european network on debt and development

Arrears Clearance: Loan Laundering and Creditor Co-Responsibility

EURODAD Report

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This report was written by Gail Hurley at EURODAD. It is a EURODAD paper but the analysis presented does not necessarily reflect the views of all EURODAD member organisations.

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Executive Summary

This paper explores how the international community currently deals with arrears clearance operations, in particular to the international financial institutions (IFIs). Currently, for all developing countries the total amount of external debt in arrears stood at US$130bn in 2003. The regions most in arrears difficulties are Sub-Saharan Africa and Latin America.

This paper examines several recent cases of arrears clearance operations, such as the Democratic Republic of Congo, Iraq, Haiti and Nigeria. We argue that in many cases, these arrears should not be cleared in the first place because the debts are odious or illegitimate in origin. In addition, we reveal how current approaches to the problem have several other very serious knock-on effects. These include the negative impact on countries' overall levels of indebtedness to the international financial institutions; the implications on countries' policy space or autonomy; the impact on donor aid budgets and on poor countries' very scarce financial resources.

Given these considerations we find that current approaches to the arrears problem only serve to support the skewed and highly conditional (re)engagement of countries with the international community. This perpetuates the debt-poverty and dependency trap many developing nations find themselves in. It also exonerates creditors from all co-responsibility for the crisis and thus contributes to "moral hazard" on the part of the creditors. Given that several other countries are likely to embark on this same well-trodden path in the near future – such as the Republic of Congo and Liberia – Eurodad has produced this discussion paper to highlight the concerns we have with current approaches and to suggest to the international community that there are alternative ways forward.

The proposals outlined in this report include practical steps to address the historic unpayable – and in some cases illegitimate – debt burdens of the past at the same time as measures to improve future lending and borrowing practices. And as this paper will show, these proposals for reform are not radical but are politically achievable, not to mention essential. Measures need to be undertaken by both debtor and creditor governments and commercial banks alike. They require the full involvement of national parliaments and local and international civil society actors. More specifically we recommend that the international community support comprehensive debt audit processes, as well as alternative more egalitarian forums for debt work-out processes: in this context we propose alternatives to the Paris and London Club forums. We indicate that civil society organisations are working to define a set of responsible international financing standards for the future and urge the international community to support these efforts.

We believe that action comes down to sheer political will. If donors and creditors show willingness to embark on more fundamental reform of the international debt architecture, in partnership with all relevant stakeholders, this will indicate their readiness to seriously address the debt problem and the gross power imbalances that characterise the current system. Certainly NGOs and social movements around the globe will continue to fight for an approach to international development finance that is based on solidarity, not conditionality, penalties and gross inequalities.

1. Introduction

2005 saw huge mobilisations around the globe – of civil society organisations, social movements, churches, academics, prominent persons and members of the public – to push the international community, and in particular the G-8, to do better on aid, debt and trade. On debt, the G-8 responded to popular pressure in July 2005 with an announcement to cancel US$40bn in debt owed by 18 Heavily Indebted Poor Countries (HIPCs) to the IMF, World Bank and African Development Fund (AfDF). By the end of the year, the Paris Club of wealthy creditor nations had also agreed to cancel US$18bn owed by Nigeria to the Club.

While it is indeed significant that the international community has acknowledged for the first time that 100% cancellation of some multilateral debts is urgently needed and can be accomplished, these announcements spectacularly failed to address the fundamental problem of skewed relations in the global debt architecture. The global financial architecture continues to be characterised by the same gross power imbalances that replicate debt dependency over and over again. Some of the main features include preservation of the de facto privileged creditor status of the international financial institutions (IFIs), highly conditional grant and loan financing, highly conditional debt relief, the phenomenon of "false" aid, massive financial flows from South to North and an unfair trade and exchange regime.

One key and very recent example of some of these broader structural, underlying problems is the November 2005 deal struck between Nigeria and the Paris Club. In order to obtain a debt write-off of US$18bn, Nigeria was required to pay-out US$12.4bn to Club members: US$6.3bn to clear arrears and US$6.1bn in a debt buy-back. This cash – from an impoverished nation – will flow straight into the coffers of wealthy creditor nations, with the UK, France and Germany the biggest beneficiaries. To put the scale of this pay-out into perspective, Nigeria will pay-out more in just a few months than the G-8 multilateral debt deal will deliver for 18 poor countries in a decade. The Nigeria deal is also contingent upon the authorities agreeing to have their macroeconomic policies monitored by the IMF under a new "Policy Support Instrument" (PSI). But perhaps most importantly, many of the debts had been described by Nigeria's President Obasanjo as of "highly dubious origin": the cash was loaned to military dictators and now consists in large part of accumulated interest and penalty charges.

This paper explores one particular aspect of the inequity in the current global financial architecture: processes of arrears clearance by countries in arrears on their external debt repayments. By exploring the recent cases of arrears clearance by the Democratic Republic of Congo (DRC), Iraq, Haiti and Nigeria we find, very worryingly, that current approaches to the arrears problem support the skewed and highly conditional (re)engagement of countries with the international community. This perpetuates the debt-poverty and dependency trap many developing nations find themselves in. But worse, we show that in many cases, these arrears should not have been cleared in the first place because the debts were odious or illegitimate in origin.

Looking at several country cases we ask:

- Whose interests are we actually furthering when arrears are cleared?
- Does arrears clearance actually lead to reduced debt burdens?
- How do current practices alter the structure of a country's debt burden?
- What are the conditionalities usually associated with processes of arrears clearance?
- How are issues of creditor co-responsibility and illegitimate debt dealt with?
- What are the alternatives to current procedures?

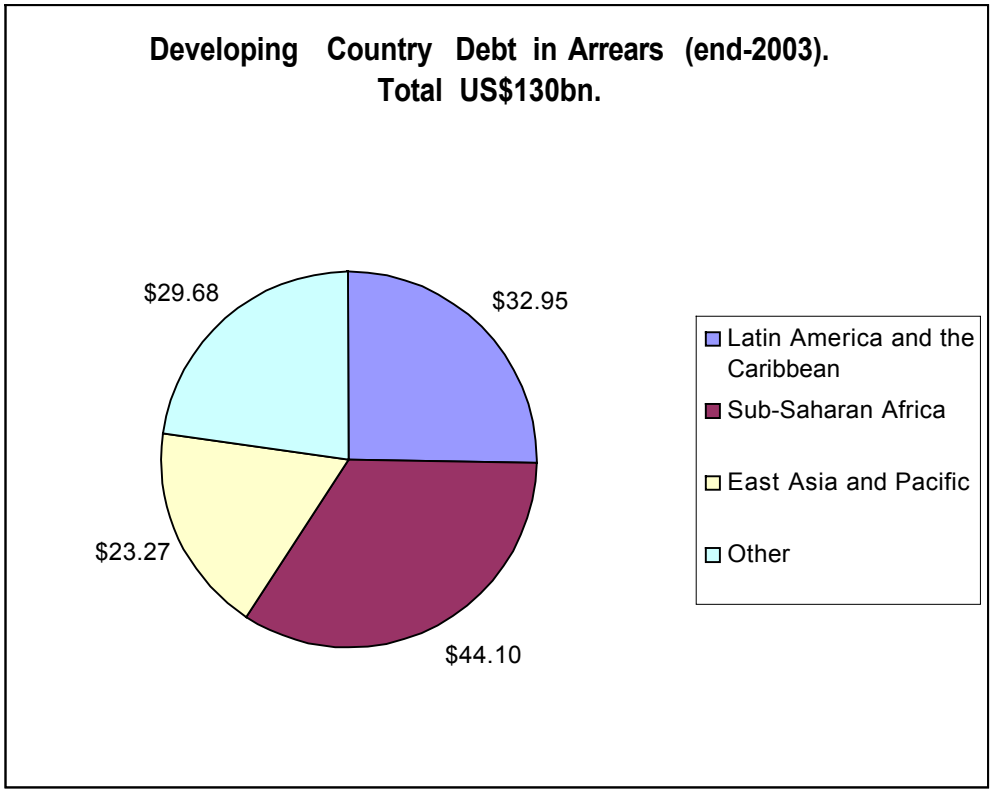
Our examples point very clearly to the inequity and unsustainability of current approaches but most importantly asks what alternative policy choices can be made by the international community. It concludes with concrete proposals for reform and for achieving political progress.

Finally, since processes of arrears clearance are not widely known about or reported on, this paper also aims to explain in a straightforward manner the mechanics of often complex, behind-the-scenes procedures.

2. Debt in arrears: what kinds of numbers are we talking about?

According to the World Bank (Global Development Finance 2005), for all developing countries, the total amount of debt in arrears stood at US$130bn in 2003 (principal and interest in arrears). This figure is on an upward trend. In 1990, debt in arrears stood at US$112.5bn. By 2000, it had fallen slightly to US$96.25bn to rise again quite significantly over the next three years. These figures are highly indicative of a **protracted and structural debt crisis** which has not been comprehensively dealt with, since a country falling into arrears on its external debt service obligations is an obvious sign that it is experiencing debt service and wider economic difficulties.

The region currently in the biggest arrears crisis is Sub-Saharan Africa with US$44.1bn of debt (principal and interest) currently in arrears at end-2003. The Latin American and Caribbean region follows behind with US$32.95bn (principal and interest) in arrears at end-2003. Again, these figures are highly indicative of the broader debt and development challenges that face these two regions, and in particular Sub-Saharan Africa which is the continent furthest away from making progress towards internationally agreed development targets as set out in the Millennium Development Goals.



Figures in US$ billions. Source: World Bank Global Development Finance 2005.

3. Arrears clearance: what's it all about?

Historically, countries defaulting and going into arrears on their external debt obligations is not uncommon. Mexico, Brazil, Argentina, Nigeria, Democratic Republic of Congo, Iraq, Zimbabwe and Sudan are just a few of the recent and better-known examples. Reasons why are diverse but often include one or more of the following contributing factors: financial and economic collapse (which in turn may have been provoked by over-borrowing, over-lending and/or increased interest rates); civil conflict; national or regional political tensions; natural and/or human disasters such as drought or famine; and corruption or international isolation due to strategic geopolitical or human rights concerns.

In lots of cases, countries have defaulted principally on commercial private debt and/or bilateral debt while they have continued to service multilateral debt. This is because the multilateral financial institutions are de facto treated as preferred creditors which means that a default on multilateral debt could result in a country being cut-off completely from international credit. This would leave it unable to access much-needed funds. Other countries however have indeed defaulted and gone into arrears on **all** of their outstanding external debt obligations. Again this may be for a number of reasons and for varying lengths of time. During this time however, interest and penalty charges will continue to accrue which quickly become unsustainable and out of control for many countries.

What is then common to these cases is the "circus" these countries must go through to clear their arrears, in particular to the international financial institutions. Should the country seek to gain access to new loans and grants from the official donor community – as well as broader re-engagement with the international community after a period of isolation – arrears clearance to the multilateral financial institutions is the first non-negotiable step they must take.

Processes of arrears clearance are usually extremely complex, involve lots of clever accountancy tricks and are invariably conducted behind closed doors. So what do these processes typically involve?

The process, in particular for low-income countries, typically involves the country in arrears appealing to the international community for financial support. Several bilateral donors then usually step in to help the country clear its arrears. This help may be in either grant or loan form and the indebted country may also have to supplement this assistance with its own reserves. In the case of Haiti, which cleared US$52mn of arrears to the World Bank in January 2005, it used US$40mn of its own (very limited) reserves coupled with a US$12.7mn grant contribution from the Government of Canada. Probably due to the current geopolitical importance of Afghanistan, it was able to clear its overdue obligations to the Asian Development Bank, World Bank and International Monetary Fund (IMF) with grant contributions from Italy, Japan, Norway, Sweden, the United Kingdom and the Afghanistan Reconstruction Trust Fund. The case of Nigeria in November 2005 involved the full clearance of arrears to bilateral creditors (members of the Paris Club) in exchange for a partial (60%) debt write-off. Nigeria used its own international reserves taken from the "excess crude-oil fund".

What happens next?

In many cases of arrears clearance to the multilateral institutions, what tends to happen is that only several days later, the IFIs then re-lend the country in question even larger sums of money. In June 2003, the Democratic Republic of the Congo was immediately re-lent US$450 million from the World Bank upon clearance of its US$132mn in arrears to the International Bank for Reconstruction and Development (IBRD) and the International Development Association (IDA). Iraq cleared overdue payments of US$ 81mn to the IMF and was immediately re-lent US$436.3mn by the Fund. Just four days after Haiti cleared its US$52mn to the World Bank, it received US$73mn in new assistance from the Bank: US$36mn in grants and US$37mn as

credits. And of course, where bilateral donors did not provide their original support in grant form, part of the new loan(s) will pay-back the donors which helped "bail-out" the country in the first place.

4. Dubious debts: but the creditors don't care

In many cases, very strong arguments could be made that these arrears should not be cleared at all. Current practices of arrears clearance are unjustified on the grounds that, in lots of cases, the debts being cleared are **odious and/or illegitimate** in nature. These debts should never be repaid to the international financial institutions or rich country governments in the first place. Current approaches only serve to cast a thick fog over debts of dubious origin and means that creditors avoid taking co-responsibility for the bad lending decisions of the past.

According to the doctrine of **"odious" debt** developed by Russian legal scholar Alexander Nahum Sack in 1927, debts may be deemed "odious" (and thus unenforceable) when:

- The debt is contracted without the consent of the population affected;
- The credit did not benefit the population concerned;
- At the time of the transaction, the creditors were aware of the illegitimate status of their partner as well as of the fact that the credit was very unlikely to be used for the benefit of the population.

The concept of **illegitimate debt** can be expanded much further however. It may be applied to loans issued for ill-conceived development projects for example. It may also be applied to loans that were perhaps "legitimate" in the first place, but because of unfair interest rates and penalty charges levied against the sovereign debtor in case of non-payment (or reduced payments) the debt has simply ballooned out of control over time.

Our country examples reveal very strong arguments for invoking the concepts of odious or illegitimate debt (and in some cases both). This suggests that these arrears should not be cleared simply because it is "accepted" international practice to do so. Instead, they reveal the need for fair and independent assessments of the legitimacy of the debts in question.

Democratic Republic of Congo

In July 2002, the Democratic Republic of Congo (DRC) cleared its arrears to the International Bank for Reconstruction and Development (IBRD). Arrears amounted to US$132mn (of which US$81mn was overdue principal payments the rest in interest). In the same year, DRC also cleared arrears to the IMF and AfDB. DRC was in arrears to the AfDB to the tune of US$779mn and to the IMF, US$503mn. These transactions meant an unexpected cash windfall for the multilateral institutions. These debts had little prospect of ever being repaid by an essentially bankrupt, impoverished and conflict-ridden nation.

In DRC, lenders knew full well that their loans were personal bribes to Mobutu, then President. They knew the Congolese people never consented or received benefits from the loans. Indeed in 1978, Erwin Blumenthal (an IMF official appointed to run Congo's central bank) reported that large amounts of lenders' cash had simply gone walkabouts and that there was *"no chance, I repeat no chance, that [Congo's] creditors will ever recover their loans."* Congo's foreign debt then stood at $5bn. Nevertheless, in the 1980s, after Blumenthal left, the World Bank, IMF among other northern creditors lent Mobutu almost US$5bn more. In this case however, the international financial institutions did recover significant portions of their cash. But more importantly, the whole process of arrears clearance served to obscure the fact that at least some of these debts were of highly dubious origin and odious in nature.

Nigeria

In the 1970s and 1980s, successive military governments borrowed unchecked against future oil receipts, predominately from the Paris Club. Many of these loans however were simply looted (with full complicity of creditors) and could reasonably be described as odious. Others were not used judiciously or transparently and so projects for which the loans were obtained largely failed. But Nigeria is also a clear case of a country whose debt burden has ballooned out of control because it has failed to service **all** its obligations **on time** and **in full.**

In the 1990s Nigeria's military dictators effectively broke-off working relationships with Paris Club creditors. The compounding of interests, accumulation of arrears and penalties on late payments constitute the main reason why Nigeria's debt has spiralled out of control. Original loans from Paris Club creditors amounted to just US$16.7bn, accumulated by the military regime between 1964 and 1990. Since 1985, Nigeria has paid creditors US$11.6bn in debt service. In 2001 however, the country still owed the Paris Club a total of almost US$31bn. All in all then, about 50% of the total debt (US$14bn) can be attributed to the cost of Nigeria falling into arrears. These are "phantom" debts, decided on and enforced by creditors as punishment.

Indeed Nigeria's President, Olusegun Obasanjo has described most of Nigeria's external debt burden as "of dubious origin". When President Obasanjo assumed office in 1999, he said that from a historical, moral, environmental and human rights perspective, the country's external debt was illegitimate. In November 2005, the country secured a write-off of US$18bn form Paris Club creditors but in exchange Nigeria paid Club members US$6.3bn to clear arrears – on debts that we can reasonably describe as highly questionable in origin.

Haiti

In March 2002, the World Bank in an independent evaluation of Bank assistance to Haiti from 1986 to 2001 concluded, "the development impact of IDA lending had been negligible". In January 2005, impoverished Haiti used US$40mn of its international resources to clear arrears on these debts to the Bank. Despite the Bank's acknowledgement that this development lending clearly failed and had no tangible impact, it is Haiti, not the Bank that pays for these failures.

These examples are indicative of a much broader culture of "creditor impunity" which currently characterises international debt management. Creditors like to be seen to be generously cancelling some of the debts owed by some of the poorest countries (debts which are fundamentally uncollectible anyway), however they will never acknowledge their role in bad lending decisions and for the accumulation of unsustainable and often illegitimate debt burdens. The limited cancellations afforded some countries are more often than not also highly conditional.

In fact, clearing these debts can be said to contribute to "moral hazard" on the part of the creditors who avoid a substantial part of the cost of their imprudent – and often negligent – lending practices. Despite clear evidence that some loans should never have been made in the first place or had no beneficial impact, creditors recoup their cash and therefore have no incentive to change their behaviour. This is particularly the case for the international financial institutions.

This is because, due to the de-facto preferred creditor status of the IFIs, bilateral donor funds have frequently been used on a large scale to bail-out the multilateral lenders. For example, bilateral donors (Belgium, France, Sweden and South Africa) issued DRC with sizeable new loans to enable it to clear arrears to the IBRD. International donors also supported Congo's AfDB and IMF arrears clearance operations. Thanks to these bailouts, the IFIs have "bad debts" (in every sense of the word – illegitimate and uncollectible) written-off their books plus they receive unexpected extra cash. Finally they take no responsibility for past behaviour. In cases such as

these – but also faced with total project failure in Haiti – the IFIs should cover the costs of writing-off these debts from their own loan loss reserves and retained earnings.

However, creditors (IFIs, governments and the private sector) also need to recognise that they have not exercised fairness with respect to interest rates and penalty clauses. Although some creditors may claim they have responded to this concern in loan agreements made after our case studies, the fact remains that they have not recognised the illegitimacy of historic debts which have ballooned uncontrollably because of the harsh interest and penalty clauses they have imposed in the past. They have the power to change this but choose not to do so.

In national law of course, there are certain guarantees against usurious (or unreasonable) interest rates and penalty charges levied against citizens who are unable to pay their debts. In July 2005 in the UK, a couple who feared losing their home after a loan of less than £6.000 (US$11.000) spiralled to more than £380.000 (US$700.000) recently had their debts cancelled by a judge who ruled that interest and penalty charges were "extortionate" and "unfair". In international law however no such protections for debtor nations exist and according to some loan contracts creditors have the power to increase interest rates unilaterally and exponentially. This remains the case despite the fact that this was one of the very clear causes of the 1982 debt crisis. In this context, recent moves by the Parliament in Nigeria to cancel interest and penalties on the external debt burden can be understood.

5. South North Financial Flows: A Perverse Logic

Clearing odious and/or illegitimate debt in arrears is one very serious issue. But current approaches to debt arrears clearance also accentuate another very serious problem: the perverse resource transfer from South to North. Globally, debt repayments from South to North far outweigh the amount received back from the North in aid, investment and other resource flows. The summary table below indicates the scale of the problem, and reveals that more money is flowing South-North than the other way around, and that Southern countries retain a huge burden of debt stocks. They demonstrate very starkly the inequity and unsustainability of the world's present financial architecture.

Summary debt and financial flow figures (US$)

	End 2000	**End 2004**
Developing country debt stocks	2,282 billion	2,597 billion
Developing country debt service paid	376 billion	374 billion
North-South resource flows	200 billion	220 billion

Source: World Bank Global Development Finance 2005

It is a perverse system one which prioritises debt service payments and arrears clearance when it is clear that these seriously undermine urgent investments in human need in developing countries. They also reveal how far away Northern Governments are from meeting their international commitments such as the Millennium Development Goals. Two recent cases of significant resource transfer from South to North in order to clear arrears – Nigeria and Haiti – have generated fierce criticism in particular. Below, Eurodad sheds more light on the details and highlights the strength of feeling expressed by local organisations in these countries.

Nigeria

In October 2005, the Government of **Nigeria** reached a deal with Paris Club creditors on partial cancellation of the US$31bn owed to the Club. But in order to obtain an overall cancellation of

about 60% of debt owed to the Club, Nigeria agreed to pay up-front US$6.3bn in arrears plus a further US$6.1bn to buy-back the remainder of its debt from the Club (at a discount). In total, the deal amounted to a momentous US$18bn write-off but in exchange Nigeria agreed to pay-out US$12.4bn to Club members.

> *"[The Paris Club deal] will further accentuate the perverse resource transfer from the poor debtor to the rich creditor nations".*
> *Dr. Chu Okongwu, Former Finance Minister, Nigeria, 2005*

The Nigerian Government's decision to pay-out such a considerable sum to Paris Club members – and Paris Club members' decision to accept this cash – has generated fierce criticism from civil society organisations and religious leaders around the globe. The African Network for Environment and Economic Justice (ANEEJ) has commented *"as desirable an exit from debt peonage is, it is scandalous for a poor debt distressed country, which cannot afford to pay US$2bn in annual debt service payments to part with over US$6bn up-front".* According to ANEEJ, 79.500 Nigerian children die before the age of five every month. 70% of Nigerians live on less than US$1 per day. The cash will be taken from Nigeria's "excess crude-oil fund" and handed straight over to creditors, with the UK taking 27%, France 19%, Germany 17%, Japan 14%, Italy 7%, the Netherlands 5% and several other creditors taking a smaller share each. In the case of Nigeria's payments to the UK – to clear arrears and to buy-back the remainder of the debt – the UK will benefit from a windfall payment of US$3bn from impoverished Nigeria.

Haiti

In January 2005, **Haiti** used US$40mn of its own (scarce) international reserves to clear its arrears to the World Bank. This was supplemented by a US$12.7mn grant contribution from the Government of Canada. Camille Chalmers, Executive Director of the Plate-forme Haïtienne de Plaidoyer Pour un Développement Alternatif (PAPDA) described the then interim government's decision to part with US$40mn as "*an insult to the poverty and misery of the Haitian people"* which must never be repeated.

This US$52.7mn in total will flow straight into the coffers of the World Bank. Meanwhile, Haiti is the poorest country in the western hemisphere and one of the most disadvantaged in the world, as social, economic and environmental indicators reveal. According to the World Bank, an estimated 76% of Haiti's 8 million people live in poverty and income inequality is among the highest in the world. Annual income per capita stands at just US$361 and Haiti ranks 146 on the Human Development Index (HDI). Half the population live on less than 1US$ per day and half is illiterate. Added to these critical concerns are rapid economic decline, shortage of water, electricity, employment, access to primary health care and education and deforestation. Economic growth in the country declined by a further 3.8% in 2004.

These two examples beg the question: whose interests are we actually serving by insisting on these large payments from these impoverished nations? The creditors or the populations in the countries concerned? Could this cash not be much better spent?

6. A bitter irony: arrears clearance cranking up the debts

These processes of arrears clearance also have several other very serious implications and knock-on effects on debtor nations. One of these is the fact that, in multilateral arrears clearance operations, the IFIs benefit from unexpected cash windfalls on debts that had little prospect of ever being repaid and often hadn't been serviced for many years.

This additional cash injection received by the IFIs during processes of arrears clearance is then converted into fresh loans for developing countries, according to the charter and policies of the multilateral institutions. This potentially aggravates the already inflammatory debt problem of many developing nations. Indeed our examples suggest that current processes of arrears clearance, rather than help to place countries firmly on a path towards reintegration and longer-term development and debt sustainability, instead only aggravate overall levels of indebtedness. They also serve to alter the structure of a country's external debt burden, increasing overall levels of indebtedness to the IFIs and therefore their measure of debt dependency on the IFIs and the international community more broadly.

In 2004, Iraq it cleared overdue payments of US$ 81mn to the IMF. It was then re-lent US$ 436.3mn by the Fund (a full five and a half times more). The Democratic Republic of the Congo was immediately re-lent US$450 million from the World Bank upon clearance of US$132mn in arrears to the IBRD and IDA. Moreover in the case of DRC, it could be argued very strongly that the whole process amounted to "loan laundering" on the part of the IFIs: old odious loans made to Mobutu Sese Seko are cleared by international donors and replaced by fresh "clean" credits to the new Kabila Government. Crucially, these new funds all come tied to IMF and World Bank conditions and policy priorities. This in turn has very serious implications on countries' freedom to define their own macroeconomic and social policy priorities.

7. More cash yes – but only if you do exactly as we say

As a result of arrears clearance, it is true that countries will have access to desperately needed new funds. This of course is one of the reasons why a country will clear its arrears. Importantly however, this fresh cash – more often than not from the IMF and World Bank – comes with important strings attached and has the effect of locking countries into a certain invariably market oriented reform path.

The IMF's "emergency post conflict assistance" (EPCA) to **Iraq** in 2004 is one such case in point. The Fund describes its ECPA programme as underpinned by *"a prudent fiscal policy that aims to limit spending to available government revenues and external resources, the use of the exchange rate to anchor inflationary expectations, and the implementation of key structural reforms to transform Iraq into a market economy."* In 2005, the Financial Times described the reforms as *"free-market economics so sweeping a bust of Milton Friedman might be erected in Baghdad to fill the empty plinth where the stature of Saddam Hussein once stood".*

Iraq's worsening social indicators confirm that these are indeed strange priorities. The country's social indicators are now among the worst in the region and indeed the world. According to the World Bank (2004), infant mortality has increased to 107 per 1000 live births (compared to an average of 105 in Sub-Saharan Africa, the most disadvantaged region of the world). In 2002, GDP declined by 4% and a staggering 31% in 2003. One quarter of primary school aged children do not attend school. Human security remains a massive problem with almost daily car bombings and unemployment exceeds fifty per cent. Nevertheless, Laith Kubba, a Spokesperson for Iraq's Prime Minister, Ibrahim Jafari, declared in June 2005 that Iraq would *"honour the IMF's demands to cut public spending".* This will involve the slashing of 1.6 million further jobs and an end to subsidies on electricity and oil products: 9 out of 26 million Iraqis live below the poverty line.

In January 2005, the Bank gave **Haiti** US$73mn in fresh support, of which a massive US$61mn would be devoted to *"economic governance"* support measures, and in particular public private partnerships and governance in the education and health sectors. On the announcement, Camille Chalmers, Executive Director of Plate-forme Haïtienne de Plaidoyer Pour un Développement Alternatif (PAPDA) expressed surprise at the policy priorities. The programme *"in fact prioritises sectors associated with the process of privatisation of the country's main public companies. It is significant that the first tranche of funds […] does not support job creation, support to small or*

medium enterprises or access to basic social services but in fact supports the putting in place of market procedures designed to accelerate the transfer of capital to transnational corporations. It is a strange and surprising priority given the country's state of economic collapse and urgent humanitarian need," remarked Chalmers.

These concerns are characteristic of much broader concerns with highly conditional loan and grant financing for developing countries from the multilateral institutions and bilateral creditors. Donor (and lender) funds are nearly always highly conditional and Southern Governments must adhere to these conditions if they are to receive all or part of the funds. While it can be argued that some of these conditions are necessary, such as conditions which ensure that the money will not be misappropriated, a large number of the conditions donors attach to their lending impose specific economic policies on developing countries, determining fiscal and monetary choices and pushing for privatisation of essential services like water, health, education and trade liberalisation.

In sum, current approaches to arrears clearance and debt write-downs only serve tighten the stranglehold of the IFIs over debtor economies and the freedom they have to decide their own economic policies and priorities. Furthermore if we consider that, in most if not all our examples, countries in arrears have been effectively cut-off from international assistance for many years, there would therefore be powerful incentives for cash-strapped governments to take out fresh loans from international institutions and other sources. This leaves them extremely vulnerable to external political pressures and means that they can be effectively "rail-roaded" into accepting highly conditional new loan and grant financing.

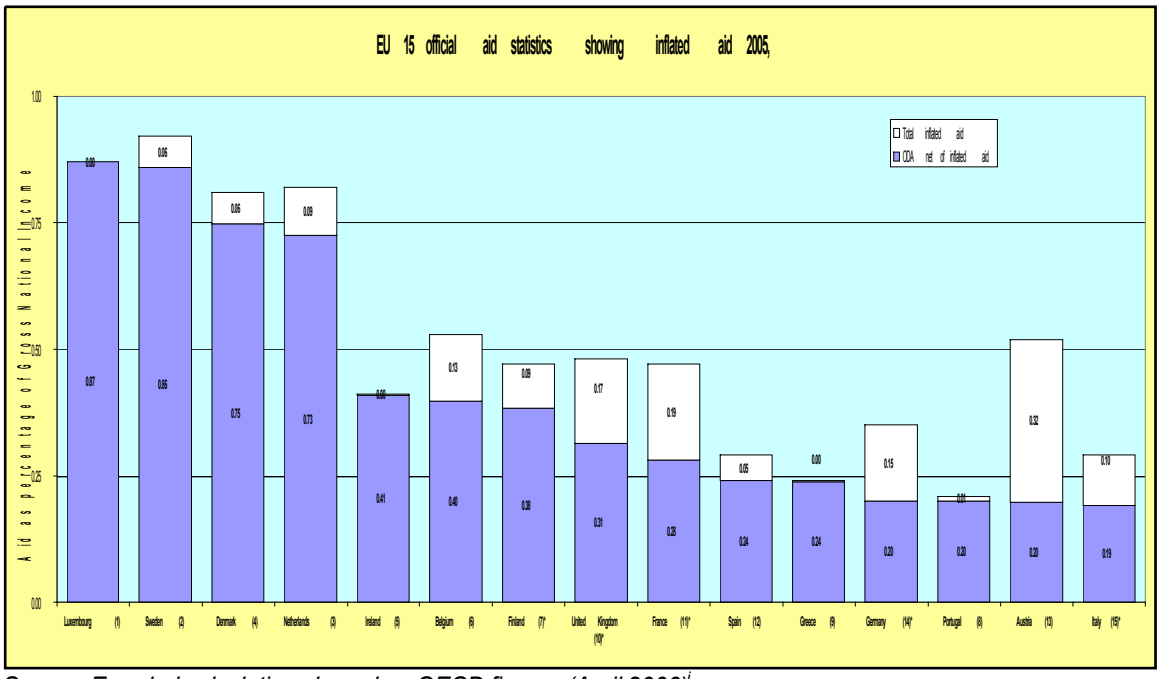
8. The aid that isn't: the many guises of international aid

Another very serious implication of arrears clearance operations is that, where bilateral donors step-in to help countries clear their arrears to the multilateral institutions, these efforts **count towards Official Development Assistance (ODA)** in the donor country**.**

DRC's arrears clearance operations were supported principally by bilateral donors, including Belgium, France, Sweden and South Africa. Afghanistan was able to clear its overdue obligations to multilateral creditors thanks to grant contributions from Italy, Japan, Norway, Sweden, the United Kingdom and the Afghanistan Reconstruction Trust Fund. More recently, in January 2005, the Government of Canada stepped-in with a US$12.7mn grant to help the interim authorities in Haiti clear substantial arrears to the World Bank. These all inflate ODA.

Electorates in the North rarely realise that, in cases such as these, so-called development assistance never actually reaches developing countries but flows straight back into the coffers of wealthy multilateral institutions. This deceives the public that more money is being spent on development than is actually the case. Spending such as this is not the same as spending on health, education, water, rural roads or other expenditures that can be considered to directly benefit the poor. But funding arrears clearance operations from aid budgets is not only misleading. It also risks penalising countries that are not indebted, as aid resources are diverted towards heavily indebted countries.

Again, these cases are highly indicative of much broader structural problems within the international financing system: the problems of "inflated aid" and lack of additionality in debt relief operations. A recent report by Eurodad and a coalition of European NGOs has revealed that a massive €13.5bn of European ODA is not in fact "real" aid but "inflated" aid. Of the €41bn that the European Commission estimated EU countries to have spent on aid in 2005, NGOs argue that at least €13.5bn should not be classified as such because it was spent on debt cancellation operations, immigration spending and educating foreign students in the EU.



Source: Eurodad calculations based on OECD figures (April 2006)[i]

The international community must recognise that it is duty bound to provide effective international cooperation, and not cheat its way towards meeting internationally agreed aid targets or compensating the IFIs for bad debts. This only serves to deprive those who need it most from much-needed funds and civil society groups will continue to demand that governments do not inflate their aid figures. Indeed, Eurodad in partnership with Southern and Northern NGOs will be closely scrutinising the actions of the international community with respect to two future likely cases of arrears clearance to the IFIs: the Republic of Congo and Liberia. Rather than these countries follow the same well-trodden and highly problematic path as outlined in this paper, Eurodad calls very strongly for a fresh approach in these two cases based on the recommendations as described in detail at the end of this paper.

9. Coming soon: cases of arrears clearance to watch out for

Republic of Congo

The Republic of Congo is in arrears to a whole array of bilateral, multilateral and commercial creditors. Multilateral creditors include the African Development Bank, BADEA, the OPEC Fund and the EU. Bilateral creditors include members of the Paris Club.

Congo's external debt as of end-2004 was estimated at US$9.2 billion in nominal terms, equivalent to US$9 billion in 2004 net present value (NPV) terms, which makes it one of the world's most indebted developing countries on a per capita basis. Debt service in 2006 is estimated to represent a massive 43 percent of fiscal revenues.

The Republic of Congo is emerging from a series of violent civil wars which have scarred its history since independence in the 1960's. These conflicts have had devastating effects on Congo-Brazzaville's economy and its population's welfare. In 2004 the United Nations Human Development Index ranked Congo 144 out of a total of 177 countries. According to the World Bank, around 70 percent of Congolese people currently live below the poverty line, compared to

about 30 percent in 1993. Primary education attendance dropped from 90 percent in 1990 to 40 percent in 2000; and during the same time life expectancy dropped from about 52 years in the early 1990s to 48.6 years in 2002. Unemployment affects more than 50 percent of the active population.

The Republic of Congo has been classified as a Heavily Indebted Poor Country by the World Bank and IMF. Since the signing of a peace agreement between the government and almost all the remaining rebel groups in March 2003, the country has been entering into negotiations with creditors on the treatment of its external debt burden. This includes a number of plans to clear the country's substantial arrears to multilateral creditors.

According to the Republic of Congo's decision point document, Congo-Brazzaville is in arrears to the AfDB to the tune of US$148.4mn. To clear these arrears, a triple-pronged approach has been formulated. This will include the Republic of Congo paying one third of the total, Norway, France and the European Commission paying another third and the AfDB providing a fresh grant to cover the other third. In the case of the bilateral donor assistance, this will of course be counted as ODA. Arrears to the European Union meanwhile total US$39.2mn. The sad part about the debt to the European Union in particular is that European Development Fund (EDF) money that had been pledged to the country will be diverted to the AfDB to clear the country's arrears, i.e. it will not be available for the government to spend in-country on development programmes which is a key plank of the EDF. This EDF money could be much better spent.

Liberia

Liberia has remained in arrears with the IFIs for almost 20 years. No loans have been made to the country by the World Bank or International Monetary Fund since 1984 when the country entered into a period of serious violent conflict. During this time, interest and penalty charges on previous loans have continued to accrue.

To the IMF alone, Liberia owes a total of US$775mn at end-2005 of which a staggering US$439.65mn is in charges and interest on overdue payments. The country's arrears to the Bank stand at US$373 million.

In November 2005, Liberia held its first presidential elections since the end of 14 years of civil war. US-educated banker Ellen Johnson-Sirleaf won over 60% of the vote and has committed to rebuilding the economy, rooting-out corruption and revisiting the land tenure system. Expectations are high both within Liberia and throughout the international community.

Her government however faces the insurmountable challenges of consolidating peace, reconstructing the economy and building basic infrastructure – all completely destroyed by over fifteen years of intermittent civil strife. Poverty is widespread (per capita income of US$110), the country's macroeconomic position is fragile and still well below pre-war levels, a large number of ex-combatants still need to be integrated into economic life and the public debt is large and unsustainable. GDP per capita fell by an astonishing 29.5% in 2003. It recovered somewhat in 2004 by 23.1% but real income per-capita remains at one-third of pre-war levels. In 2005's Article IV Consultation, the IMF concluded that *"Liberia faces daunting challenges in its quest to rebuild the economy and reduce poverty".*

Despite these concerns, the Bank and Fund had still been pressuring the previous transitional government to resume monthly token payments towards arrears with the two institutions, a large part of which comprises penalties and interest. The Bank and Fund have also announced that a plan is underway to clear the country's substantial arrears to the two institutions as part of a broader re-engagement strategy with Liberia.

10. Proposals

Despite arrears clearance operations being essentially a marginal accounting issue, our examples reveal that in fact they have very serious implications with regards the nature of a country's reengagement with the international community. Our case studies have shown how current approaches to arrears clearance have supported a skewed reengagement of countries in crisis: loans of questionable origin are ignored (and even "laundered"), countries' overall levels of indebtedness to the multilateral institutions increases significantly, countries' policy autonomy is severely compromised and donor aid budgets are also very negatively affected.

This paper also suggests that current approaches to arrears clearance are highly symptomatic of the much deeper structural imbalances in the global financing system which at every turn replicate debt dependency in developing nations while exonerating creditor nations and institutions from all co-responsibility for this situation.

The cases cited in this report lend significant weight to the call for a fresh approach to arrears clearance and to debtor creditor relations more broadly. And unlike previous creditor-designed "solutions" to the debt crisis, the measures outlined in this paper involve debtors, creditors, civil society organisations and other stakeholders alike in their design and implementation. They are not radical. On the contrary, they are all very doable, can be pursued in parallel and aim most importantly to put debtors and creditors on a more equal footing. This creates the conditions for a longer-term solution to the global debt crisis.

11. Taking Responsibility

Many bilateral donors will, in private conversations, admit that using scarce ODA funds to bail-out the IFIs in multilateral arrears clearance operations amounts to "money down the drain". Yet they argue that they are compelled to do so because there is no other way to secure a country's broader reengagement with the international community. These same donors however hold majority shares in many of the most important multilateral institutions and are therefore directly responsible for these institutions' lending and debt recuperation policies as well as the IFIs' wider lack of accountability and global preferred creditor status.

At the same time, as the case of Nigeria has most recently shown, bilateral creditors have also been quite happy to recoup significant amounts of their cash by accepting US$12.4bn from the country to settle outstanding arrears and debt obligations even though many of the original loans were of highly questionable origin. This paper urges creditors – bilateral and multilateral alike – not to blindly insist on arrears clearance and instead support greater equity, transparency and participation in wider debt work-out mechanisms. This "democratic" approach necessarily involves the fair and transparent redress of current unpayable and illegitimate debt burdens coupled with the development of fair and transparent processes for the taking-on of new loans in the future.

- **Addressing the mistakes of the past: ways and means**

This paper has shown that many of the debts in our case-studies could reasonably be described as odious or illegitimate in origin. Yet countries (or donors) have cleared arrears on these debts and in some cases debtor countries had serviced them for some years. While some of these debts may have subsequently been cancelled, this has been done because the international community has (belatedly) acknowledged that they were fundamentally uncollectible and the debtor economies unsustainable as opposed to any recognition of odiousness or illegitimacy. Instead, the international community could have supported fair and independent assessments of the legitimacy of the debts in question.

Several ideas have emerged of ways in which the current top-down approach to international debt management may be redressed: one – the fair and transparent arbitration procedure – aims to ensure impartiality in decision-making; another proposes an alternative more egalitarian forum for working-out debt solutions; the final proposal puts forward the idea of debt audits – on both debtor and creditor country side – to establish the true nature of the debt and therefore find a just solution acceptable to all.

Ensuring fair assessments

Some civil society organisations such as Erlassjahr.de, AFRODAD and others have supported proposals for a "fair and transparent arbitration procedure" or FTAP. The FTAP was first proposed in 1987 by Austrian academic Kunibert Raffer who suggested the internationalisation of Chapter 9 of the US Insolvency Code which protects government municipalities in cases of bankruptcy. The key features of Raffer's model include a neutral decision-making body which would "arbitrate" and ultimately decide which debts need to be declared null and void, and which need to be repaid; comprehensiveness of procedure, i.e. **all** debts would be dealt with in one comprehensive process and no creditor would be excluded; the right of both debtor and creditor to be heard; protection of the human, social and economic rights of the citizens of the debtor country; the institution of automatic stay and transparency of process and decisions. This procedure has the advantage in that it can ensure comparability of treatment between countries. Debtors and creditors should be able to turn to such an independent mechanism as a serious option should they so choose. Regrettably however, the international creditor community has thus far shied away from such proposals, preferring instead to insist on repayments even where these seriously compromise the social and economic viability of the debtor.

An Alternative to the Paris and London Clubs

More recently, another proposal has emerged for an alternative more egalitarian forum to debate and agree on "fair debt work-out processes". The proposal for an "international multi-stakeholder working group on fair debt work-out processes" was an outcome of the recent "multi-stakeholder consultations on sovereign debt" organised by the UN FfD Office in the follow-up to the 2002 Monterrey conference on financing for development. The three dialogues, which took place in New York, Maputo and Geneva in 2005 brought together representatives of creditor and debtor countries, the international financial institutions, private sector, academics, civil society organisations and other experts to discuss the debt of both low and middle-income developing countries. According to the proposal, which received the unanimous support of the full range of diverse stakeholders present at the dialogues, this global group should explore crucial issues such as greater debtor and creditor transparency, a code of conduct for debtors and creditors, operationalisation of the doctrine of odious debt and provision of arbitration or mediation services to facilitate dispute settlement with a view to putting the group's proposals into formal practice. The working group could be convened under the auspices of the United Nations. Within Europe, several NGOs have approached their governments over recent months to urge them to back the creation of such an initiative, both politically and financially. NGOs will continue to pressure their governments to examine this proposal more seriously since it represents one possible forum within which all actors would in principle have an equal say in the design and implementation of solutions which impact their lives and livelihoods.

Debt audits to establish the true character of the debt

Debt audits are not a solution in themselves to the debt crisis however they can act as an important tool to study and analyse a country's wider debt portfolio. This helps to highlight and substantiate arguments of odious and illegitimate debt, which in turn can help open up arenas for political debate on possible solutions and alternatives. Debt audits can therefore strengthen local and national debt campaigns and movements as well as challenge the debt policies of both

Southern and Northern Governments, and the IFIs. They are therefore an important political tool in any strategy which aims to find a lasting and fair solution to the global debt crisis.

Debt audits can be undertaken in both debtor and creditor nations. They can act as a powerful instrument to call into question not only individual loans and the terms under which they were contracted, but also the wider economic and political contexts that have contributed (and continue to contribute) to over-indebtedness. Debt audits therefore need to be comprehensive in scope and not just limited to a simple financial audit of the debt. There can be both official and civil society debt audits.

According to Jubilee South, debt audits should cover:

- Review of the debt within a broader historical perspective of national and global political and economic trends and realities;
- An accounting of outstanding debt obligations and examination of the terms under which the debt was incurred or the loan made, including accompanying conditionalities, stated purposes of the loan and how the funds were actually used;
- Stock-take of the socio-economic, political and environmental impacts of the debt in the debtor nation, with testimonies from affected peoples and communities;
- Review and analysis of government laws and policies on lending and borrowing, including debt collection policies in the North and debt repayment policies in the South;
- Scrutiny and critique of the policies and operations of other lenders such as the IFIs and commercial banks.

Recommendation:

- Eurodad, in partnership with other civil society organisations and social movements such as Jubilee South, calls on both debtor and creditor governments to initiate official debt audit processes without delay. These investigations should be public and involve parliaments and civil society fully. Civil society organisations, experts and other actors should be involved in development of the audit methodology, the investigation and follow-up process in full. The debt audit must lead to the cancellation of debts which are found to be illegal, odious or illegitimate and those which seriously compromise the ability of the debtor country to invest in the basic needs of its peoples. Looking forward, governments should support alternative more egalitarian and transparent forums for working-out debt difficulties or disputes. We propose that governments back the creation of an international multi-stakeholder working group both financially and politically. This would send out a clear message that they no longer support the top-down, arbitrary and highly politicised approach to debt work-outs and instead are looking to redress the balance in a fair and participatory manner.

12. Avoiding future debt crises

Past unpayable and illegitimate debts need to be fairly and effectively dealt with, but it is also essential to ensure that the mistakes by borrowers and lenders of the past are not repeated in the future. This necessitates a very frank critique (and redress) of past lending and borrowing decisions, but it also represents an important opportunity for the international community – in full cooperation with civil society – to develop a set of international standards for more responsible financing in the future.

- **Responsible international financing standards**

The examples cited in this paper have revealed the importance (and urgency) of open, transparent and responsible processes for taking on and extending new loans. Should the international community be of the opinion today that it would have been better not to support Mobuto Sese Seko or Saddam Hussein with large-scale credits, it ought not only to sanction the cancellation of these claims on the grounds of illegitimacy but it should not miss the opportunity to work for more responsible standards in international lending.

The broader loan procurement process must be made far more transparent, participatory and accountable to ensure that the development priorities outlined in loan agreements reflect the aspirations of the people of the debtor nation. Action needs to be take on both creditor and debtor country side and should include reforms which guarantee transparency by both creditor and debtor, a meaningful role for parliaments and civil society in loan negotiation (and monitoring) processes (such as timely access to information), fair negotiations between creditor and debtor, an end to unfair interest and penalty clauses, the cessation of economic policy conditions on loans which insist on unproven reforms such as wholesale privatisation, and comprehensive reform of procedures to address unsustainable debt burdens and/or cases of default should these arise: it makes little sense to impose court fines, heavy penalties and/or endless restructurings on poor, heavily indebted and distressed partners and indeed only serves to compound the problem rather than resolve it.

At the same time this paper has shown that the current global finance system is characterised by a broad culture of creditor impunity within which it is the sovereign debtor that assumes all the risk. This is simply not fair and indeed is not the case in domestic national law. Any future international financing standards must incorporate risk sharing between both creditor and sovereign debtor, i.e. if a project funded by a loan fails, both creditor and debtor should bear losses. Creditors must also be able prove due diligence and good faith: there are just too many cases where creditors have (knowingly and corruptly) extended loans to governments or individuals they knew would not used the funds judiciously or were not authorised to assume the credit in the name of the state[ii]. There are still other cases where creditors have not respected all necessary legal and/or constitutional procedures which govern the taking-on of new credits in the debtor country. These debts may be deemed "illegal" and "odious"debts and creditors should assume the losses in these cases.

Recommendation:

- Civil society organisations are working actively for a comprehensive and fair set of international financing standards. Importantly, these must be decided independently from the IFIs to avoid a clear case of conflict of interests. Some form of multi-stakeholder forum could be envisaged within which all actors would have an equal say, including debtor governments and civil society. We recognise that a minimal set of fiduciary conditions and respect for human rights standards may be necessary in loan agreements but this does not mean that creditors should decide upon them unilaterally and without wider consultation, and they should not be used to impose a whole range of more intrusive governance conditionalities on debtor countries.

13. Conclusions

This paper has focused on one small aspect of the current debt crisis: the problem of countries in arrears on their external debt obligations. We have outlined some of our main concerns in relation to current approaches to the problem and have laid a series of alternative options on the table. We have argued very strongly that there are better, fairer and more sensible ways to go forward than current practices. We urge the international community not to waste crucial time but to action on the recommendations outlined in this report. This is particularly the case given that there are undoubtedly a number of country cases coming to the fore in the near future.

Although it is true that the measures outlined in this report will not in themselves solve the debt crisis – falling commodity prices, falling terms of trade and rich country subsidies all play their part in this jigsaw puzzle of contributing factors – nevertheless they will demonstrate a commitment by the international community to seriously and more equitably address the debt problem. In this context, rich countries should not view the efforts undertaken by the G8 in 2005 as "the end of the story" on debt. Indeed, this paper has shown that the steps undertaken last year represent a mere "drop in the ocean" when we consider the structural reforms that need to be undertaken in relation to the broader global financial architecture.

Action comes down to a question of sheer political will. If creditors prefer the current heads in the sand approach and choose to continue with current practices, they should not be surprised if and/or when civil society groups and debtor governments use the threat of repudiation to advance their demands. CSOs around the globe will continue their work to expose these critical concerns and to fight for an approach to international development finance that is based on solidarity, not conditionality, penalties and gross inequalities.

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16. Endnotes

[i] See**: Joint European NGO Report: EU Aid: Genuine Leadership of Misleading Figures, April 2006**. The report includes the full methodology used to make the calculations cited in this report (http://www.eurodad.org)

[ii] The Paraguayan Government recently repudiated some of its commercial debt on the grounds of illegitimacy. The details of the case are as follows: Between 1986 and 1987, Paraguayan Consul in Geneva, Gustavo Gramont Berres, requested a US$85mn loan in the name of the government. The Stroessner dictatorship was in power at the time (Stroessner was in charge between 1954 and 1989). The loan was granted by the "Overland Trust Bank" in Geneva Switzerland, allegedly with full knowledge by the bank that this individual had no legal right to request a loan in the name of the state. Despite this, the loan went through and was allegedly used for the purposes of personal enrichment. Certainly, the current Paraguayan Government maintains that none of the funds ever reached Paraguay. The Overland Trust Bank has subsequently ceased to exist but before its dissolution, it sold the debt on to nine banks which then demanded full reimbursement of the funds by the Paraguayan State. The government refused to pay-up on the grounds that the debt was fraudulent, so in 1995 bondholders took the Paraguayan State to the Swiss courts for non-compliance with the contract. The ruling was that the Paraguayan State had to pay-up: the full US$85mn plus interest amounting to 185% of the principal. The Paraguayan Government however squarely rejected this. In August 2005, the Paraguayan Government refused payment of these debts contracted under Alfredo Stroessner's regime. On 26 August 2005, the government presented its final decision: Presidential Decree 6295 declared that the Paraguayan authorities consider these debts illegal and therefore the state has no obligation to reimburse them. The same day, Paraguayan Minister for Foreign Affairs informed his Swiss counterpart of the government's decision. The Paraguayan Government also made known its decision to the Swiss courts, stressing that it did not recognise the jurisdiction of the Swiss courts and indeed considered their verdict a violation of the rights of the Paraguayan State and of international law. Indeed the Presidential Decree describes the judgement as "arbitrary" and the whole case as "fraudulent". This was the reason why they were prepared to take the case to the International Court of Justice. In October 2005, the Paraguayan President gave the following speech before the United Nations General Assembly: "This fraudulent act was committed by officials under a corrupt dictatorship which, in collusion with a group of international banks is looking to take resources from us that our country urgently needs" (excerpt)**.** Gustavo Gramont, ex-consul was subsequently taken to court and jailed in Paraguay. During the case, he testified that he had received a commission of some US$6mn from Overland Trust Bank. In this case, the Paraguayan Government took unilateral action not to pay-up. Paraguay considered that it had solid proof and documentation that the debt was illegal and also that lenders were complicit. The Paraguayan Government also invoked the country's Constitution of 1967, which states that loans must receive the express authorisation of the Executive arm of the government. In this context, the loan guarantees given by the individual in the name of the state were therefore non-existent. The individual in question had no authority to act as representative of the Paraguayan State and lenders did not observe all due domestic and constitutional processes which regulate the taking-on of new loans.