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Low-Income Country Debt Cancellation: H.R. 2634 and S. 2166

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Summary

In recent decades, the rapid growth in poor country debt has emerged as a foreign policy concern. There have been many efforts to help reduce poor country debt. In 1988, a group of major creditor nations, known as the Paris Club, agreed for the first time to cancel debts owed to them instead of refinancing them on easier terms as they had done previously. In 1996, the International Monetary Fund (IMF), the World Bank, and the regional development banks agreed to allow a portion of debts owed to them by a select group of countries to be cancelled. This effort is known as the Debt Relief Initiative for Heavily Indebted Poor Countries (HIPC). At the Gleneagles Summit of the Group of Eight (G8) nations in July 2005, the HIPC effort was expanded to provide 100% cancellation of all multilateral debt for countries that have completed the HIPC program. This expanded effort is known as the Multilateral Debt Relief Initiative (MDRI).

Some analysts believe that existing multilateral debt relief initiatives are insufficient. They want debt relief for more countries than are currently eligible. To this end, Members of the 110th Congress introduced the Jubilee Act for Responsible Lending and Expanded Debt Cancellation of 2008 (H.R. 2634/S. 2166). The bill has been approved by the House of Representatives and reported favorably by the Senate Foreign Relations Committee.

The act seeks to expand HIPC/MDRI debt relief to an additional 24 countries, which are eligible to receive 100% of their World Bank assistance from the International Development Association (IDA), the World Bank's low-income lending facility. So-called "blend" countries, those eligible to receive World Bank assistance from the concessional and market-rate windows of the World Bank, would not be eligible for Jubilee debt relief. The act directs the Secretary of the Treasury to undertake negotiations with other bilateral creditors and with the multilateral agencies in order to provide complete debt relief for the 24 countries.

Proponents of the legislation argue that on equity and policy grounds, a strong case can be made that the so-called Jubilee countries should have access to the same level of debt relief as provided to the equally-poor HIPC countries. Critics counter that the proposed legislation raises several policy concerns. First, even if the United States approves the proposal, multilateral debt relief would require the assent and collaboration of other donor nations, many of whom have expressed little interest in a new round of multilateral debt relief. The proponents of the legislation want the international financial institutions (IFIs) to absorb the cost of additional debt relief from existing resources. It is not clear if other major countries would agree to such a plan. Also, the IFIs' capacity to maintain the present size of their programs might be constrained if debt relief were funded out of existing resources. Lastly, many analysts question the ability of debt relief — absent broader social, economic, and governance changes in the poor countries — to achieve poverty reduction and growth. The proponents argue, nonetheless, that it is unfair and wrong that one group of very poor countries should have their debts forgiven totally while another very similar group must repay in full. This report will be updated as events warrant.

Contents

Background: The HIPC and MDRI Programs 1

Congressional Action 3
The Jubilee Act Proposal 3
Content of the Legislation 3
Findings 3
Debt Cancellation 4
Framework for Responsible Lending 5
Harmful Conditionality 6
Other Matters 7

Potential Beneficiaries 7

Estimated Cost of the Jubilee Act 9

Theory of Debt Cancellation 13
Debt Overhang: Theory 13
Debt Overhang: Evidence 14

Implementation Concerns 15

Policy Issues 16
Additionality 16
Conditionality 17
Funding Jubilee Debt Relief 18

List of Tables

Table 1. Jubilee Act Beneficiaries: Debt and Debt Service (2004) 8
Table 2. Debt Owed to IFIs, 2007 11
Table 3. Potential U.S. Bilateral Costs, 2007 12

Low-Income Country Debt Cancellation: H.R. 2634 and S. 2166

The bills titled the "Jubilee Act for Responsible Lending and Expanded Debt Cancellation" (H.R. 2634 and S. 2166) seek to provide 100% debt relief to the many poor countries that did not qualify previously for debt relief through the World Bank's HIPC (Heavily Indebted Poor Country) program. This legislation builds on more than a decade of debt relief efforts at the international financial institutions (IFIs) that aim to benefit the poorest countries.

This report discusses previous efforts to cancel debt owed by low-income countries. It summarizes the Jubilee debt reduction proposal and provides an overview of House and Senate action. It assesses the likely cost of a possible Jubilee debt reduction program. Finally, the report examines some possible implementation and policy issues.

Background: The HIPC and MDRI Programs

Since 1996, the World Bank and IMF have coordinated an effort by multilateral and bilateral official creditors to reduce the foreign debt of the nations categorized as heavily indebted poor countries (HIPCs). In 2005, the G8 countries agreed during their summit meeting in Scotland on a Multilateral Debt Reduction Initiative (MDRI) which aims to augment the HIPC program.[1]

For much of their history, the IFIs have served as lenders of last resort to countries suffering from financial crisis. Thus, the IFIs argued that since they provided assistance to countries unable to borrow from anyone else, they should receive preferred creditor status. This means that the World Bank and the IMF would be paid first in the event that borrowers ran into financial difficulties, and that debts owed to them would not be reduced under any circumstances. If they forgive debt owed to them by their borrower countries, the IFI's argued, they would have less money available in the future to help other countries needing IFI aid. It would also set a bad example, they said, as it would give debtors the impression that they could borrow money from the IFIs without a commitment to pay it back. The latter is called the "moral hazard" argument against debt relief. From this perspective, debt relief should be a last recourse and should include a requirement that debtor countries

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[1] More information on the 2005 debt relief agreement is available in CRS Report RS22534, *The Multilateral Debt Relief Initiative*; and CRS Report RL33073,*Debt Relief for Heavily Indebted Poor Countries: Issues for Congress*, both by Martin A. Weiss.

adopt reforms and new policies to reduce the likelihood that they will need more debt relief in the future.[2]

Despite initial reservations, and at the G8's request, the World Bank and the IMF created the Heavily Indebted Poor Countries (HIPC) debt relief program in 1996 to reduce some multilateral debt in conjunction with bilateral debt forgiveness. According to the IMF and the World Bank, the goal of the HIPC program was to help the poorest and most indebted countries meet their "current and future external debt service obligations in full, without recourse to debt rescheduling or the accumulation of arrears, and without compromising growth."[3]

In 1999, the program was expanded to provide deeper, faster, and broader debt relief. Initially, the HIPC program determined that a debt service-to-exports ratio of 250% was sustainable. Moreover, it took a minimum of six years for borrowers to qualify for debt relief. Critics charged that this ratio was too high and the time-frame to qualify for debt relief was too long. When the program was redesigned in 1999, the debt service-to-exports ratio was reduced to 150%, and the time period was shortened. It was also anticipated that the debt service ratio (the share of export revenue needed to service foreign debt) for HIPC beneficiaries would be in the range of 15 to 20%. The HIPC program was also modified to include a greater focus on poverty reduction efforts. Countries receiving debt relief were now explicitly required to use money freed up by debt relief for poverty reduction.

HIPC debt relief is provided in stages, based on each country's performance against a defined set of economic targets and requirements. HIPC-eligible countries must successfully implement IMF-prescribed reforms for three years before reaching the "decision point," which makes them eligible to receive intermediate debt relief. Following a further track record of good economic policy, a country reaches "completion point" where the remaining debt relief is granted.

In June 2005, G8 finance ministers proposed the Multilateral Debt Relief Initiative (MDRI) to provide financing for the World Bank to be able to completely forgive all of the HIPC countries bilateral and multilateral debts once they completed the HIPC program. The eventual MDRI agreement was a compromise agreement between the United States and European countries.[4] U.S. officials had reportedly argued that the cost of multilateral debt relief could be borne by the institutions and did not require donors to contribute any new assistance. Other creditors believed the institutions should be compensated for their debt forgiveness to avoid diverting

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[2] Rutsel Silvestre J. Martha, "Preferred Creditor Status under International Law: The Case of the International Monetary Fund." *International and Comparative Law Quarterly*. 39:801-826 (1990).

[3] Anthony R. Boote and Kamau Thugge, "Debt Relief for Low-Income Countries: The HIPC Initiative," *International Monetary Fund*, Washington, D.C., 1999

[4] Elizabeth Becker and Richard W. Stevenson, "U.S. and Britain Agree on Debt Relief for Poor Nations," *New York Times*, June 10, 2005.

potential resources that could be lent to the poorest countries.[5] Any debt relief, they argued, should be additional to existing multilateral assistance. The compromise plan entailed the multilateral development banks receiving new money from creditor nations to offset their debt reductions while the IMF would absorb the cost of debt relief using internal resources.

Congressional Action

The Jubilee Act Proposal

The Jubilee debt cancellation act would require the Secretary of the Treasury to seek new arrangements with the Paris Club of Official Creditors (an informal group of the wealthiest countries that would cancel 100% of the bilateral and multilateral debt owed by two dozen poor countries that were not eligible to receive debt relief from the HIPC program and are not covered by the MDRI.[6] The act would also require the United States to seek changes in the framework for international lending to poor countries and limitations on the conditions countries would have to meet in order to receive debt cancellation.

The original Jubilee Act was introduced in June 2007 by Representative Maxine Waters and several others. The House Financial Services Committee held hearings on the bill in November 2007. It subsequently marked up and reported the bill favorably in April 2008 (H.Rept. 110-575) with several amendments in the form of a substitute. The House of Representatives debated and passed the bill (283-182) on April 16, 2008, after approving the committee substitute amendment and three amendments proposed from the floor. A companion bill, S. 2166 was introduced in November 2007 by Senator Robert Casey, Jr. The Senate Foreign Relations Committee held hearings on the bill in April 2008. It marked up and reported the bill favorably, with several amendments, in June and a report was filed (S.Rept. 110-438) in August 2008. S. 2166 was placed on the Senate calendar on August 1, 2008.

As introduced in the House and Senate, H.R. 2634 and S. 2166 were almost identical. Each had four sections. The House added two additional sections at the end of H.R. 2634. The Senate added a new Section 3, renumbering the rest of S. 2166, and it added two new sections at the end of the bill. The new Section 6 is very similar to the comparably numbered section in the House bill. The new Section 7 addresses a different issue. Because of renumbering, the section designations for other topics are different in the House and Senate bills.

Content of the Legislation

Findings. Sections 1 and 2 contain both bill's short title and findings. The findings section presents information and arguments that seek to justify the need for

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[5] *Ibid.*

[6] Additional information on the Paris Club is available in CRS Report RS21482, *The Paris Club and International Debt Relief*, by Martin A. Weiss.

the legislation. The House passed the bill without making any changes in the findings. The Senate Foreign Relations Committee edited and condensed the findings, removing controversial language or assertions and emphasizing areas of consensus.

Debt Cancellation. Section 3 of the original language of H.R. 2634 and S. 2166 directed the Secretary of the Treasury to seek agreement among the other members of the Paris Club and the IFIs for the 100% cancellation of all multilateral and bilateral debts owed by 24 poor countries that previously had not received debt relief from the HIPC or MDRI programs. Multilateral debt cancellation was to be financed, "to the extent possible," the bill said from the ongoing operations, procedures, and accounts of each international financial institution. Aid levels should not be reduced, the bills said, when countries received reductions or cancellations in their debt.

H.R. 2634 and S. 2166 would require that countries receiving relief under the Jubilee plan should (1) allocate the savings from debt cancellation towards poverty-reducing expenditures; (2) engage civil society in the allocation of these expenditures; (3) develop and implement effective policy reforms to ensure that savings from debt cancellation are redirected to poverty reduction efforts and that any future borrowing be conducted in a responsible fashion; and (4) produce a publicly available annual report disclosing how the savings from debt cancellation were used.

The Jubilee debt cancellation plan would encourage debt relief recipients to allocate at least 20% of their national budget to such social services as basic health care, education, and clean water for all people in the country. It also seeks agreement among the IFIs and donors to assure that the external financing needs of low-income countries will be met primarily through grants rather than new lending and that countries receiving debt cancellation will not have their future levels of aid cut proportionally (as is the current arrangement under MDRI).

As originally proposed in the House and Senate versions of the Jubilee Act, countries would be eligible for debt relief if: (1) They are eligible for financing from the International Development Association (IDA) but not the World Bank (i.e. IDA-only); (2) They have transparent and effective budget execution and public financial management systems; (3) They do not have an excessive level of military expenditures; (4) They have not repeatedly provided support for acts of international terrorism, as determined by the Secretary of State; (5) They are cooperating on international narcotics control matters; (6) They do not engage in a pattern of gross violations of internationally recognized human rights; and (7) They do not engage in, or allow entities in their jurisdictions to engage in the proliferation of weapons of mass destruction, related materials and components, or associated delivery systems.

The House Financial Services Committee added a new subsection to the bill making it clear that, while the Jubilee Act directed the Secretary of the Treasury to seek a new debt relief plan, it did not authorize the Secretary to agree to U.S. participation in such a plan without future congressional assent.

The House Committee also added language (in Section 4 of the House bill) requiring that the Secretary of the Treasury seek an agreement among the IFIs and the

Paris Club creditor countries that countries could receive debt relief only if they met certain additional tests. The governments of recipient countries would need to (1) take steps to assure that the savings from debt relief are used to improve infrastructure, improve education and social services, reduce mortality and redress environmental degradation; (2) make policy decisions through transparent and participatory processes; (3) adopt an integrated development strategy emphasizing poverty reduction through economic growth and employing monitorable goals;(4) implement transparent policy making and budget procedures, good governance and effective anti-corruption measures; (5) broaden public participation and popular understanding of the principles and goals of poverty reduction, particularly through economic growth and good governance; (6) promote the participation of citizens and non-governmental organizations in the government's economic policy choices; and (7) produce an annual report disclosing how the savings from debt cancellation were used and make the report publicly available and easily accessible to all.

The House of Representatives added two additional eligibility requirements during its consideration of H.R. 2634 on April 16. The first, a floor amendment proposed by Representative Dana Rohrabacher, said that countries could receive debt relief only if their governments were chosen by, and they permit, free and fair elections. The second, a floor amendment introduced by Representative Mario Diaz-Balart, said that countries would not be eligible for debt cancellation if they have business interests with Iran.

The Senate Foreign Relations Committee did not add the House amendments regarding eligibility to the Senate version (S. 2166) of the Jubilee debt cancellation bill. However, the Committee did add, to the criteria that countries had to meet in order to be eligible for debt cancellation, a stipulation that their governments must have demonstrated democratic governance and transparency in decision making.

The Senate Committee also struck from the bill the language which sought to ensure that aid levels from the IFIs and bilateral donors would not be reduced when countries received debt cancellation. The House left this provision of the bill unchanged. At the urging of the United States, the G-8 countries had agreed previously that foreign aid levels to poor countries would be reduced correspondingly when their debt service payments were reduced through debt cancellation.[7]

Framework for Responsible Lending. H.R. 2634 and S. 2166 require the Secretary of the Treasury to seek agreement among the IFIs and the Paris Club countries on a new framework for transparent and responsible international lending to low-income countries. The new framework should assure that official lenders are more transparent in their credit operations and that affected communities and civil society have opportunities to participate in loan decisions. It should also seek to insure that all creditors (public and private) contribute to preserving the gains of debt relief for poor debtor countries.

The House and Senate bills originally directed the Secretary to seek agreements that would prevent certain kinds of private investors ("vulture funds") from buying

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[7] Se CRS Report RS22534, *The Multilateral Debt Relief Initiative*.

poor countries' international debt obligations a deeply discounted market value and then seeking to recover the original value through legal or other processes. The House Financial Services Committee dropped the language about "vulture funds" from H.R. 2634 on grounds that these would be the subject of future legislation. The Senate Foreign Relations substituted, for the original language in S. 2166, a stipulation that the United States should work with other governments to discourage, rather than to prevent, vulture fund activity in poor debtor countries. The Senate Committee added additional language to the bill directing the Secretary to work with other countries to secure commitments from non-Paris Club creditors that they would not sell debt owed to them by poor countries to other creditors who did not intend to provide debt relief.

The House and Senate bills originally directed the General Accountability Office (GAO) to perform audits of the debt portfolios of countries with questionable loans in which there were allegations that odious, onerous or illegal debt was subscribed in order to facilitate corruption or activities that were not in the interest of the people of those countries. The Senate Foreign Relations Committee changed from "shall" to "should" the directive that GAO audit loans made by the IFIs and the U.S. Government. It also replaced most references to odious debt with references to sustainable debt, shifting the focus to a concern whether the debts were sustainable at the time they were incurred. The Senate Committee left unchanged the directive that these audits should investigate the process by which the loans were contracted, how the funds were used, whether any international or U.S. laws were violated and whether the debts were odious or onerous.

Harmful Conditionality. Original language in H.R. 2634 and S. 2166 directed the Secretary of the Treasury to seek agreement among the IFIs and the Paris Club creditor countries that debt cancellation in the future would not be premised on countries adopting what the legislation called "harmful" economic or policy conditionality. The legislation mentioned, in particular, requirements that countries impose user fees for primary health or education programs, that they raise the price that low-income households must pay for basic public services such as education, health care, drinking water or sanitation, that they limit workers' ability to exercise effectively internationally recognized worker rights (as recognized under U.S. law,) that they adopt polices which degrade the environment or that they limit their budgetary expenditures (particularly in the context of an agreement with the IMF) for essential healthcare or education expenses or adopt hiring or wage bill ceilings. The bills required the Secretary to file a report annually, during the next four years, detailing the steps taken to accomplish the purposes of that section of the legislation.

The House Financial Services Committee replaced the concept of "harmful" conditionality with a directive that the Secretary seek agreement among the IFIs and Paris Club creditors that there should be no conditions on countries' access to debt cancellation other than the procedural and governance factors noted above. The Senate Foreign Relations Committee deleted any references in S. 2166 to specific practices or policies. Instead, it directed the Secretary to seek agreement that there should be no conditionality for debt cancellation that would "significantly increase the cost of public services for low-income households" or that deepen poverty or degrade the environment.

The Senate Committee also struck out the requirement that Treasury report annually on the implementation of the legislation. Instead, it required that Treasury file a report, by the end of December 2009, showing the extent to which previous rounds of debt cancellation were accompanied by conditionality requiring countries to adopt user fees on primary education or health care, increases in the cost of basic public services to low-income people, or the adoption of caps or limitations on government spending for education and health care or hiring or wage bill ceilings. Experts disagree about the extent to which multilateral and bilateral debt cancellation in the past has been predicated on countries adopting economic or policy conditions of that sort.

Other Matters. The House Financial Services Committee added a new Section 5 to H.R. 2634 expressing a Sense of Congress that the United States should pay off its $596 million in arrears (overdue payments) to IDA and the regional development banks. It also said the United States should become current on all its commitments to fund debt reduction through the HIPC and MDRI programs. The Senate Foreign Relations Committee added a new Section 3 to S. 2166 stating a similar Sense of Congress recommitting the United States to fund its existing arrears to the multilateral banks. It also expressed a Sense of Congress that the provision of debt cancellation to a low-income country should not be followed by a reduction in the level of U.S. development aid. It said the United States should encourage other creditors not to make such reductions in their levels of aid to those countries.

During its consideration of H.R. 2634 on April 16, 2008, the House approved an amendment by Representative Alcee Hastings of Florida (new Section 6) expressing the Sense of Congress that the Secretary of the Treasury should seek the immediate and complete cancellation of all Haiti's debts to the IFIs or an immediate suspension of debt repayment obligations. The Senate Foreign Relations Committee added a corresponding Section 6 to S. 2166, urging a similar cancellation of Haiti's debts or debt service payments to the IFIs.

The Senate Committee also added a new Section 7 to S. 2166. This directed the Secretary of the Treasury to submit a report to Congress by the end of June 2009, discussing the feasibility of adding a new loan facility to the IMF. The new facility would be intended to provide temporary financing to help low-income countries cover their debt service obligations in situations where their economies have been struck by economic shocks beyond their control. The bill mentioned, for example, natural disasters and sharp spikes in commodity process. It said that a facility of this sort would minimize the need for additional debt relief in the future.

Potential Beneficiaries

There are 24 countries that only receive IDA assistance, but for various reasons are not included in the HIPC or MDRI debt reduction plans. Most often they were not included because their debt burden was considered to be sustainable at the time the list of HIPCs was compiled and they therefore were not deemed to need debt cancellation. They include Angola, Bangladesh, Burma, Cambodia, Cape Verde, Djibouti, Georgia, Kiribati, Kenya, Kyrgyz Republic, Lesotho, Maldives, Moldova,

Mongolia, Nigeria, Solomon Islands, Somalia, Tajikistan, Timor-Leste, Tonga, Republic of Yemen, Vanuatu, Vietnam, and Zimbabwe. Supporters of the legislation expect nine of the 24 countries would immediately qualify for debt relief: Georgia, Cape Verde, Samoa, Vietnam, Kenya, Mongolia, Lesotho, Moldova, and Vanuatu.[8]

Table 1 shows the total long-term debt of each of these countries, plus the amount each owes to the IMF. (For technical reasons, debt owed to the IMF is not considered long-term debt.) It also shows the share of each country's export income that is used for total debt service (TDS). This includes payments of both principal and interest. In some instances, the latter data were not available.[9]

Table 1. Jubilee Act Beneficiaries: Debt and Debt Service (2004)

(Millions of U.S. Dollars)

	Total Long-Term Debt	Bilateral Creditors	Multilateral Creditors	Private Creditors	(IMF)	Debt Service Ratio (%)
Angola	8,630	3,055	379	5,196	0	15
Bangladesh	19,171	3,906	14,722	543	231	5
Burma	5,646	3,508	1,285	853	0	4
Cambodia	3,016	2,066	950	0	97	8
Cape Verde	465	83	360	22	96	NA
Djibouti	415	114	245	56	21	NA
Georgia	1,434	596	835	3	266	11
Kenya	5,978	2,226	3,426	326	103	9
Kyrgyz Rep	1,740	602	1,132	6	207	14
Lesotho	726	92	563	71	38	5
Maldives	305	34	185	86	0	5
Moldova	753	262	449	42	126	12
Mongolia	1,306	497	809	0	44	3
Nigeria	31,303	26,098	2,964	2,241	4,586	8
Solomon Islands	155	39	112	4	0	NA
Somalia	1,949	1,119	793	37	174	NA
Tajikistan	744	249	485	10	122	7
Tonga	81	14	67	0	0	NA
Vanuatu	81	9	72	0	0	NA
Vietnam	15,411	9,249	4,697	1,465	277	NA
Yemen	4,800	2,538	2,185	77	376	4
Zimbabwe	3,558	1,471	1,610	477	293	NA

(Timor-Leste and Kiribati are not included because data were unavailable.)
Source: World Bank. *Global Development Finance, 2006*

[8] *Frequently Asked Questions on the Jubilee Act: How Much Will it Cost?*, Jubilee USA Network, April 16, 2008. Available at [http://www.jubileeusa.org/jubilee-act.html].

[9] Data in **Table 1** are from 2004, the last year for which across-the-board data for all countries was available.

As **Table 1** indicates, Nigeria, Bangladesh and Vietnam would be the largest beneficiaries of Jubilee debt cancellation. Burma, Kenya, Yemen, Zimbabwe and Cambodia would also benefit substantially. None of the countries listed in **Table 1** have debt service ratios as high as the 15 to 20% levels that were an objective of the 1999 Enhanced HIPC debt cancellation program.[10] As noted before, it was on account of their comparatively lower debt service ratios that these countries were not originally included in the HIPC program.

The per capita income and poverty levels of the countries shown in **Table 1** are comparable, however, to most of the countries that were beneficiaries of the HIPC program. In fact, several of these countries have per capita income levels that are lower than countries in the HIPC group.

In 2005, the focus of attention shifted, with the advent of the MDRI, from debt sustainability to 100% debt cancellation for the countries of the HIPC group. On that basis, many questioned why one group of very poor countries should have their foreign debts eliminated while the countries of similar group received no debt cancellation at all. The Jubilee debt cancellation bill is a reflection of that concern.

Estimated Cost of the Jubilee Act

The additional countries that would be eligible for Jubilee debt relief owe the United States a little over $2.2 billion. The Jubilee USA Network (see note 7 above) estimates that to cancel the bilateral U.S. debt covered in the proposal would cost approximately $957 million, depending on which countries "opt in" to the agreement and the discount rate applied in determining the net present value of the debt that is forgiven. This is in line with official U.S. estimates. According to the U.S. Department of the Treasury, the cost of forgiving additional U.S. bilateral debts covered under the Jubilee Bill would be approximately $700 million to $1 billion.[11] The Federal Credit Reform Act of 1990 says that Congress must appropriate a sum equal to the net present value of the debt before the U.S. Government can write off any obligations owed to it by countries, institutions or individuals. **Table 2** shows the amounts that the potential beneficiaries of the Jubilee Act owe to the IMF and World Bank. **Table 3** shows the amounts that they owe to the U.S. Government and the likely budgetary cost of cancelling those debts.

To cover the multilateral costs of Jubilee debt relief, the proposed Jubilee Act states that "to the extent possible, financing the debt cancellation [should come] from the ongoing operations, procedures, and accounts of the institution, without undermining the financial integrity of the institutions." (H.R. 2634, Section 3.) It is unclear, however, given that IDA-only borrowers account for a substantial share of multilateral development bank (MDB) operations, with over $30 billion in outstanding debt, whether adequate funds are available from internal sources to fund

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[10] Except perhaps for Angola, where debt to private creditors comprises a significant share of the total.

[11] E-mail exchange between authors and the Department of the Treasury, April 18, 2008.

debt cancellation without additional contributions by donor countries.[12] The IBRD general reserve currently contains about $37 billion in paid equity and retained earnings. Proponents claim that the World Bank could transfer $10 billion to IDA from its general reserve to fund debt cancellation.[13] They also say the World Bank could transfer an additional $3.9 billion by 2020 by increasing its allocation to IDA from IBRD net income by $300 million annually. Furthermore, they argue that the International Finance Corporation (IFC) could similarly transfer $5.9 billion from reserves and net income through 2020 for this purpose. Also, they say the International Monetary Fund could sell some of its stockpile of gold to fund additional cancellation of debt owed to IDA by potentially eligible poor countries. As discussed below, there are reasons to question whether internal resources of this magnitude will be available.

[12] These figures on IBRD assets are drawn from the World Bank *Annual Report, 2007.*

[13] See, for example: Thomas Chupein, *World Bank Group Resources & Debt Cancellation.* Briefing note 6, June 2008. A joint publication of the American Friends Service Committee and the Jubilee USA Network. Available at [http://www.jubileeusa.org].

Table 2. Debt Owed to IFIs, 2007

Millions of U.S. Dollars

Countries that are not HIPCs, but are IDA-only		
	IMF	**World Bank**
Angola	0	364.7
Bangladesh	500.4	10,098.2
Cambodia	0	532.4
Cape Verde	14.2	266.3
Djibouti	17.4	147.1
Georgia	236.8	876.2
Kenya	213.1	2,931.9
Kiribati	0	0
Kyrgyz Republic	145.4	650.4
Lesotho	36.3	299
Maldives	6.3	74.3
Moldova	161	429.5
Mongolia	26.8	328.8
Myanmar (Burma)	0	793.4
Nigeria	0	2,300.1
Samoa	0	76.8
Solomon Is.	0	46
Tajikistan	45.8	359.7
Timor Leste	0	0
Tonga	0	20.3
Vanuatu	0	13.4
Vietnam	176.8	4254
Yemen	208.3	2049
Zimbabwe[a]	138.9	977
Sub-Total	1,927.6	27,889
HIPC Opt-out Countries[b]		
Bhutan	0	86.4
Laos	26.8	684.4
Sri Lanka	255.7	2,363.1
Sub-Total	282.6	3,133.9
GRAND TOTAL	**2,210.2**	**31,022.9**

Source: IMF and World Bank websites, October 2007. Includes IDA and IBRD.

a. Zimbabwe is currently considered a "notional blend" country by IDA, so it is unclear if it would meet the IDA-only requirement at this time. However, if Zimbabwe re-engages with the donor community in the future, it is likely to be reclassified as IDA-only.

b. These countries may have been eligible for HIPC, but declined to participate. Sri Lanka's debt ratios since have fallen below the thresholds for HIPC eligibility. They would be a potential beneficiaries under the Jubilee Act.

Table 3. Potential U.S. Bilateral Costs, 2007

To Forgive Bilateral Debt Owed the U.S. Government

(Millions of U.S. Dollars)

Countries that are not HIPCs, but are IDA-only		
Country	**US Credit Exposure (Inc. Guarantees)**	**Est. Budget Cost to Forgive[a]**
Angola	362.7	28.7
Bangladesh	250.9	177.1
Cambodia	425.6	64.7
Cape Verde	0	0
Djibouti	0	0
Georgia	42.4	10.7
Kenya	84.3	54.4
Kiribati	0	0
Kyrgyz Republic	0	0
Lesotho	0	0
Maldives	1.7	1.1
Moldova	56.2	30.3
Mongolia	0	0
Myanmar (Burma)	0	0
Nigeria	0	0
Samoa	0	0
Solomon Is.	0	0
Tajikistan	16.3	5.1
Timor-Leste	0	0
Tonga	0	0
Vanuatu	0	0
Vietnam	415	334.4
Yemen	99.4	38.4
Zimbabwe[b]	188.9	16.3
Sub-Total	1,943.4	761.2
HIPC Opt-out Countries[b]		
Bhutan	0	0
Laos	0	0
Sri Lanka	563.4	376.3
Sub-Total	563.4	376.3
GRAND TOTAL	**2,506.8**	**1,137.5**

Source: Foreign Credit Reporting System data as of 6/30/07.

a. Actual costs would vary depending on the timing of debt forgiveness. It is also unlikely that all countries would be eligible for debt relief in the first year.

b. See Notes to Table 2.

According to the World Bank's 2007 annual report, IDA-only countries represent $51.3 billion of $102.5 billion of outstanding IDA credits.[14] This balance is after IDA's write-off of $32.6 billion of development credits to 22 IDA-only countries that have completed the HIPC/MDRI process. Debt burdens for all HIPC/MDRI countries have declined dramatically. The World Bank estimates that overall debt burdens will decrease from $105 billion prior to the HIPC program's introduction to an estimated $8 billion once the MDRI program is completed.

The 24 countries covered by the Jubilee debt relief legislation were not beneficiaries of the HIPC program. According to the World Bank 2007 Annual Report, IDA has approved $34.27 billion in loans to these countries, of which $26.11 billion has been disbursed and $8.1 billion is awaiting disbursement. Several prospective loans are under consideration for these countries and may be approved before the end of the 110th Congress. The Jubilee debt relief bill has no cutoff or effective date beyond which loans will not be included in the loan cancellation plan. Thus, loans that have not yet been approved may be eligible for debt cancellation by the time the debt cancellation program proposed by Jubilee Act becomes effective.

Theory of Debt Cancellation

Debt Overhang: Theory

From an economic perspective, debt relief is grounded in the "debt overhang" theory, which holds that the accumulation of a large stock of unpayable debt will inhibit development by disuading potential lenders and investors. The theory had its origins in the debt experience of Latin America in the 1980s. It was formulated in light of the positive economic growth that several heavily indebted countries experienced following a 1989 debt relief initiative known as the "Brady Plan," named after then-U.S. Treasury Secretary Nicholas Brady.[15] Under the Brady Plan, substantial amounts of debt owed to private creditors was cancelled, with the backing and assistance of the multilateral agencies, and growth in the region revived.

The theory suggests that if investors expect a country's debt level to impair its ability to repay its loans, they will not invest out of a concern that the government may resort to distortionary measures, such as expanding the money supply (which promotes inflation) or raising taxes on their profits to finance debt payments.[16] Even if the debt is not being serviced, the theory suggests that it is still an impediment to economic growth because of the overhang of debt discourages new private investment.

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[14] World Bank. *Annual Report,2007.*

[15] Walter Molano, "From Bad Debts to Healthy Securities? The Theory and Financial Techniques of the Brady Plan," *Business and the Contemporary World*, VIII, 1997, No. 3-4.

[16] Paul Krugman, "Financing vs. Forgiving a Debt Overhang." *Journal of Development Economics*, vol. 29, 1988, pp. 253-268; and Jeffrey Sachs, "The Debt Overhang of Developing Countries," in Guillermo A. Calvo and others, eds., *Debt Stabilization and Development, Essays in Memory of Carlos Dias Alejandro*, Oxford, U.K.: Basil Blackwell, 1989.

When a large stock of external debt is present, creditors could continue lending rates in hopes that this will spur economic growth and that the recipient country will one day be able to repay its debts. Creditors are generally unwilling to make new loans, however, when they are not being repaid for their prior loans. According to debt overhang theory, it is better to forgive the debts, either entirely or to some reduced "sustainable" level so that investor confidence will be restored. With this renewal of confidence, the inflow of private investment will resume, economic growth will resume and the country will be able to borrow additional money and service debt at a higher level of national income.

Debt Overhang: Evidence

A 2002 study of 93 developing countries between 1969 and 1998, and a follow-up study of 61 countries over the same time period, were cited as strong support for the debt-overhang theory. The first study found that external debt began to have a negative impact on growth when its net present value[17] exceeded 160% to 170% of exports and 35% to 40% of GDP. Study simulations suggest that doubling the average stock of external debt in these countries would slow down annual per capita growth by ½% to 1%. The second study found that doubling a country's average external debt level would reduce growth of both per capita physical capital and productivity by almost 1%. The studies concluded that large debt stocks negatively affect growth by slowing both the accumulation of physical capital and productivity, often at the expense of investment.[18]

The question, however, is whether this theory — which grew out of the experience of middle-income developing countries — is relevant also for poor countries. Several studies suggest that it is not. They point to two key differences between the Brady and HIPC countries.[19] In contrast to the Brady countries, there never was a significant amount of private investment in the HIPC countries, and the HIPC countries have never suffered a negative net flow of resources because inflows of foreign aid are typically more than sufficient to cover debt payments.[20] Moreover, debt relief that the HIPC countries have received has not been sufficient to allow them access to private sector credit markets.

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[17] Net Present Value (NPV) of a country's total debt is the discounted sum of all future debt-service obligations (interest and principal). This measure takes into account the degree of concessionality of a country's debt stock. Whenever the interest rate on a loan is lower than the market rate, the resulting NPV of debt is smaller than its face value.

[18] Catherine Pattillo, Helene Poirson, and Luca Ricci, "External Debt and Growth," *IMF Working Paper No. 02/69*, April 1, 2002; and Catherine Pattillo, Helene Poirson, and Luca Ricci, "What Are the Channels Through Which External Debt Affects Growth?," *IMF Working Paper No. 04/15*, January 1, 2004.

[19] Countries receiving assistance through the Brady Plan were Argentina, Brazil, Bulgaria, Costa Rica, the Dominican Republic, Ecuador, Ivory Coast, Jordan, Mexico, Nigeria, Panama, Peru, the Philippines, Poland, Russia, Uruguay, Venezuela and Vietnam.

[20] Serkan Arslanalp and Peter Blair Henry, "Helping the Poor to Help Themselves: Debt Relief or Aid," *National Bureau of Economic Research Working Paper 10230*, January 2004.

Experience suggests that official creditors behave differently than private creditors when they are faced with debtors that do not pay. Rather than retrenching or withdrawing, as private lenders might have done, the HIPC countries' bilateral aid donors continued to provide those countries with substantial amounts of aid during the 1990s even though the unpaid debt to them from the HIPCs continued to grow. Bilateral creditors do not seem to be dissuaded from providing needy countries with new assistance, as theory would predict, by the overhang of unpaid debt that those countries already owed. In the case of the HIPC and MDRI programs, the goal of debt cancellation is not one of encouraging foreign donors to provide more (because the debt overhang is reduced) but rather one of reducing the amount that the poor countries need to pay to service their debts. The resources to fund new development activities comes from diversion of the debt service funds to other uses rather than from new flows of official or private funds from abroad.

Implementation Concerns

Debt cancellation can be effected relatively quickly, but the benefits of the debt cancellation accrue to the recipient countries much more slowly. Debt cancellation does not transfer new resources. Rather, it eliminates the requirement that countries make debt service payments to retire their debt. The benefit of debt cancellation accrues to the former debtor, not at the time the debt cancellation is announced, but rather at the time the country would otherwise have had to make payments to service its debt. The amount the recipient saves will depend less on the size of its debt than on the terms and conditions of the loans themselves. Concessional-rate loans accounted for much of the debt scheduled for cancellation through the HIPC and MDRI programs, as is most of the debt that would be cancelled through the Jubilee Act. The annual payments for concessional rate loans are relatively small compared to the face value of the debt.[21] Consequently, the amount the beneficiaries will be able to spend for the poverty alleviation and social development activities mandated by the Jubilee Act will be modest and distant in time from their present needs.

It is possible that many of the potential beneficiaries might not be able to qualify for debt relief under the Jubilee debt cancellation plan. The Senate bill (S. 2166) says, for example, that — in order to be eligible — countries must have "transparent and effective" fiscal and budgetary mechanisms in place to ensure that the savings from debt relief will go towards poverty reduction. They must also demonstrate democratic governance and transparent decision-making. The House bill (H.R. 2634) requires that countries make their policy decisions through transparent and participatory procedures, they meet "good governance" standards, they have effective anti-corruption measures in place, and they have democratically elected governments.

[21] For IDA loans, for example, the payments are zero percent of the outstanding balance during the first 10 years, 2% annually during the next ten years, and 4% annually during the final twenty years of the repayment period. This means that 80% of the benefit from debt cancellation will not accrue to the recipient until at least 20 years from the date the original loan was approved.

They must also promote the participation of citizens and non-governmental organizations in the economic policy choices of government.

The proponents of the Jubilee Act say that nine countries (Georgia, Cape Verde, Samoa, Vietnam, Kenya, Mongolia, Lesotho, Moldova and Vanuatu) are likely to meet right away the requirement that they have "transparent and effective" fiscal and budget mechanisms.[22] It seems likely, though, that some of these countries and many others on the 24-country list may not meet the other standards included in the legislation. Many would likely need time and foreign aid before they can meet the governance and procedural standards embodied in the House and Senate bills.

The original point of the HIPC program was a concern that too much of a country's scarce foreign exchange resources were being used to fund debt service and not enough was available for development purposes. The MDRI and the proposed Jubilee Act would require that countries spend their savings from debt cancellation on programs aimed at the alleviation of poverty. For the most part, however, those expenditures are made in the countries' own currency and not in foreign exchange. In effect, the money in a government's budget that previously would have been used to purchase the foreign exchange needed for debt service can be used instead for domestic social or development programs. The HIPC and MDRI programs anticipate that foreign aid levels will decline in pace with the reduction in the former debtor's debt service obligations. The "freed-up" foreign exchange, the money that would have been used previously for debt payments, is now expected to be the source of funding in lieu of development aid.

The Jubilee debt cancellation bill says nothing, however, about the way countries should use their "freed-up" foreign exchange. Countries can chose to use that money to fund the import cost related to new development activities if they wish, but there is no obligation that they do so. The money could be used instead to fund the purchase of consumer goods, luxury goods, arms or other things that are not basic to the development process. There is no assurance under the current legislation that a country's expenditures for development-related imports will increase beyond the level needed to supply the incidental requirements of the country's enhanced domestic expenditures.

Policy Issues

Additionality

Debt cancellation is seen by many as a relatively inexpensive way to provide additional aid to needy countries. The money has already been contributed to the recipient country. Only a small amount of new money is needed to cancel the outstanding balance. The key word is "additional." The World Bank's Independent Evaluation Group (IEG) reported in 2003 that aid flows to HIPC debt cancellation recipients increased after the onset of the HIPC program but that aid levels overall had

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[22] *Frequently Asked Questions on the Jubilee Act: How Much Will it Cost?*, Jubilee USA Network, April 16, 2008. Available at [http://www.jubileeusa.org/jubilee-act.html].

decreased.[23] Consequently, IEG said, "there appears to have been redistribution from non-HIPCs to HIPCs since 1998." Aid to non-HIPC poor countries declined as the existing resources were concentrated more on the HIPC beneficiaries. The fact that the costs of funding debt relief are generally charged against the donor countries' foreign aid budget compounds the problem.

If the new round of debt relief contemplated by the Jubilee debt cancellation bill is accompanied by an increase in the overall levels of foreign aid, then other countries will not see their aid levels fall when the countries in the group targeted by the Jubilee legislation receive new debt relief. On the other hand, if aid levels do not increase in proportion to the benefits the new beneficiaries from the Jubilee program, the gains for the Jubilee beneficiaries will be matched by losses by the non-Jubilee countries and the overall development effect of the Jubilee debt cancellation program could be neutral at best.

Conditionality

The House and Senate Jubilee debt reduction bills both contain high standards that countries must meet in order to qualify for assistance under the proposed program. The question is whether this is a way of seeing that only "worthy" countries receive debt relief or whether the standards are an integral tool in the development process that is the goal of the legislation.

Some of the standards seem to be aimed at rewarding countries — for example, those with democratically elected governments, no business contacts with Iran, cooperative policies regarding international terrorism, drugs and mass weapons proliferation — that have pursued what might be considered desirable goals. Those goals may not have much connection to the development process itself. Other standards in the legislation, however, do have such connections. These include the requirements that countries make policy through transparent and participatory procedures and that they have transparent policy and budgetary procedures, good governance and effective anti-corruption procedures.

Many analysts believe that weak governance and a lack of institutional capacity are greater barriers to growth in poor countries than is the overhang of unpaid debt. Difficulty in managing debt is often a symptom, they believe, of deeper and more fundamental economic and societal problems. Political leaders in developing countries are often aware of these difficulties but find it difficult to mobilize the support necessary to overcome entrenched resistance to change. The prospect that their countries' foreign debts may be cancelled if they undertake the needed reforms may be an incentive that will capture the popular imagination and facilitate reform. Debt cancellation by itself might have only limited positive effects if underlying conditions in the governance and policy process are unchanged. However, if countries are able to find the political will to institute the reforms that are necessary to qualify for debt cancellation under the Jubilee Act, they will likely be able to make more effective use of the resources freed by debt cancellation than they might otherwise

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[23] World Bank. *An OED of the HIPC Initiative.* Operations Evaluation Department (later renamed the Independent Evaluation Group.) 2003.

have been. Indeed, some analysts believe that it is the process of making and achieving those changes, rather than the proceeds from debt cancellation, that would have the most positive developmental effects.

Funding Jubilee Debt Relief

The Jubilee Act does not authorize the United States to spend money to help provide additional debt relief. Appropriations will be required, however, if the program goes into effect and the United States agrees with others to cancel debts owed to it by the proposed beneficiary countries. The Jubilee Act presumes that the international financial institutions will use "internal resources" (money currently in their financial reserves and anticipated future IFI income) to offset the cost of cancelling the debt which is owed to them. There may be enough money available from these sources to offset much of the cost of multilateral debt cancellation.

It is uncertain, however, that other IFI member countries will want to make debt cancellation for this particular group of countries their highest priority and to dedicate the IFIs' internal resources to that goal. In that case, debt cancellation for those countries will require either that the international agencies absorb the cost by shrinking the size of their programs or that the United States and other donor countries contribute money to offset that cost. IDA, for example, has typically funded about 40% of its new loans with money received from the repayment of earlier loans.[24] If those "reflows" are reduced, IDA will either need a new source of funding to make up the difference or it will have to reduce its future level of assistance to recipient countries.

Funding MDB debt cancellation for these 24 countries from MDB and IMF "internal resources" may be difficult to achieve. There are competing claims for those resources. Following a recommendation by the World Bank's Development Committee in 1999, for example, the IBRD's member country governments have been allocating a major share of the Bank's net income each year towards expanding IBRD reserves. Since then, the ratio of IBRD equity (paid in capital plus retained earnings) to outstanding loans has increased from 23.9% to 40.8%. This means that the IBRD has almost $41 dollars in reserves for every $100 of outstanding loans.[25]

It is conceivable that the Bank's member countries may decide that IBRD net income is sufficient and that a larger share of the IBRD's net income could now be allocated for other purposes, such as debt cancellation. Jubilee USA proposes that the IBRD transfer an additional $300 million annually from its net income for the next dozen years in order to fund debt relief for the 24 countries addressed in the Jubilee bill. The World Bank has been doing this already. In the past three years, it allocated $1.7 billion from its net income to help fund IDA and various debt relief initiatives. It also made similar transfers previously. It is not clear, though, that the Bank's member countries would agree that debt cancellation for these 24 countries is the highest priority goal for which they want to make a long-term commitment of these

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[24] Jonathan E. Sanford, "IDA Grants and HIPC Debt Cancellation: Their Effectiveness and Impact on IDA Resources," *World Development*, September 2004.

[25] *Ibid.*

resources. In the future, for example, there might be competing claims that substantial amounts might be spent from the IBRD net income to meet pressing international health or poverty-alleviation or environmental concerns. Countries may have different views as to how these present and future claims should be weighed.

There may be less reason to believe that the World Bank's member countries will be willing to withdraw substantial sums from the Bank's reserves to pay the cost of debt cancellation for these 24 countries. As noted earlier, the Bank's member countries have made a concerted effort since 1999 to expand the size of the reserves. The Development Committee[26] believed the Bank needed larger reserves so it could take on more risks in its loan program in order to enhance their development impact. The Committee thought the IBRD should expand the size of its operations in some countries, even if this meant that the share of its exposure in individual countries would increase. The Committee thought the Bank should be more innovative and more willing to lend money in the face of difficult and risky problems. It also thought the Bank should expand its volume of lending to lower middle-income countries even though these countries were often considered less creditworthy than are emerging market borrowers. These initiatives all increase the risk factor in IBRD lending and they still seem to be present concerns. If the size of its reserves were to shrink, because money was allocated for other purposes, the Bank's member countries would likely need to decide whether its loan program should become more cautious or whether it should go ahead with these activities even though its financial backstop had shrunk.

Another effect of a reduction in the size of the IBRD's reserves might be a reduction in the size of the Bank's annual income. The Bank invests its equity and retained earnings in order to generate income to fund its operating costs. In 2007, the IBRD earned about $1.2 billion from investments while its total net income for the year (exclusive of mark-to-market adjustments on the value of its portfolio) was about $1.7 billion[27]. If the Bank's investment income diminishes as a result of the decline in the size of its reserves, the IBRD would face difficult choices. It might need to consider whether to reduce the amount it allocates annually from surplus revenue for humanitarian and development aid, whether to reduce its administrative budget further, or whether to increase its amount it charges its IBRD borrowers so as to increase its revenue from loan operations. Each of these choices has pitfalls that the member countries would need to discuss.

Jubilee USA has also proposed that debt cancellation might be funded through the sale of gold by the IMF. IMF gold sales have always been a sensitive and controversial topic. At present, the IMF member countries are proposing that a

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[26] The Development Committee is a forum of the World Bank and the IMF that facilitates intergovernmental consensus-building on development issues. The Committee's mandate is to advise the Boards of Governors of the Bank and the Fund on critical development issues and on the financial resources required to promote economic development in developing countries.

[27] The World Bank 2007 Annual Report, available at [http://web.worldbank.org /WBSITE/EXTERNAL/EXTABOUTUS/EXTANNREP/0,,menuPK:1397243~pagePK:64168427~piPK:64168435~theSitePK:1397226,00.html]

substantial amount of gold should be sold in order to create an endowment fund that will pay the costs of the IMF's research and surveillance activities. Because its lending volume has substantially declined, the IMF does not currently have enough income to cover its operating expenses. The member countries are proposing that the IMF's "public goods" activities should be funded independently through an endowment. A proposal to approve IMF gold sales for this purpose is expected to come to Congress in 2009.

It is unlikely that the IMF member countries will abandon the proposal that gold be sold in order to underwrite the Fund's administrative costs so that gold sales for debt reduction can be the new priority. More likely, if the IMF were to propose that gold be sold to pay for debt relief, it would be in addition to the existing plan. Careful negotiations were necessary to secure agreement for the current gold sale plan. It is not clear that gold producer countries, central banks and other holders of gold would easily endorse a plan to roughly double the amount of gold the IMF could sell. Likewise, it is not clear that Congress would easily endorse a larger gold sale plan. There have been many proposals in the past that gold be sold by the IMF to help finance IDA debt forgiveness.[28] Institutionally and substantively, there has been strong resistance among the members to that idea. Careful discussion would be needed within the U.S. Government and among the IMF member countries to see if there is sufficient support now for an expanded gold sale plan.

In the past, and as proposed in the Jubilee debt cancellation bill, poor countries have had to meet specified conditions in order to qualify for debt cancellation. At the decision point, however, once they have qualified, their debt payments are irrevocably cancelled and they do not need to take additional steps (or maintain the reforms they adopted to qualify) in order to retain the benefits of debt cancellation. Supporters say this procedure is necessary in ensure stability and to assure countries that they can program the money gained from debt cancellation without worry that their debt cancellation will be taken away. Critics argue, however, that there is no assurance under this procedure that the reforms adopted to qualify for debt relief will be sustained. Many instances have been cited where adherence to the reforms has deteriorated once debt cancellation has been achieved.

Those who share this latter concern might consider whether some form of tranching might be employed to ensure that countries continue to meet the standards that were required for debt cancellation once their debt cancellation program has been approved. For example, countries' debt payments for a five year period might be forgiven on the understanding that, to have their debt payments for the next five years similarly waived, they must continue to meet the terms they had to meet in order to qualify for debt relief in the first place. Currently, the debt cancellation under the HIPC program is an irrevokable action. Once a country qualifies for cancellation, it no longer needs to make future payments on the forgiven loans even if it regresses on its policy reforms or it equivocates on its promises.

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[28] See CRS Report RS22729, *International Monetary Fund (IMF): Financial Reform and the Possible Sale of IMF Gold*, by Martin A. Weiss and Jonathan E. Sanford.