V The Scope for Multilateral Debt Relief

Issues Raised by the Multilateral Debt Problem

The problem of multilateral debt, like that of bilateral debt, is one which affects mainly the severely indebted low-income and lower-middle-income debtor countries of Africa, Central America and the Caribbean. It may, as the 1990s wear on, eventually also affect a number of countries in Eastern European and the former Soviet Union (FSU) unless prophylactic action is taken in time. The problem concerns mainly debt owed by certain countries to the IMF, and the hard windows of the World Bank and African Development Bank. In the case of the World Bank certain steps have already been taken to ameliorate the distress caused by debt servicing obligations to a reasonable extent. Debt owed to other multilateral institutions (especially the Asian Development Bank) does not pose as much of a problem. In the case of the Arab multilaterals, however, fairly large take-outs and negative transfers have, at the margin, added to the problems of a few African SILICs.

For countries whose external debt burdens are already severe any additional debt service obligations to any creditor (but especially to all preferred creditors) compromises their recovery and development prospects. In the case of some African countries, arrears to the African Development Bank and other multilaterals are rising as they attempt to keep current with the World Bank and IMF. These developments do not augur well for these countries in terms of damaging their financial relationships with some key institutions while becoming increasingly vulnerable to the conditionalities, strictures (and occasional management whims) of the Bretton Woods twins. The disconcerting inadequacy in the performance of some multilateral creditors since 1987 has thus added to rather than subtracted from the debt burdens of countries which need to be dealt with more sensibly. Doing so would raise several questions about relations between these institutions as creditors and their debtor-members which need to be addressed much more systematically by the international community. These include the following:

- Should the unwillingness of multilateral lending agency managements and their developed country members to contemplate rescheduling, refinancing, cancelling or converting multilateral claims – on the same basis as private and bilateral claims – now be reconsidered?
- If multilateral claims were to be treated on a basis similar to other creditor claims what would be the impact on the financial standing, capital structure and international market access of the multilateral institutions?
- Are bilateral and private creditors prepared to further subordinate their

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claims to those of multilateral agencies to enable a greater proportion of debt servicing be diverted to multilateral creditors through the 1990s – i.e. will bilateral and private creditors consider a much larger volume of cancellations and conversion of their claims than has hitherto occurred?

- Given the urgency of restoring positive multilateral net transfers to a wider group of SILICs and SIMICs what needs to be done by way of: (i) reducing multilateral debt service burdens through the 1990s; (ii) increasing multilateral disbursements; and (iii) increasing the concessionality of the multilateral lending mix for both SILICs and SIMICs?
- How should multilateral institutions and their managements be made more accountable for the consequences of their own actions?
  [At present any default on the part of the management or staff of these agencies – in, for example, misdesigning investment projects and adjustment programmes, misconstruing and misunderstanding the nature of debtor economies, engaging in imprudent over-lending or under-lending etc. – is paid for either by the debtor countries through enforced even if unaffordable debt service or by other creditors who have to tolerate higher levels of defaults, cancellations and arrears in order for multilateral debt service to be pre-emptively financed. No mechanisms are in place for multilateral lenders who err in their credit judgements to bear directly the costs of those errors.[8] That omission has, in part, led to the problem of multilateral over-lending which multilateral agency managements are understandably reluctant to have dealt with in the same way, and with the same sanctions and penalties, as they often advocate for other creditors].

These issues and questions need to be systematically and thoroughly addressed as a matter of the international public interest. In raising them for consideration as part of an international agenda for reform of multilateral institutions in the 1990s this paper eschews further detailed discussion of these questions and issues at this juncture – although the time for such discussion is perhaps overdue! Instead attention is turned to what might be done in the immediate future to ameliorate the growing burden of multilateral debt and to reverse some of the trends that would make its

8 Multilateral agency managements are becoming increasingly defensive about this issue. They have, through their lives created mechanisms and bureaucracies for insulating themselves, almost perfectly, from bearing any of the costs of mismanagement. Unlike their counterparts in private banks who are occasionally subject to the discipline of the marketplace, or in bilateral agencies who are often subject to the cruder discipline of politics, senior managers in multilateral agencies have effectively become answerable to no clear or singular authority. When discipline is attempted to be imposed on them the usual reaction is a playing of one lobby against another within the institution. The issue of accountability in the management of multilateral financial institutions is one which demands urgent political attention on the part of the leadership of the international community.

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servicing increasingly untenable for many developing countries over the rest of this decade.

Arguments against Multilateral Debt Reduction: Opposition to transparent and systematic multilateral debt relief is based mainly on two arguments. The first is that providing such relief would incur the *moral hazard* of rewarding countries that were unwilling to accept conditionality and exert maximum efforts to adjust. These moral hazard arguments are echoes of arguments that were repeated *ad nauseam* between 1983-89 when they were applied to the servicing of debt due to commercial banks. As experience with subsequent commercial debt relief clearly demonstrated these arguments were hollow then and are no more meaningful now. The real moral hazard may be a different one – i.e. permitting multilaterals as creditors to be insulated completely from the consequences of their own often poorly judged actions and lending decisions which have unarguably played a role in creating and exacerbating the problem.

The second argument concerns the *preferred creditor status* of multilaterals which, though legitimate as a principle in its own right, may become dangerous if abused as an all-purpose cloak to shield multilaterals from full and proper accountability for their (occasionally unsound) lending decisions. The following arguments are generally used to support the multilaterals' preferred creditor status:

- The hard-window lending of multilateral institutions (other than the IMF) is financed by sales of their bonds to investors in international financial markets.[9] The multilaterals thus depend on uninterrupted debt service from their developing country debtors in order to maintain their own debt service obligations on time; full and timely repayment is therefore crucial to market confidence in these bonds which enables multilaterals to raise resources at extremely fine interest rates. This argument is sustainable in the sense that public announcement of a formal policy of rescheduling or debt reduction would worry the capital markets and increase borrowing costs for all developing countries. Such a reaction might occur not because of the absolute cost (e.g. writing down the debt of all SILICs and SILMICs, except Nigeria and Côte d'Ivoire, would have little impact on the IBRD, IDB or AfDB balance sheets) but because of the perceived risk that this might set a precedent for larger debtors. This risk might arise even if a write-down phased over several years were combined with partial conversion of debt into equity investments by the private sector arms of

9 Governments support these bond issues by pledging capital replenishments, most of which are not paid in, but are "callable" in the event that the institution concerned risks a default on meeting its own debt service obligations to bondholders.

multilateral institutions (for example, an IBRD-IFC debt swap) to support programmes of privatisation, the indigenous private sector and the mobilisation of foreign investment in low and lower-middle-income countries.

- The hard window (upper tranche) lending of the IMF is financed by quota increases which then begin to count as part of the official international reserves of member countries. As such, the argument against formal debt relief of debt service obligations to the IMF is that quotas must be risk-free with the reserve tranche being freely available for use on demand. In the absence of a new SDR emission, designed specifically for the limited purpose of extinguishing the debts of eligible SILICs, any rescheduling or reduction of debt owed to the IMF would require member countries to agree to reduce the value of their reserves.
- The capital component of SAF was funded by sales of gold held by the IMF (which belonged to member countries) while that of ESAF is funded by loans or other contributions from member governments which would be affected if rescheduling or reduction were to be permitted.
- The concessional windows of the multilateral development banks, the IMF (the SAF and ESAF interest subsidies) and the EC are funded by grants from donor countries. There is therefore no particular reason why such loans could not be rescheduled, refinanced, cancelled or converted into local currency. The main argument against this course of action, of course, is that concessional funding from donor countries is becoming increasingly limited as OECD governments come under acute budget-cutting pressures. Any relief would therefore reduce the availability of concessional resources available for recycling in the 1990s.[10]

If these arguments are taken at face value, the scope for multilateral debt relief may seem limited. However, they cannot be taken at face value. The merit of these points should be viewed against the current negative effects of multilateral debt in compromising the development prospects of a large number of low-income developing countries and the potentially positive effects that relief might have. The inflexibility of multilateral debt service now requires bilateral creditors to cancel large stocks of *bilateral* debt, accept growing arrears on the residual debt, and to provide financing for servicing debts to multilaterals. It is thus already diverting too large a proportion of bilateral concessional resource flows to low-income Africa from financing poverty alleviation and growth to financing debt service to multilateral

10 But that argument applies with equal force to the rescheduling and reduction of bilateral debt which has the same unfortunate effect. Nonetheless, bilateral debt reduction has now become commonplace although it is not yet as extensive as it should be. Moreover, if multilateral debts were to be reduced significantly the same quantum of concessional resources would not be needed to service them.

institutions. The current approach also increases the total debt overhang in these countries as other creditors capitalise their arrears and multilateral institutions refinance informally with new loans. Accumulation of excess debt then discourages investment and growth in developing countries. Up-front multilateral relief in cases where it is clearly justified could free more concessional resources to finance growth and could play a major part in assisting afflicted debtor countries to exit from the debt trap with improved prospects for sustaining growth.

Approaches and Solutions to the Multilateral Debt Problem

Reluctance to address multilateral debt problems openly and squarely and to rely instead on traditional approaches (which sometimes appear to be bordering on the opaque and surreptitious) puts pressure on inelastic donor budgets and threatens the efficacy of the development assistance system. There are other options open to consideration which would avoid any significant risk to: the capital market standing of multilateral institutions; the value of IMF members' reserves; or to the threat of even more sharply constrained concessional resources available for application to development instead of debt service. These have been raised in a number of publications and fora, and have been discussed frequently (though privately) within the multilateral institutions themselves, only to be dropped for lack of political consensus among OECD countries rather than for sound technical or financial reasons. These options now need to be discussed by wider international publics with political pressure being built up to seek other ways of refinancing or reducing multilateral debt, and clearing multilateral arrears, than simply diverting bilateral aid away from priority purposes to meeting multilateral debt service.

There is a clear danger that the continued diversion of bilateral grant aid for this purpose will erode (and perhaps permanently damage) the public constituency for maintaining continued levels of development assistance from OECD countries which are suffering from acute and seemingly domestic problems (such as unemployment). After the EBRD debacle[11] and news about the World Bank and other multilateral institutions indulging in their 'edifice complexes' and other forms of egregious waste, publics in donor

11 This concerned the public outcry against the excesses of the EBRD President in wasting administrative resources on hiring charter jets and expending lavishly on dining rooms and marble entrances resulting in the EBRD spending far more on itself in 1992-93 than disbursing to its borrowers. This paper does not deal much with the portfolio of the EBRD simply because that institution has not yet built up a disbursed and outstanding loan portfolio of any significant size.

countries are becoming increasingly intolerant of having their tax funds deployed to support multilateral institutions which are perceived as profligate and ineffectual, excessively generous in expenditure on themselves (while being draconian in imposing harsh belt-tightening discipline on their borrowers), and subject to no clear authority or control. Multilateral institutions (excluding the UN) now cost a total of about $3.5 billion annually to run (the World Bank alone accounting for over a third of this amount) and there are serious questions to be raised about whether the international system is deriving sufficient value for this expenditure.

Of the options which have been tabled to tackle the problem of multilateral debt, the following appear to deserve the most serious and urgent attention:

• **A Special SDR Emission** has been proposed by various sources in recent years for providing multilateral debt relief. The major reason for opposing this source of funding is the theoretically inflationary effect that increasing global liquidity through an SDR issue deployed for this purpose might have. These fears (most strongly expressed by Germany) have been excessively overplayed with a number of authoritative analyses concluding that such a danger is minimal and the prospects of a tailored SDR issue being inflationary are infinitesimally small. The current low-inflation environment reduces even more this insignificant risk of exacerbating inflation; in fact a case could be made in the present global climate for offsetting the negative consequences of deflationary forces. There is a compelling argument for a one-time issue of SDRs to be issued and voluntarily redistributed by the Fund's OECD members (and others with a strong reserves position) to a limited number of specific eligible countries (on a case-by-case basis) which would use these SDRs to extinguish their multilateral debt.

While there is a strong case for a sufficiently large SDR emission to enable the extinguishing of debt owed by this group of countries to the IMF, World Bank, AfDB and (to a much more limited extent) the IDB, even a smaller emission which focussed only on extinguishing debt owed to the IMF would still be worthwhile. The mechanics and issues involved in this option are arcane and complex and are not discussed in detail in this paper. But the issue is not that complicated in principle or practice. Several papers have recently been circulated within the IMF on this option (and many members of its staff and management are in favour of implementing it). These internal papers now need to be made public and debated widely. Following such discussion, international pressure needs to be brought to bear on reluctant governments to reach a positive consensus on this option or, alternatively, to find ways of proceeding without one or two governments holding the system hostage to their overplayed concerns and fears – none of which are likely to materialise.

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• **IMF Gold Sales:** The original concessional facility of the IMF – the Trust Fund – was financed by the sale of SDR 3 billion of IMF gold reserves in 1976.[12] Similar sales of SDR 3-6 billion were suggested by the US Congress and Scandinavian countries as funding sources for the SAF and ESAF. Instead, the IMF chose to set aside 3 million ounces of gold (with a value of approximately SDR 1 billion) as a reserve to guard against possible non-repayment of ESAF loans. The major current objection to gold sales is that the world market price of gold (despite recent volatile movements) is near its lowest real level since 1978. In this light the sale of gold might seem to be untimely and possibly wasteful of valuable international reserve resources. However, opinion is divided on future trends in the price of gold. Many expert market analysts believe that (following restructuring of the Russian economy and the need to increase export earnings in post-apartheid South Africa), gold production will grow faster than demand during the rest of the 1990s, possibly exerting further downward pressure on prices in the long run. Uncertainty about the gold price in the medium term is even more acute. Given rates of return on financial assets, most governments around the world have been gradually reducing (in absolute and proportionate terms) their stocks of gold reserves and investing in stable currencies or income-earning government bonds. Whether the IMF as global financier of last resort should also follow this trend is a matter of open debate on which member governments have widely differing opinions. In any event, to put matters in perspective, the amount of gold that would need to be sold at current market prices to finance a total write down of the debt of low-income Africa owed to the IMF would amount to about 10-12% of the IMF's total holdings of gold.[13]

• **Retained Earnings, Provisions and Reserves:** Following the dictates of prudence demanded by the quality of their stressed asset portfolios most multilaterals have already set aside substantial provisions and/or reserves (specific and general) to guard against possible non-payment of debt service due to them. The exception to this rule is the AfDB whose 1992 Annual Report suggests that reserves and provisions are proportionately not yet as large as those of other MDBs, especially when taking into account the higher risk it appears to be carrying in its asset portfolio. But allowing for that exception, the multilateral banks generally have substantial amounts of retained earnings accumulated as a result of generating high profits (paid for

12 This was only one-sixth of a much larger programme of gold sales between 1976 and 1980, establishing a clear precedent for gold sales now.

13 This measure has already been suggested many times: for example by Goreux, Kenen and Polak in Gwin, Feinberg et al.

by developing countries) and not paying out dividends to their shareholders. These earnings, provisions and reserves are currently not being deployed in any way other than to bolster the balance sheets of the MDBs.

For example, the extent to which they have been built up in the World Bank and IDB (where retained earnings, reserves and provisions taken together now amount to over $17 billion and $5 billion respectively) permit somewhat greater room for manoeuvre in providing debt relief to deserving countries than either institution has chosen to admit or exercise, choosing instead to transfer most of the burden for such relief on already overstressed donor aid budgets. The balance sheets of these multilateral institutions already have several levels of safety built into them. Their present reserves and provisioning policies raise a question as to whether these policies have now become a convenient back-door way of accumulating cash capital on MDB balance sheets rather than being used (even to a small extent) for the purpose which they were originally created for. The possibility of redeploying a small proportion of such provisions and reserves should therefore be carefully reexamined to establish whether these institutions could not afford (without any serious damage to their balance sheets) to: (a) write-down the stock of their hard-window debt which remains outstanding in several severely debt-distressed low-income countries; or (b) to refinance it on IDA equivalent terms; or (c) finance an up-front clearance of arrears.

• **Cancelling Undisbursed Balances of Loans and Credits Made for Projects which have Proven Unviable:** Most multilaterals now have a growing proportion of loans outstanding, as well as undisbursed, for projects which have either been suspended or have not been functioning effectively for several years. As has recently been proposed by the Wapenhans Report on the quality of the World Bank's portfolio, the undisbursed balances for such projects in all developing countries should be quickly cancelled. In the case of hard-window loans this measure would prevent the further build-up of bad debt. Action along these lines is already advanced in the World Bank and needs to be emulated by the other MDBs, especially the AfDB. In the case of soft-window credits to non-debt distressed countries which had been earmarked for such projects, scarce concessional resources might actually be released and could be used to supplement both debt reduction and new lending in SILICs.

These measures would be helpful at the margin. But they would not necessarily address the problem of outstanding multilateral loan balances already disbursed for unviable and non-functioning projects. Borrowing countries are saddled with repaying those unproductive multilateral debts even though the projects financed are not generating any returns. There is a strong moral case for appointing qualified *independent tribunals* of experts to:

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(a) examine the decision-making process behind these project loans to SILICs carefully;[14] (b) determine the extent to which the multilateral banks were themselves responsible for project failure; and (c) assess what proportion of the cost they should therefore bear by reducing or relieving the ensuing unproductive debt burden. Apart from the obvious morality of such action, and the confidence it would instil in the publics of donor countries who are becoming increasingly disillusioned with the multilaterals, this measure would also provide a mechanism to deter MDBs from expanding their lending simply to meet annual targets. It may also help to restore a sense of quality-consciousness in their approach which the Wapenhans Report (and its equivalents in the other MDBs) suggest has been diminishing. There is an even more compelling case for employing the same approach in the case of IMF-World Bank designed and imposed adjustment programmes in the affected SILICs which have subsequently failed, but which have left in their wake a debt burden which is unsustainable (the case of Zambia is a particularly egregious one). But the sheer complexity and impracticality of apportioning blame in the case of such lending makes this approach unviable and inapplicable.

The danger of implementing the measure suggested above, of course, is that MDBs would threaten to become so conservative and cautious in their operations that new lending and disbursements would fall sharply, resulting in large negative net transfers materialising in the coming years. While that threat is real and should be taken seriously, it should not be overplayed. Very large negative net transfers would affect the middle-income borrowers of the MDBs (where they have every incentive to lend and these borrowers are much more capable of looking after their own interests) and not the SILICs. Moreover, negative net transfers would bear the seeds of self-regulation because they would result in growing arrears to the multilaterals – a risk they can ill-afford to incur.

On the whole, perhaps the time for implementing such a measure is

14 The MDBs argue forcefully and correctly that they do not compel their borrowers to assume loans. Thus when the borrowing country agrees to the loan it accepts full responsibility thereafter with the MDBs being absolved. This was the same argument that commercial banks made in justifying some extremely dubious (in some cases even plainly corrupt) lending to developing countries in the 1970s and early 1980s. While that argument has some superficial logic to it, it belies the reality of the multilateral lending process as it occurs in most African SILICs. In these countries, the MDBs – and the World Bank in particular – dominate the entire lending process from beginning to end, ostensibly to compensate for lack of capacity on the part of the borrower but with the effect in practice of virtually cutting the borrower out of responsibility for its own decisions. The MDBs identify the project, prepare it, pre-appraise it, design it, appraise it, lend for it and supervise it. Under these circumstances borrowers might be forgiven for feeling that, having depended on the MDBs for expert advice, they were misled when it did not work out and that therefore they should not bear the entire cost of servicing the useless debt that was thus accrued.

overdue in reinforcing a system of internal checks and balances which appears to have broken down in the MDBs. The nature of relationships between their managements and Boards is counterproductive and ineffectual. Moreover, the quality of MDB management has been steadily diminishing, fostered as it is by an incestuous system of internal selection and promotion which does not permit MDB managers to build up any significant experience in the real world, making them poor assessors of substantive project or programme issues, and providing them little opportunity for exercising sound judgement in assessing credit quality and risk. The only real expertise that such systems inculcate is in the arts of report-writing, rationalisation, bureaucratic in-fighting and in honing presentational skills.

- **Multilateral Debt-for-Equity Swaps:** One technique which has met with considerable success in reducing the stock of private commercial debt and has more recently been proposed in dealing with the overhang of bilateral debt[15] is that of debt-equity swaps. In theory and principle, there is no reason why the same technique could not be attempted (even if for a small amount of debt) between the lending and investment arms of the MDBs (e.g. between the World Bank and IFC) in instances where it made sense and where such conversions might help to kick-start programmes of privatisation and public enterprise divestiture. Working out details like the pricing of such swaps would entail complex and tricky issues but none of these would be beyond the wit of these institutions to resolve if the will existed to undertake such operations and make them a success. Their shareholder governments should require that prospects for such conversions be carefully examined by each MDB with a view to reducing debt obligations of eligible SILICs to their hard-loan windows to the maximum extent possible.

Redistributing Donor Resources Among Multilaterals

Given the obvious limitations that are now pressing on securing additional resources from donor countries, the five options discussed above need to be explored more intensively in arresting the growth of the multilateral debt problem. But, although donor funds may be constrained, their current pattern of distribution among multilateral institutions is sub-optimal and reflects many of the same flaws that characterise the distribution of bilateral OECD-DAC aid. Several of the measures discussed below involve rethinking

15 See Mistry, P.S. & Griffith-Jones, S. "Conversion of Official Bilateral Debt", UNCTAD, Geneva, May 1992

the current distribution of resources among institutions, or among the different lending windows of each institution, in order to ensure that they: (a) make the maximum contribution to restoring prospects for sustainable development in the most debt-distressed SILICs; (b) catch up with changes in developing country income levels; and (c) avoid measures which might damage multilateral credit ratings or donor budgets.

In particular, despite the 'leverage' effect of capital subscriptions to hard windows, donors now need to concentrate resources on the soft windows of the multilateral development banks, and shift emphasis from IDA to the AfDF for two main reasons:

- Many severely indebted countries in Africa have recently fallen from middle-income to low-income status, and several more will follow them, increasing demand for soft window funds, particularly from the AfDF; without a much larger AfDF-7 replenishment which enables the AfDB to refinance some of its hard-window debts with concessional financing in the same fashion as the IBRD, the AfDB's role in Africa is likely to become marginal.
- Most remaining middle-income debtors are demonstrating their ability to attract private foreign capital or promote domestic investment, thus reducing the demand for hard-window multilateral funds.