then and even at that time had one of the lowest borrowing costs in the financial markets.

We have shown, using the example of the African Development Bank, that changes to the Bank's financial situation induced by the recommended debt cancellation exercise, are not very significant to its market position as one of the lowest cost borrowers. Some credit and bond market professionals who actually contribute the pricing decisions on the Bank's costs of borrowing have privately confirmed that the Bank's borrowing costs would not rise by any significant level<sup>41</sup>. As we have already pointed out above, we think that the Bank is excessively prudent and financially inefficient.

If, for instance, the Bank were to double its current level of reserves, estimates show that its cost of borrowing would only go down by about three hundredths of a percent. Such an exercise would not be financially efficient as the opportunity cost of holding those reserves would be far higher than the small decrease in borrowing costs<sup>42</sup>.

Any increase in interest costs would be minor (1-2% of current interest costs) and could easily be financed by a compensating reduction in the Bank's operating costs (through more efficient operations for instance). Even if this were not possible, the cost of increase would be spread across the Bank's borrowers and lie well within the range of frequent changes in market based lending rates.

The Bank has, for many years, been allocating a proportion of its net income to the IDA, a transaction identical in spirit and effect to what we have proposed<sup>43</sup>.

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<sup>40</sup> [http://www.worldbank.org/debtsecurities/the\\_ibrd\\_credit\\_financial\\_str2.htm](http://www.worldbank.org/debtsecurities/the_ibrd_credit_financial_str2.htm)

<sup>41</sup> On the condition of anonymity as it would be unprofessional for them to make comments unauthorized by their employers

<sup>42</sup> Many major international banks have actually made strategic decisions to settle for slightly higher borrowing costs (lower reserves) in order to be able to put their funds to more efficient use.

<sup>43</sup> i.e. this money could instead have been allocated to the reserves. So, in opportunity cost terms, this amounts to a resource transfer out of the reserves to the HIPC's (and other IDA borrowers)

Incidentally, some IBRD borrowers have been increasing Overseas Development aid (ODA) Budgets. India, for example, has recently said that it intends to double its current \$700 million ODA budget and plans to add African nations its list of aid recipients.

***Does the IBRD have any excess resources left over after total HIPC debt cancellation? How can these be used?***

In the discussion above we have established that the IBRD can generate resources of up to about \$24 billion in NPV terms. It is also clear that these resources can be allocated to HIPCs without in any way seriously jeopardizing the Bank's lending capacity or increasing its lending rates. Of these resources only about \$13 billion<sup>44</sup> (NPV) is needed for total HIPC debt cancellation.

The balance \$11 billion could be used to make IDA concessional loan terms more generous; however, our preferred option is to use this money to fund higher grant flows to HIPCs in order to try and meet the MDGs.

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<sup>44</sup> Once we include the part of the existing commitments for debt cancellation that has not been funded yet (between \$2 billion and \$4 billion) then this figure is higher by the corresponding amount.

## **PART C**

### **The contextual interpretation of the IOB evaluation**

#### **Background**

The operation evaluation department (IOB) of the Dutch ministry of foreign affairs commissioned a study of 'international debt relief' the findings of which have been published. This section seeks to draw together the analysis in this paper and interpret it in the context of the IOB findings. Various relevant sections of the IOB evaluation are presented in italics and followed by a commentary.

#### **3.5.1**

*Debt relief efforts made by the international community have so far led to only a slight actual reduction of the debt stock. This is because the volume of debt relief has generally not been large in relation to outstanding debt, and also because a large part of received debt relief only restructured debt and did not cancel it. With the exception of Nicaragua and Mozambique, the annual accretion of new debt in the countries investigated was greater than annual debt relief.*

We agree with the IOB conclusion and stress that this is especially true of multilateral debt. The total post HIPC multilateral debt is still expected to be \$30.4 billion (NPV) or 70% of the pre HIPC \$43.6 billion (NPV) level. So the multilateral institutions plan to write off only 30% of their debt; the G7 countries in comparison have agreed to write off 65% of the HIPC debt owed to them.

Also, the group of countries examined in the paper have already accumulated more than \$5 billion mostly in new loans post decision point.

#### **3.5.3**

*In general, debt relief in the 1990s for the eight countries was additional to regular aid. On the one hand, it came partly from creditors that were not donors (e.g. private banks and former socialist countries); on the other hand, debt relief from donors/creditors was probably financed partly at the expense of aid to other, less indebted countries. The take-over of multilateral obligations by bilateral creditors was usually also non-additional for recipient countries because it often replaced other forms of programme aid. At the same time, this modality of debt relief is the only one that unambiguously frees resources for the debtor country because debt service to multilateral institutions was always paid.*

We agree with the IOB conclusion that multilateral debt relief always frees up resources for debtor countries; we also agree that in the past such debt relief was usually non additional for the recipient country as it came at the expense of other program aid.

However, as we have shown in Part B, multilateral debt relief at least by the IMF and the World Bank can be financed by their own resources without in any way compromising their present or future operations. This debt relief then would not come

at the cost of program aid and would be strictly additional. The money for the debt relief will come from the release of some of the excessive reserves (and gold) held by these institutions.

### **3.5.4**

*During the 1980s, private creditors were bailed out by official lenders. This also occurred in the 1990s, but bilateral donors then also bailed out multilateral creditors on a large scale. Bilateral donors were in a sense substantially contributing in three different ways to the financing of the concessional loans from the multilaterals: firstly, by making the loans possible through subsidies and periodical 'replenishments'; second, by agreeing with the preferential status of the loans, thus reducing the value of their own claims; and finally, by giving extra aid to the debtors concerned, including debt relief on (or the take-over of) multilateral claims. This was not efficient. Such bilateral financing and bailout enabled multilateral creditors to continue to provide imprudent loans for longer than would have been feasible if they had been saddled with the consequences of their own lending policy. Protection against part of those consequences by bilateral donors created moral hazard on the part of the institutions concerned. Of the new loans that governments of the six HIPCs took up in the 1990s, roughly 80% were granted by multilateral institutions (only Nicaragua had rather less, with approximately 60%).*

We agree with the IOB conclusion that the repeated and continuing bailout of multilateral institutions by bilateral creditors creates a moral hazard; this has encouraged excessive lending by the multilaterals sometimes for white elephant projects such as the one described in the box below.

#### **A failed loan for the cashew-nut industry in Tanzania<sup>45</sup>**

In the 1970s, the World Bank lent Tanzania \$45m to develop its cashew-nut industry, in part to build processing plants. But the Bank overestimated the market for cashew-nut exports and the business never really took off. Few of the plants were ever fully operational, and most now are completely dormant.

Much of the equipment was bought from Japan. Tanzania owes Japan more than it owes any other government – \$661m. Italy ranks third in its list of government creditors, at \$203m. Many of these debts are associated with the cashew-nut fiasco.

When Christian Aid visited World Bank officials in Tanzania to ask them about this, they made it clear that the cashew-nut debacle is ancient history as far as they are concerned. They have admitted their mistake and want everyone to move on. But this is not ancient history for Tanzania.

Today, despite enhanced HIPC debt relief, the government of Tanzania is still paying off about half of its debt to the World Bank and some of its debts to the Japanese government.

Despite many such examples of lending money for ill-conceived projects the Bank and the Fund have never had to book any losses; they have written a self-delusional record of never making a bad loan by refusing to ever recognize a formal loss. Default is masked by rolling over bad debts each year, with enough added to cover new interest

<sup>45</sup> Taken from *Owning the loan – poor countries and the MDGs*, Christian Aid and Afrodad, 2004

costs till such a time that they are bailed out by bilateral creditors. These are financially unsound practices that would invite regulatory reprimand in any private sector environment. Even under the HIPC initiative, the lion's share of the debt cancellation on offer by the multilateral institutions is being financed by bilateral contributions.

This is why we believe that the bilateral creditors should not finance any more of the multilateral debt cancellation under the HIPC initiative; instead the multilateral institutions should be made to cancel all HIPC debt which will not only release significant additional resources for meeting the MDGs but also equally important reduce the moral hazard that has been created in the past and encourage more responsible lending practices.

#### **4.7.7**

*Prospects for long-term debt sustainability are not favourable. Even if debts should become sustainable in relation to exports in the short term, thanks to the HIPC initiative, this situation will soon be reversed if trade deficits remain at their present high level. The moral hazard for multilateral institutions has given rise to too great a volume of loans. To ensure a sustainable debt level in the future, it is necessary that a larger portion of the trade deficits be financed from grants and/or that the volume of loans to these countries should decrease, particularly those from the multilateral institutions.*

We reach the same conclusion as the IOB; that the prospects for long term debt sustainability are not favourable. However we are looking at debt sustainability from a stock (wrt GDP) not flow (wrt exports) perspective. Like the IOB, we also have suggested that most future external financing should be in the form of grants not loans; however unlike the IOB we look at the need for external financing from the perspective of financing the MDGs not trade deficits though of course the two are related.

#### **4.7.8**

*With respect to the sustainability of the debt for the government, an additional fact is that all countries are faced with a rapidly increasing domestic debt on which far higher interest must be paid. In the six HIPCs this can practically nullify any positive flow and stock effects of the HIPC initiative.*

We completely agree with this result from the IOB evaluation but interpret the implications on the potential for domestic resource mobilization instead. The focus on domestic resources increased significantly especially after the Monterrey conference. There is a risk however that in a bid to raise ever higher levels of domestic resources HIPC countries could end up with unsustainably high levels of domestic debt. The IOB results show that this is already starting to happen. We include this limitation in our analysis by trying to limit our model only to sustainable levels of domestic revenue mobilization.

There is a risk that under the current situation where HIPCs are receiving only a fraction of their external resource needs in the form of grants/loans, they might resort to excessive domestic revenue mobilization through domestic borrowing in a bid to try and meet the MDGs. This situation is exacerbated by severe structural constraints on mobilizing tax revenues and low domestic income, consumption and savings levels.

Unrealistically high projections for domestic revenue by the Bank and the Fund can also increase the pressure on HIPCs to raise resources through domestic borrowing. It is thus imperative that both additional external debt cancellation and higher aid flows help close the MDG resource gap.

### **5.6.3**

*As regards modalities, too much debt relief was given in the form of restructuring rather than of forgiveness, and it was oriented too much towards reducing debt service (claims) rather than debt stock. The complete elimination of arrears proved the most effective form of debt relief because it produced stock effects, but that form was little used. However, countries that had little if any arrears (only Bolivia and Jamaica in this evaluation) did benefit from flow relief.*

We support this finding of the IOB evaluation and hence favour of an immediate cancellation of 100% of the debt stock (including arrears). This would allow HIPCs to capture the full benefits of debt cancellation and immediately free up scarce resources for MDG related spending.

### **5.6.4**

*Highly indebted countries were given more aid, but that was largely in the form of project aid and thus did not relieve the debt service plight. To the extent that aid consisted of new loans, it only increased the debt stock. Partly due to the fact that multilateral institutions did not themselves face the (full) costs of incautious lending policies (moral hazard), the volume of loans was too large and prolonged the unsustainability of the debt burden.*

We point out that even post HIPC debt relief - debt service (mostly to multilateral creditors) for the group of countries considered in this paper will constitute more than 25% of the total domestic resources available for MDG spending. We agree that the debt service plight of the HIPC countries continues and to the extent that multilateral institutions do not face the costs of reckless lending and unpayable debt by writing off all HIPC debt this plight will remain. That is why in this paper we have laid down clearly defined mechanisms whereby the important 'next step' of self financed multilateral debt cancellation can be taken.

### **5.6.5**

*The context in which debt relief was given has contributed to its lack of relevance. Imposing policy conditions on debt relief was not efficient because countries only implemented what they had already intended to do. Other measures were only temporary or cosmetic, or were implemented after great delay. Moreover, some elements of the policy prescribed by IMF and World Bank (which most countries nevertheless began to carry out, although (only) along broad lines and frequently with delay), did not contribute to economic growth in the manner intended.*

This conclusion lends strong support to our proposals for a total debt cancellation that is contingent not on any detailed policy prescriptions but only on a shortage of resources needed to meet the MDGs. Our paper shows that this need has already been proven in all the country level MDG costing studies carried out thus far, by nef, the UNDP, the World Bank and the Millennium Project, all of which show that much higher levels of resources than are currently available through grants or loans are needed in order to meet the MDGs.

Country level costings for HIPC countries done by nef<sup>46</sup> clearly show that all HIPCs face a severe shortage of resources needed to meet the MDGs. In performing the calculations for this paper, we have looked at all country level MDG costing estimates available. It is clear from this that nef estimates are not inflated but in fact lie in the middle of the range between the World Bank and UNDP estimates on the one hand and the Millennium project estimates on the other. It is useful to point out that UNDP/World Bank estimates are on average 80% of nef estimates and using them does not change our conclusion in any way. Though there are serious limitations in the nef methodology, a study of the other estimates helps make nef estimates more credible. It is our opinion then that the conclusion of our case studies, that Malawi, Mozambique, Tanzania and Uganda all need total debt cancellation and higher grants, can be generalized to the HIPC as a group. This is why we favour total unconditional debt relief for all the HIPCs.

### **5.6.6**

*The econometric research has shown that high debt (in relation to GDP) has a negative effect on economic growth. This backs up the findings of the country studies, namely, that it is essential for debts to be reduced through forgiveness and fewer new loans.*

This finding from the IOB evaluation report supports our thesis that high levels of debt stock (as a percentage of GDP) is undesirable and unsustainable. In the paper we have shown how current debt stocks as well as an accumulation of new debt in order to finance the MDGs can lead to a situation whereby in 2015 HIPCs could end up with very high levels of debt in relation to GDP. We have shown for instance that if Malawi financed its MDG resource gap purely through concessional loans, it would end up with a debt to GDP ratio of at least 276% in 2015. This debt overhang will clearly have a negative effect on economic growth and divert precious resources away from welfare spending. That is why in common with the IOB, we recommend that HIPC countries receive most external assistance in the form of grants not loans.

### **7.5.2**

*The debt relief that is given at the Completion Point of the HIPC initiative implies a reduction of the debt stock and thus reduces uncertainty regarding future payments. However, the large bilateral contributions to multilateral debt relief, and the expectation of multilateral institutions that they will again be bailed out in future, means that moral hazard continues among those institutions, as does the risk of too great a lending volume and adverse selection in the allocation of loans and grants.*

### **7.5.3**

*This evaluation has concluded that debt relief often does not release funds but that it nevertheless, particularly in the case of elimination of arrears, can be beneficial to economic growth by reducing debt overhang. Some concern regarding a possible reduction of loans and grants to other low-income countries with low levels of debt, is certainly not misplaced. However, it is a positive factor if lack of additionality causes multilateral institutions to make fewer new loans to highly-indebted countries because it reduces the chance that the latter will in future suffer unsustainable debt levels. With a stagnating world-wide aid budget, extra payments by bilateral donors to multilateral institutions – intended to guarantee the ‘additionality’ of their concessional funds – signify merely that grants are converted into loans, possibly causing the debt problem to persist.*

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<sup>46</sup> The Unbreakable Link, Romilly Greenhill, New Economics Foundation, 2003.

We agree with the above assessments of the IOB evaluation. These help reinforce the central message of our paper which is that multilateral institutions must cancel HIPC debt; cancel it purely out of their own resources and not through additional bilateral contributions. This will reduce moral hazard and discourage excessive lending and adverse selection.

We alleviate the concern raised by the IOB evaluation that multilateral HIPC debt cancellation could come at the cost of loans and grants to other low income countries or that it would not constitute additional funds. We do this by showing that the two largest multilateral institutions (and possibly others) namely the IMF and the World Bank could easily afford to cancel HIPC debt using their own resources in a way that does not jeopardize their operations at all.

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