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**Patricia Alvarez-Plata  
Tilman Brück**

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## **External Debt in Post-Conflict Countries**

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### **ABSTRACT**

In the development literature, there exists no systematic study of external borrowing in post-conflict countries. We address this gap by analyzing statistical and case study evidence from three African countries. We find that many war-affected countries face rising debt arrears and deteriorating relations with creditors. Rebuilding trust between lenders and borrowers is hence a crucial but often slow process. Furthermore, donors to war-affected African countries have been slow to grant exceptional debt relief based on odious debt or on financial requirements. Debt relief for post-conflict reconstruction should embrace a more forward-looking and more generous conditionality.

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## 1. INTRODUCTION

External borrowing is a core element in nearly all poor countries' development strategies, including almost all war-affected developing countries. Foreign loans can be used to finance public spending aimed at increasing growth, development and security. However, external borrowing can also be used for private gains or for financing warfare. Similarly, overcoming conflict requires raising and redirecting scarce public finances, including borrowed funds, from war-related activities towards sustainable development. Both processes - using external borrowing wisely and building peace - are massive challenges for poor countries and donors alike.

Despite substantial research on external debt management in general and on post-war reconstruction in developing countries, surprisingly few studies have addressed the external debt held by post-conflict countries. Given the special problems faced by countries at war or emerging from war, and the importance of external debt to the post-war transition in these countries, it is useful to assess the case for special debt management strategies and for above average debt relief for post-conflict economies. A key motivation for this study is that unresolved debt issues in the post-war conflict can significantly hinder the international community's commitment to reconstruction and limit the scale of its involvement. There is then a real risk that a lack of unresolved debt issues leads to underinvestment in peace and development and hence to a resumption of conflict. In short, external debt can be one of the causes of the conflict trap.

Our paper analyses three related issues. First, we survey recent trends of external borrowing for conflict-affected countries and ask if these trends can be explained by the special burdens and needs of these countries. We will thus explain how post-conflict countries indeed are different from non-conflict economies. Second, we examine policy options concerning debt forgiveness (based both on wider moral and narrower economic concerns) and the effects of external borrowing on aid for post-conflict economies. This part of the analysis will thus probe into questions of policy design including the choice of indicators of debt sustainability, debt conditionality, and additionality. Third, we investigate the institutional framework of post-conflict debt management, from both the lender and the borrower perspectives. This issue includes a focus on the critical lender-borrower relationship at the end of conflict (when arrears threaten to prevent the reintegration of the former war economy into the international donor framework) and an

assessment of the suitability of international debt institutions for coping with debt under conflict.

Our analysis draws on literature from the distinct fields of external borrowing and post-conflict reconstruction, aggregate quantitative evidence covering all developing countries, and country case study evidence. We structure our analysis along the three perspectives of historical context, policy options, and institutional framework, supporting our general findings on each issue with case study evidence from three highly indebted poor post-conflict economies in Africa. The choice of country case studies for this paper was motivated by their diverse experience of conflict funded by debt (in the case of Mozambique), piece-meal debt relief policies being negotiated over years, using up scarce domestic capacities (in the case of Uganda), and unusual post-war institutional relations (in the case of the DRC), thus mirroring the experience of many war-affected economies, even if that part of our analysis is not statistically representative.

From a historical perspective, we demonstrate that the post-conflict environment poses special challenges and experiences unique circumstances concerning debt, arrears and aid as well as trust and institutional relations. Mozambique serves as an example of how war and debt are strongly intertwined, calling into question the responsibilities of the donor community in forgiving badly lent debt.

From a policy perspective, we identify the shortcomings of existing analytical and policy approaches to dealing with highly indebted wartime economies. We sketch how protracted the debt relief process has been for Uganda, thus squandering the opportunity to accelerate post-war reconstruction by denying the special circumstances of indebted post-war countries.

From an institutional perspective, we derive the need for a coherent and consistent approach to post-war reconstruction, where debt policy and debt management are but one strand of a successful transition from war to peace. The case of the DRC indicates how very worthwhile efforts in debt accounting can be lost if not met by similar progress on other macro-economic or poverty alleviation policies. The challenge for donor policy coherence is massive in the field of post-war debt management as well.

Having said this, we acknowledge that some of these issues are of a normative character. In our study we emphasize the positive criteria and choices involved in these decision making processes. We do not argue that war-affected economies follow

different laws of economics. Instead, our analysis identifies many similarities between developing countries with or without conflict. However, conflict sharpens the related debt and development challenges, thus raising the stakes and requiring even more focused and sustained policy responses. In short, we argue that what is a good debt policy for war-affected countries may also be a good debt policy for other developing countries, but that the reverse is not always true.

The paper is structured as follows. Sections 2 to 4 provide a conceptual framework for the analysis of post-conflict debt drawing on recent trends, analyzing debt institutions and policies for debt relief. Section 5 assesses the experiences of three case studies (Mozambique, Uganda and the DRC) to indicate how recent trends, institutions and policies have been developed and applied in each of these three cases. Section 6 concludes and derives some policy recommendations.

## **2. ARE POST-CONFLICT COUNTRIES DIFFERENT?**

### **Aggregate Trends**

Table 1a summarizes some salient features of recent trends in external borrowing for 38 war-affected and peace-time economies, comparing debt indicators for low-income countries at war, post-war low-income countries, and low-income countries which did not experienced war in the preceding 12 years. The data on debt and aid are derived from the World Bank's GDF and WDI statistics. They are based on all severely and moderately indebted low income countries (LIC) for which data were available.

Debt stocks as a share of GNI have remained fairly constant for most low-income countries (LICs) since 1990. LICs at war, however, have experienced above average and rising indebtedness in the late 1990s. LICs emerging from war were able to reduce their debt levels since 1995, possibly because of debt rescheduling and forgiveness.

Given the weak export performance of war-affected countries, both war-time and post-war LICs have much higher debt-to-export ratios than peace-time economies. The position of the post-war economies in this regard has, however, been improving steadily over time and converging with the overall mean in recent years. Foreign aid to post-conflict countries in absolute terms is lower than aid given to countries at war or at peace. However, in relation to their GNI, post-conflict countries receive the highest amount of aid on average while countries currently affected by war receive the least support.



The sources of official debt between conflict-affected and peace-time economies have changed over time (Table 1b). Conflict-affected countries (including both war-time and post-war countries) doubled the share of debt from multilateral creditors in the period 1990 to 2002 while peace-time economies only raised that share by 50 per cent. In turn, conflict-affected countries reduced their share of bilateral debt by a quarter while peace-time economies reduced that share by only ten per cent. By 2002, the conflict-affected countries have less debt as a share of total debt with bilateral official creditors than does the reference group. This also implies that, for better or for worse, bilateral donors have less influence on policy conditionality in these countries vis-à-vis the multilateral lenders. At the same time, this trend heightens the need to monitor and optimize multilateral policies for war-affected countries.

In summary, the data indicate that during a war debt levels rise and after a war debt levels fall. Debt sustainability indicators worsen for two reasons during war: debt levels rise and indicators of economic activity worsen. Furthermore, debt for conflict-affected countries has been multilateralised over the last fifteen years, with bilateral lenders strongly reducing their exposure to war-affected economies. These data hence demonstrate that war-affected countries do indeed have different trends with respect to their foreign debt than do peace-time countries.

### **Arrears with Multilateral Donors**

Post-conflict countries with external debt arrears face severe difficulties to accessing much needed funds from the international community as the international community is not usually willing to lend or donate to countries in arrears on debt. For multilateral donors, arrears are a problem as they signal the end of business as usual for assistance to a country (Birdsall et al. 2003). Re-establishing a working institutional relationship between a highly indebted war-affected developing country on the one hand and the multilateral institutions on the other hand is thus crucial for resolving a debt crisis.

Bilateral donors respect the primacy of multilateral donors in this respect and treat breaches of contract by borrowers with multilateral creditors as a signal that contracts with bilateral creditors will not be honored any further, either. However, the issue of how to deal with countries in arrears is not yet well established by the international community. Furthermore, war-affected countries find this process even more challenging than other developing countries.

Normalizing relations with multilateral donors in a post-war setting generally requires six steps. First, an indebted country must form a working an internationally recognized government, thus articulating a functioning voice in this process. Second, the government must establish the domestic political will to normalizing relations and build up some minimal managerial capacity for debt management. This last part is particularly difficult for war-affected countries. Third, the country, assisted by the international community such as the IMF, must undertake a stocktaking exercise (also called “debt reconciliation”) to establish the level, the nature and the lenders of the outstanding stock of foreign debt. Post-war countries may face problems in completing this step if records were lost during the war (as happened in Liberia).

Fourth, a country has to formally re-establish its relations with the IMF and other international donors and their agencies to start building some trust. Trust may be built up, for example, by starting nominal but regular payments to an international financial institution. Fifth, the government has to develop a national debt management policy and start implementing this policy with its partners. This should address in particular the issue of arrears. Without starting to clear arrears, a developing country cannot re-establish working relations with the international donor community. Finally, the government can enter into debt relief negotiations with its Paris Club and non-Paris Club donors.

Arrears to international financial institutions may delay the commencement of peace building (beyond the signing of the peace deal) and postpone reconstruction unless a post-war government succeeds in obtaining bridge loans from bilateral official creditors. Bridge loans are very short-term loans, often only lasting a few days, by bilateral lenders to developing countries keen to fulfill their obligations to multilateral institutions but unable to do so from their own resources. Once the multilateral lending resumes upon receipt of the bridge loan, the resources from the multilateral loan can then be used to repay the bridge loan - potentially leaving an indebted country financially no better off than before. Surprisingly, bridge loans by bilateral donors appear to help governments gain credibility with multilateral donors.

The paradox of bridge loans is that they allow a developing country to gain short-term credibility by appearing more financially liquid than they are. However, the multilateral lender knows that this creation of liquidity is an artifact, established by willing donors. The benefits of bridge loans entail the resumption of multilateral lending in the longer term, the commitment of bilateral donors to that country and the prevention of a

significant loss of reputation associated with default to international lenders. The costs of bridge loans include the burden on capacity by donors and recipients to arrange the bridge loans and the financial cost of such short-term lending.

An innovative approach to overcoming large and protracted arrears to the multilateral institutions by post-conflict countries was developed by IDA in 1999 (Michailof et al. 2002). The IDA authorized the limited use of grant financing to support economic recovery during the pre-arrears clearance phase. However, by 2001 only one out of the five post-conflict countries in Africa with large and protracted arrears that could have qualified for these IDA grants did in deed qualify, namely the Democratic Republic of Congo. Therefore, arrears continue to be a key obstacle to establishing sustainable and workable debt management strategies for post-conflict economies.

### **Exceptional Burdens and Needs**

War-affected economies can be expected to carry extra burdens in terms of their development agenda as a result of excessive, war-induced mortality, morbidity and refugee movements, excessive asset destruction, capital depreciation and capital flight, possibly inflation, a large trade deficit and a considerable budget deficit. This war-induced burden is sharpened further by the fact that post-conflict countries have weaker institutions and capacities for raising domestic debt, for negotiating external financial support, and for coordinating aid than do other developing countries. This is related to the fact that rebels often target the effectiveness of the government, thus leaving a post-war government weak in areas like tax collection. Having less remaining debt (or at least having comprehensive debt restructuring) lowers the burden on constantly re-negotiating debt service in future years. Mozambique is a good example of how such negotiations can absorb much time and efforts of the indebted country (see below).

Furthermore, expectations are crucial for the success of post-war transition. Negative expectations about the prospects of peace can damage the peace process, reduce domestic consumption and investment, and prevent the return of flight capital, thus increasing the war-burden on the economy (Collier and Gunning 1995). Unresolved foreign debt represents unresolved donor relations, thus de-stabilizing international expectations and signaling the international critique of war-time or post-war-time macro-economic conditions.

In addition to having higher burdens, post-war countries have high financing needs for the (re-) construction of public goods, for the provision of public infrastructure and for

current expenditure. This is composed both of the costs of making peace, such as demobilization programs, and the costs of establishing working institutions. Thus, post-conflict countries have higher financing needs than even other developing countries with a similar output but not carrying the burdens of previous war. This implies a further case for debt relief for post-conflict economies, which will be addressed in the next section.

### **3. DEBT RELIEF AND POST-CONFLICT RECONSTRUCTION**

In the sparse literature on external debt policy in post-conflict economies, there are several arguments for deeper debt relief for post-conflict economies, including the exceptional burdens and needs of post-conflict economies as argued above, debt overhang effects, and odious debt. All these arguments favor early and significant debt relief to achieve a successful transition to peace and prosperity. However, the effects of debt relief for post-conflict economies will also depend on the scale of additionality, that is on the degree of substitution between debt and aid, which will be considered in this section as well.

#### **Debt Relief and Growth**

Moral hazard considerations would suggest that the prospect of eventual debt relief may induce a desire to contract high levels of debt by developing countries. It could be argued that in a conflict setting the moral hazard issue is heightened to the extent that governments may deliberately risk violent conflict as a way of achieving debt relief. However, while it appears plausible that in many countries (such as Mozambique) foreign debt was used to fund ongoing wars, there appears to be no case of a government starting war with the objective of achieving debt relief. Instead, military, political and other economic motives always appear to be leading determinants of conflict. While moral hazard may be an important issue in debt relief generally, it does not seem to be a special concern in the case of post-war debt relief.

Debt relief might promote growth through three channels (Addison et al. 2004): by reducing uncertainty concerning debt repayments, by lowering the debt service payments (thus making additional resources available for public investment), and by reducing the debt overhang effect. For the post-war context, Menzies (2004) shows how a creditor pursuing the recovery of some debt and the attainment of humanitarian goals can balance these considerations within an optimal contract framework. Such framework must recognize the potential conflict between different policies, including

the ending of a civil war. In a time-horizon relevant for many policymakers, the repayment of foreign creditors by post-war countries is a substitute for the attainment of peace. Thus, debt forgiveness could increase the chance of peace.

Addison and Murshed (2003) argue that debt relief may reduce political grievances through broad-based public spending. This emphasizes the need to view economic and political processes jointly in the post-war period. Alternatively, debt relief could free resources to buy off the war party. However, even if debt relief were forthcoming, the fiscal system may be too degraded to achieve the promised transfer. Moreover, a given fiscal transfer that would have prevented war might be insufficient to achieve peace once war has started. The timing of debt relief is hence critical to achieving an effective macro-economic impact of debt relief.

A country suffers from debt overhang if its debt is so large that the expected debt service costs will discourage further domestic and foreign investment (Sachs 1989). In the case of the highly-indebted, poor countries (HIPCs), debt relief may not stimulate investment and growth as these countries do not suffer from debt overhang. In fact, HIPC countries often receive positive net transfers from creditors rather than negative ones (Arslanalp and Henry 2004, Birdsall et al. 2003). However, as debt stocks are very high in these countries, the continued reliance on disbursements leaves these countries in a very perilous situation, with a high degree of policy uncertainty stemming from future donor behavior. A further obstacle to investment and growth in these countries derives from a lack of basic economic institutions. Therefore, the energy and resources devoted to the HIPC initiative could be more effectively employed as direct foreign aid.

Despite the strong case for accelerated debt relief for post-conflict economies based on uncertainty or exceptional burdens, several authors demonstrate that much debt relief and aid is motivated by other, less altruistic reasons. Kanbur (2000), for example, views concerns over debt servicing to be a key reason for the failure to enforce conditionality. In accordance with Claessens et al. (1997) and Birdsall et al (2003), Kanbur also argues that foreign aid is often granted to ensure „normal relations” with regular debt servicing. This, however, also provides a safety net for private creditors and reduces the risk of lending to regimes that are not creditworthy. Addison and Murshed (2003) and Kanbur (2000) recommend that peace-building governments should receive faster debt relief, ensuring that peace is not delayed by the inevitable difficulties that wartime governments face in meeting donor policy conditionality. Therefore, debt relief should be monitored for its effect on growth, poverty reduction and peace building and to

prevent it from being squandered on political donor priorities unrelated to genuine development objectives.

### **Odious Debt and Debt Relief**

Odious debt, even though a normative issue, could be defined as debt incurred by a dictator not for the needs or in the interest of the society but to strengthen the despotic regime. This debt is not an obligation for the nation but it is the personal debt of that regime, consequently falling within its power. The interesting question from an economic point of view is how odious debt can arise in the first place, given that odious debt carries a high risk of default.

There have been numerous approaches from legal and moral scholars to formulate a theory of odious debt (Hanlon 2006). One early approach dates back to Alexander Sack, a professor of law and former minister in the Tsarist government in the early 20<sup>th</sup> century, who tried to formalize the legitimacy of foreign debt in light of the Bolsheviks repudiation of Russian debts after the Russian Revolution (Sack 1929).

An alternative approach based to odious debt rests on two criteria. First, a regime must have the ability to use debt contrary to the interest of the population. This criterion shifts the responsibility for the debt from the overall population to the ruling regime alone. Second, the debt must pass a certain threshold to harm future economic development. If both conditions are fulfilled, it is very likely that at least part of the external debt is odious.

In a case study of the Democratic Republic of Congo (DRC), Ndikumana and Boyce (1998) argue for debt relief based on the doctrine of odious debt. They review the evidence that the official and private creditors of the Mobutu regime knew, or should have known, that there was a high risk that their loans would not be used to benefit the Congolese people. Based on an estimate of capital flight, Ndikumana and Boyce conclude that during 1968 and 1990 Zaire was in fact a net creditor to the rest of the world, exporting more capital than it imported.

Hence the way the debt was acquired and spent can determine if and how such debt should be repaid. For example, the relative generosity of the international donor community vis-à-vis the DRC in forgiving debt (see below) was also based implicitly on the notion that much of the DRC's debt was odious.

There are some historical precedents for the doctrine of "odious debt", with a new government repudiating the debt accumulated by a previous regime. During the

Spanish-American War in 1898, for example, Spain lent money to the Cuban regime for military expenditures. After its victory, the United States proclaimed that neither Cuba nor the US should be responsible for repaying the debt, as it did not benefit the people of Cuba but instead had only strengthened the old regime. In the Paris peace treaty, Spain ultimately acknowledged this debt being odious and accepted its repudiation. Another example is the Russian revolution in 1919, where the Soviet government repudiated the Tsarist debts on the same grounds. Similarly, in the Treaty of Versailles that same year, the Polish debts to Prussia were also repudiated under the odious debt doctrine.

However, there is no internationally accepted institution with the authority to measure or to declare the “odiousness” of sovereign debt. Accepting unilateral repudiation of debt without the blessing of such an institution would further undermine efforts to strengthen the enforcement of international property rights and thus decrease the efficiency of intra- and inter-temporal trade.

To prevent future odious debt from being contracted, an institution (such as the UN Security Council) might be given the authority to rate a sovereign state “odious”. Such institution could impose a loan sanction on governments that are in danger of immoral and excessive borrowing. All debt accumulated after this cut-off point would be deemed illegitimate and thus not repayable, which would decrease creditors’ incentive to lend to sanctioned regimes (Jayachandran and Kremer 2004).

### **Debt Relief and Additionality**

Additionality exists if debt relief does not lead to lower levels of other non-debt-relief-related aid flows (that is crowding out) for the debtor concerned. A broader definition of additionality would request debt relief to lead to greater aggregate resources being made available to the individual debtor receiving the relief.

A difficulty in assessing additionality stems from the counterfactual challenge of how to estimate what would have happened to aid volumes (or other economic indicators generally) in the absence of debt relief (or in the absence of conflict). We assume that debt restructurings are additional if debt forgiveness and/or debt relief is positively correlated with aid, approximated through grants including technical cooperation, where our proxy for aid does not take into account the concessional loan disbursements. Table 5 contains total debt forgiveness, total debt relief including reschedulings and the proxy

for aid flows. In order to calculate these series, we used data from the Global Development Finance database.

Overall, there is a positive and high correlation of 0.57 between debt rescheduling and debt forgiveness, pooling all the data in Table 5. The correlation coefficient for debt relief and grants for pooled data is also positive but only 0.16. In terms of additionality, this implies that grants and debt restructuring move in the same direction. The rescheduling-forgiveness additionality maybe more important in practice than the rescheduling-aid additionality.

Using cross-country data, Hansen (2004) analyses the impact of both aid and external debt reduction on growth and investment. He argues that it is of particular interest to look at the impact on growth when both debt service payments and aid flows are reduced. Decreasing debt service payments that are accompanied by falling grant levels may have a negative impact on growth. Furthermore, aid additionality can also enhance private sector confidence as investors observe that donors are committed to the country in the long-term. Thus, additionality seems to play an important role for the beneficial effect of debt relief on growth.

Ndikumana (2002) examines in an econometric analysis whether and to what extent debt relief has been accompanied by decreasing development aid flows, grants, and other forms of concessional external financing. Using both data from the donor side and data from the recipient side enables him to analyze to what extent donors reduced their disbursements of ODA and grants following debt restructurings as well as to what extent countries that have received debt restructurings subsequently received less ODA and other forms of concessional development finance. While he finds that the supply of ODA and grants declined in the 1990s, he does not find a direct causal link between the volume of debt restructurings awarded and the volume of official development financing disbursed, which confirms our analysis of the data.

#### **4. INSTITUTIONS FOR POST-CONFLICT DEBT MANAGEMENT**

One of the important consequences of violent conflict at the field of international relations is the reduction of trust between lenders and borrowers. Given the need both to reconcile past loans and to effectively contract new loans or aid, both donors and recipients must work hard in the post-war period to re-establish trusting working relations. This section will inspect existing international institutional arrangements between lenders and war-affected borrowers. The analysis will reveal how little



attention has been paid to post-conflict reconstruction by various international debt actors.

### **Definitions**

‘Debt management’ refers both to the policies governments adopt to deal with debt and to the national capacity involved in planning and implementing a debt strategy. Debt can be reduced through different debt management strategies, including debt relief. ‘Debt relief’ refers to steps that reduce the amounts of debt stocks owed and of debt service flows (that is, principal amortization and interest payments) paid by an indebted country to its creditors. Debt relief comes in two main forms: debt rescheduling and debt forgiveness.

‘Debt rescheduling’ involves agreeing new repayment terms that shift debt repayment and debt service into the future, lowering the payments in the short-run. Debt can be rescheduled by private creditors and by official bilateral creditors; multilateral organizations do not reschedule debt. Debt rescheduling does not decrease the net present value of the debt stock. It might even increase the gross sum of the future flows of interest paid. Furthermore, the process of debt rescheduling may represent a drag on scarce administrative capacities in the debtor country.

‘Debt forgiveness,’ as the name implies, involves a write-off of some portion or all of the debt. It is simply erased from the books, with the creditors taking the loss on their balance sheets. Debt can be forgiven by private creditors, by bilateral official donors and by multilateral donors. Private creditors may act individually or they may coordinate their debt forgiveness through the London Club. Bilateral official creditors can also either act unilaterally or in concert through the Paris Club. Multilateral lenders have forgiven debt for example as part of the HIPC initiative. The line between debt forgiveness and debt rescheduling is sometimes fuzzy, since rescheduling agreements may reduce total interest payments over the lifetime of the loan below those set forth in the original loan agreement.

The main institutional arrangements for debt relief in the cases of commercial bank debt, bilateral debt, and multilateral debt held by developing countries are the London Club, the Paris Club, and the Highly-Indebted Poor Countries (HIPC) initiative, respectively. In these fora, creditors and the debtor government reach agreements on the type and amount of debt relief, and on the distribution of this relief among creditors. In addition, in cases where countries have suspended debt-service payments to multilateral

creditors and accumulated arrears preventing new lending, special arrangements for clearing these arrears may also be devised.

### **The London Club**

The so-called London Club has provided an ad-hoc forum for the negotiation of private commercial bank debt between one sovereign debtor and its creditors since the 1970s (IMF 2000). The aims of the Club are to ensure the equal treatment of private bank lenders by the borrower and to allow the borrower to regain credit worthiness in international financial markets. Usually this process is initiated by the debtor and is dissolved when the negotiations have been concluded; the process often occurs in parallel with the Paris Club negotiations. Since the 1980s, London Club bankers increasingly accepted terms which included partial forgiveness in exchange for an improved performance of repayment for the remaining debt. There is no explicit policy by the London Club on post-conflict debt, thus leaving such countries being treated on the same terms as peace time countries.

Independent of London Club negotiations, private creditors have sold debt at discounted values on the secondary market. Various 'buy-back' schemes financed by bilateral or multilateral donors have enabled debtor countries to retire commercial debt at a fraction of its face value. Such schemes have also been implemented for post-conflict economies, as indicated by the cases of Mozambique and Uganda (see below).

### **The Paris Club**

The most important institution for restructuring or rescheduling official bilateral debt is the Paris Club. Its main purpose has been to provide a framework for rescheduling sovereign debt between OECD creditor governments and low income countries since the mid-1950s. Only exceptionally (for example in the case of Uganda) does the Paris Club provide grants to help post-conflict countries service their multilateral debts. Occasionally, members of the Paris Club forgive debt unilaterally. For example, Canada announced bilateral debt write-offs ahead of the Cologne summit of G-8 countries, with its initiative being designed to exceed and augment the ongoing HIPC initiative and to shame other donors into concerted action (Pearson 2005).

The emergence of alternative Non-Paris Club lenders such as China and Libya has complicated the bilateral debt negotiations and opens new financing opportunities for war-affected economies such as Sudan. On the one hand, Paris Club lenders find their bargaining power reduced. On the other hand, non-Paris Club lenders have to find

alternative forms of effective sanctions, such as withholding investments or future loans, to enforce debt repayment. In part, these trends are driven by economic opportunities such as ensuring the mutual need to trade raw materials. The case of Sudan and China, or of Venezuelan oil exports, exemplifies this evolution of new South-South trading relations where Sudan faces constraints in accessing traditional oil markets due to its ongoing conflicts and China utilizes this opportunity given its high resource needs (Patey 2006).

The intensity of the Paris Club negotiation varies strongly across countries. In particular, there are significant gaps between meetings in time of war. For example, DRC was not considered by the Paris Club during its 5-year civil war. The timing of the meetings suggests that Paris Club agreements are partly driven by the perceived institutional and macro-economic ability of indebted countries to negotiate and implement a debt agreement, which may in part be a function of the generosity and scope of past Paris Club agreements. The Paris Club therefore is not a regular review body for discussing debt management policy and strategy. This implies that the Paris Club cannot be used to re-establish trust between conflict-affected countries and donors. Also, there is no element of peer review or best practice, which may provide early warning functions or exert peer pressure on lagging debtor countries, thus helping to develop international standards on dealing with debt in conflict economies. Only a small part of the debt stock is settled each time, leaving the need for future negotiations. In theory, it should be possible to avoid the need for repeated meetings and be possible to agree an exit rescheduling much earlier than is currently practiced, thus reducing the burden on scarce capacity in post-conflict economies.

However, several trends prevent exit rescheduling from being agreed for war economies. First, donor interests in, attitude to and disbursements of aid towards war economies in recent years can be seen to be an exogenous political trend driven in part by civil society engagement in both North and South which emphasizes the humanitarian costs of conflict. Second, and related to the first point, the definition of sustainability has changed over time, as exemplified by the HIPC initiative which is slowly recognizing that post-conflict economies are indeed different (see below). Third, donors are concerned that moving to generous terms too quickly raises moral hazard problems for conflict economies (see below). Fourth, exogenous shocks (including renewed wars) may push the debt indicators of indebted countries back beyond a given and previously overcome threshold. Fifth, the special burdens and needs of post-war

economies have only been recognized as such in recent years, thus enabling new deals to be reached which had not seemed possible before. Finally, the post-war capacity of indebted countries may rise over time, with the Paris Club expertise being built up. This may allow repeated participants in the Paris Club to build bargaining strength and hence achieve better deals over time. Thus the Paris Club has come to recognize that previous debt arrangements for post-conflict economies have not achieved sustainability, leading to improved terms.

In the Paris Club, conditionality is provided by insisting on the existence of an IMF program which demonstrates the need for debt relief. If there is no agreement with the IMF (perhaps due to arrears), then the Paris Club will not provide debt relief. This emphasizes the importance of establishing functioning donor-recipient relations in the post-war period, as argued below.

### **The HIPC Initiative**

The highly-indebted poor country (HIPC) initiative was conceived in 1996 by the multilateral donor community to help the most indebted and poorest developing countries escape their development trap (Addison et al 2004). HIPC assistance is determined by bringing the net present value of external public debt down to a critical threshold. The key threshold was specified initially as a debt-to-export ratio of between 200 and 250 per cent.

The initiative was revised in 1999 (IMF and World Bank 1999) because of ongoing controversies over its modes of operation and its effectiveness (Fedelino and Kudina 2003, Hjertholm 2003, IDA and IMF 2001, Sanford 2004, Sun 2004). The enhanced HIPC initiative allowed for broader and deeper debt relief (covering more countries and cutting more debt), accelerated debt relief (granting debt relief at the decision point and bringing the completion point forward), and strengthened the link between debt relief and poverty alleviation (adopting poverty reduction strategy papers, PRSPs, which prioritize the use of freed resources for poverty alleviation). However, the revisions did not account for the unique circumstances of war-affected HIPCs (for a rare exception, see IMF and World Bank 2001). These circumstances are outlined and discussed below.

Even in peaceful economies, the assessment of long-term debt sustainability should shift from a single debt indicator to a more complex and comprehensive system of indicators (IDA and IMF 2001). There are three key determinants of sustainability: the existing stock of debt, the development of fiscal and external debt management

capacity, and economic growth and new concessional external financing. Both debt sustainability and the development process generally require the analysis of policies, institutions, exogenous factors and debt management over the long-term.

However, the strong focus of the HIPC initiative on a narrow and short-term range of debt sustainability indicators may be misleading or even counter productive in a post-war economy. On the one hand, private financial flows in the form of remittances of returning flight capital might be important for funding development in post-war countries. These sources of funding are not currently included in the HIPC debt sustainability analyses. On the other hand, given that civil wars always weaken the state and its ability to raise taxes (see above), the levels of domestically mobilized public resources will be even lower in a war-affected developing country than in other developing countries.

Furthermore, the weakness of institutions in war-affected countries implies that export revenues may be accruing to non-state and even non-taxable actors, thus weakening the ability to service debts. This point is particularly acute if these exports are recorded in the statistics. This suggests that debt as a share of exports may be a less useful, if not an overly optimistic, indicator for assessing debt sustainability than it is in peaceful HIPCs.

The HIPC initiative effectively aims to maximize the consistent repayment of albeit reduced debts, thus potentially placing a stronger fiscal burden in terms of its debt payments on countries emerging from war and international isolation (like Uganda and Mozambique) than for countries remaining isolated (like Sudan or Liberia). Therefore, such high debt service burden in absolute (measured in dollars per capita) and relative (measured in share of total spending) terms may reduce the fiscal peace dividend and hence prosperity in such a weak state. It is crucial for the peace process that there is a peace dividend in terms of public spending, poverty reduction and output growth. If debt service payments increased by more than military spending fell (assuming that demobilization programs do allow a reduction in military spending at all), then this may be a high price to pay for rejoining the international community.

Linked to the low share of government in the economy is the issue of weak institutional capacities in post-war economies. While this limited capacity indicates the need for flexibility in assessing the track record, it is important that the link between debt relief and effective poverty reduction policies is not weakened. More generally, the assessment of track records in post-conflict countries should extend beyond macroeconomic stability and also pay attention to consolidating peace, security and

poverty reduction (World Bank and IMF 2001). Such generalized assessment of sustainability should then use both quantitative indicators of economic and poverty alleviation performance but could also include qualitative information, for example to address the issue of odious debt (see below).

The need for a stable, medium-term track record is a key element of the HIPC initiative. However, the usual requirement for a three-year period of good policy seems problematic for countries keen to escape the conflict trap. For countries with a good prospect for peace, it is worth dropping or reducing the time lag between the decision and the completion points, and front-loading a large amount of debt relief so that the government has additional resources to offer for redressing grievances. This assumes that the peace dividend is large enough to compensate successfully for the foregone revenue from conflict businesses (Addison and Murshed 2003).

The analysis of the HIPC initiative from the point of view of conflict economies suggests that post-conflict economies require both new forms of conditionality and an enhanced scale of debt relief. The fact that war-affected HIPCs include some of the worst performers in terms of foreign debt and human development do not change our conclusions, instead they sharpen them.

## **5. CASE STUDY EVIDENCE**

### **Mozambique: The Paradox of High Debt and High Aid**

Mozambique, which had only become independent in 1975 following years of warfare, suffered another devastating conflict from the early 1980s till the end of 1992, when a peace accord ended the civil war (Newitt 1995). The aim of the rebels had been to destroy the capacity of the then socialist government, formed by the Frelimo party, to direct the country. In rural areas in particular the rebels generally fulfilled that objective. Since the end of the war, the country has turned to multi-party democracy, with the Frelimo party democratically winning all presidential and parliamentary elections. This has ensured a high degree of political consistency both internally and in dealing with donors.

The economy was badly damaged by both conflicts (Colletta, Kostner et al. 1996; Addison and de Sousa 1999). GNI per capita was USD 650 in 1993 (Table 6) and the national poverty headcount of Mozambique was 69.4 per cent in 1996 (Government of Mozambique 1998; Government of Mozambique 2004). Since then, Mozambique has

experienced sustained growth. The average annual GDP per capita growth for the period 1995 to 2002 was 5.6 per cent (World Bank 2005). GNI per capita rose to USD 990 in 2002 while the national poverty headcount of Mozambique dropped to 54.1 per cent in the same year.

Mozambique's exports of goods and services per capita increased slowly throughout the 1990s and accelerated in recent years. However, much of the increase in the mid-1990s was based on an improvement in export prices of prawns, cotton and cashew, and on the start of electricity exports from the Cahora Bassa dam to Zimbabwe in 1998 (Falck 1999). The external financial balance of Mozambique since the end of the war was supported by a high and rising level of foreign aid.

Until the late 1970s, Mozambique did not accumulate noteworthy amounts of external debt. During the first years of independence, the reduction of foreign reserves was sufficient to finance the current account deficit. However, shortly after stepping into its prolonged civil war, Mozambique's external debt increased rapidly and soon became unsustainable. Even though Mozambique, in contrast to other conflict-affected countries, did not entirely stop servicing its debt during the war, significant principal arrears vis-à-vis official creditors accumulated during this period. By 1993, Mozambique's debt-to-GNI ratio reached nearly 300 per cent and the external debt-to-export ratio even added up to 1400 per cent (Table 6). These tremendously high ratios did not only reflect a high increase of debt accumulated during war but also strongly reduced output indicators.

Until the early 1980s, the loans were primarily granted by the Eastern bloc and by oil-exporting countries. The Soviet Union, for example, was one of the main lenders. Commercial debt was of little consequence for Mozambique. After the ruling Frelimo party formally abandoned Marxism in 1989 and a new constitution paved the way for a free market economy, multilateral institutions, particularly the World Bank and the IMF, became the main lenders. Thus, public and publicly guaranteed long-term multilateral debt stock doubled in only four years, reaching nearly USD 700 million in 1992. However, despite a significant modification of Mozambique's composition of external debt, the share of concessional debt remained constant and at a very high level by the end of the civil war.

Mozambique thus experienced the paradoxical situation of being one of the most highly indebted but at the same time most aid-receiving developing countries in the world. The case of Mozambique including war, declining incomes, rising poverty and increasing

debt during the war shows that post-conflict (and war-time) development cannot be studied in isolation from debt. In fact, debt accumulation during conflict as well as the importance of peace for development should be addressed by donors explicitly.

While Mozambique appears to have build strong debt management structures, the frequency of its debt rescheduling (for example for the Paris Club - Table 3) suggests that a leaner debt operation might have saved scarce human capital for more productive tasks. While the opportunity costs of not having a debt management capacity are large (as argued in the case of the DRC), the opportunity costs of having an overextended debt management capacity in response to donors' demands also entails important opportunity costs for an impoverished developing country.

In comparison to other post-war economies, Mozambique received above average debt relief totaling an estimated USD 4.3 billion. In addition, a commercial debt buy-back operation in December 1991 eliminated USD 203 million of debt, of which USD 119 million were outstanding interest arrears (Dijkstra 2003). Extra resources from debt relief granted in 2001 started to be allocated through the fiscal system and into basic social expenditures (including into the strengthening of the disbursing fiscal and social institutions), and thus helped to redress some of the regional inequalities in living standards.

Aid flows remained relatively stable over the 1990s, but declined after 1995 (Table 5). However, in 2002 aid doubled as a consequence of the flood in 2001. During the 1990s, with the exception of 1990, aid and debt forgiveness ran more or less parallel. In particular, above average debt forgiveness did not result in decreasing aid flows. From 1999 on, however, aid and debt forgiveness ceased to move in the same direction. Yet significant debt forgiveness resulted in only very small decreases of aid flows. Overall, Mozambique has very slowly escaped the paradox of being highly indebted and highly aid-dependent.

### **Uganda: Slow Road to Debt Reconciliation**

Uganda has suffered a series of internal and international conflicts and political coups in its recent history (see Nannyonjo 2005). The current president, Yoweri Museveni, led a rebel group which came to power in 1986, ending the country's civil war. He has since cautiously moved the country to a managed form of democracy and cooperates close with multilateral and bilateral donors. Uganda's GNI per capita has increased from 974 USD in 1989 to 1370 USD in 2002 (Table 7). Internationally, Uganda has been actively



involved in several regional wars, including in the DRC and Sudan. Domestically, rebel groups (including the Lord's Resistance Army) have terrorized the North of the country since 1986.

While Uganda's external debt started increasing in the 1970s, the rapid rise of the country's debt stock to unsustainable levels began in the early 1980s (Table 7). One of the major factors contributing to Uganda's huge external debt was the high and expansionary fiscal policy incurred by successive Governments, mainly to finance the civil war (Barungi and Atingi 2000). In fact Uganda's external debt stock during the war of 1981 to 1988 grew by 14 per cent a year on average, while it grew by 6 per cent a year on average during the 1990s.

There is a striking modification in the composition of external debt from 1980 to 1989. In the period before the war, Uganda borrowed mainly from private creditors followed by bilateral official creditors; multilateral debt in 1980 accounted for only 11 per cent of total debt. Given the nature of war finance in Uganda, this may suggest that donors implicitly enabled the continuation of the war. Yet during the war, borrowing from multilateral creditors increased sharply both in absolute and relative terms, thus accounting for about 45 per cent of total debt in 1989.

When Uganda emerged from war, the country had built up significant arrears on its bilateral and commercial debt payment obligations. The commercial creditors accounted for the largest part of arrears, followed by Non-Paris Club creditors, such as India, Yugoslavia, and Tanzania, with the latter being a player in the Ugandan conflict as well. However, compared to the other conflict-affected countries, arrears were not as large.

In the case of Uganda, donors and the government had to find piece-meal options for dealing with debt, because 17 per cent of the level of uninsured commercial debt of Uganda could not be rescheduled as a number of loans were owed to contractors who had work in progress or the loans were secured in various ways. Furthermore, 42 per cent of the debt owed to Paris Club governments was contracted after July 1, 1981. New debt contracted after that cut-off date is not considered by the Paris Club for rescheduling or reduction. Finally, the preponderance of multilateral debt severely limited the benefits that Uganda could achieve through traditional rescheduling, since multilateral organizations do not reschedule debt. This section will therefore review and assess the options used by Uganda to deal with commercial, bilateral and multilateral debt (Table 7).

As part of its debt rescheduling efforts, the Government of Uganda restructured its commercial debt. Uganda converted some of the debt into equity, rescheduled a portion of the debt, and discharged the remainder in a buy-back operation at a significant discount to face value of 88 per cent. This was financed by the IDA-Only Debt Reduction Facility, with co-financing from the governments of Germany, Netherlands and Switzerland (Kapoor 1995). Funds from the facility were provided to eligible countries on a grant basis, largely to finance the cash-buy back of commercial debt.

While concern has sometimes been expressed that buy-back operations at a deep discount could affect a country's ability to obtain access to short-term credit on reasonable terms in the future, in the case of Uganda the magnitude of these arrears, and the government's inability to settle them, had already reduced the government's access to short-term credit and trade lines.

The first debt treatments between Uganda and the Paris Club took place in 1981-82, covering USD 40 million (corresponding to nearly 6 per cent of total debt) and USD 19 million (over 2 per cent of total debt) under classic terms (Table 3). These were followed by operations on ad-hoc terms in 1987 and operations on Toronto terms in 1989. Thus, Uganda managed to enter in negotiations with the Paris Club during its civil war.

The remaining arrears were to non-Paris Club bilateral creditors. The final element of the debt strategy hence focused on non-OECD bilateral creditors who were owed a significant amount of arrears and penalty charges, which were still outstanding after Paris Club arrears had been cleared. The authorities contacted the respective creditors with a view to receiving terms at least comparable to Naples terms. An agreement was reached with Tanzania on the settlement of Uganda's arrears. At the time this paper was written, Uganda had no arrears the Paris Club or with multilateral creditors (with exception of BADEA where the matter is in dispute).

Uganda has benefited from debt relief from the international community since the mid-1980s. However, apart from an IDA-funded commercial debt buyback in 1992, only bilateral Paris Club creditors were willing to offer debt relief until the mid 1990s. Their relief had only a modest impact on Uganda's overall debt position, as by 1994 70 per cent of Uganda's debt was owed to multilateral creditors. Furthermore Paris Club debt relief can only apply to debts contracted before 1981.

In 1995 a number of bilateral donors set up a Multilateral Debt Fund for Uganda, into which they paid funds in order to help Uganda repay its debt obligations to multilateral creditors. Further external arrears to multilateral creditors were cleared either through concessional rescheduling (USD 10.6 million from the Arab Bank for Economic Development in Africa, BADEA) or in cash payments (amounting to USD 4.9 million) by March 1998.

Uganda was the first country to qualify for debt relief under both the first HIPC and the enhanced HIPC initiative. Before assistance for Uganda under the HIPC initiative was granted, the NPV of debt-to-export ratio at end June 1997 stood at 243 per cent. The country did not have to go through a standard six-year qualifying period. Instead, in April 1997, the Executive Board of IDA and the Fund decided in principle on Uganda's qualification for assistance under the HIPC initiative on a one-year interval to reach the completion point and on the amounts of their respective assistance at the completion point subject to satisfactory assurances of participation by Uganda's other creditors.

The year in which Uganda first received debt relief under the HIPC initiative was 1998. In total, as a result of both initiatives, Uganda was granted debt relief amounting to USD 1 billion in NPV terms to be delivered over a period of twenty years. As a consequence Uganda received substantial cash savings, averaging USD 60 million per annum over four years, accounting for almost a quarter of the total budget support over the period. The Ugandan case thus contrasts with the case of the DRC where bilateral Paris Club debt was more important.

The HIPC initiative for Uganda left room for involving a variety of donors. The African Development Bank and the IMF participated in the HIPC initiative through the HIPC Trust Fund, which was set up and funded by donors to support the HIPC initiative over and above the donors' legal obligations. This enabled the buy back of most of the AfDB loans with own contributions, as well as through donor contributions. The Nordic Development Fund (NDF) also participated in the HIPC Trust Fund by paying debt service falling due on behalf of the debtor rather than through a debt buyback. BADEA agreed with the Ugandan authorities to provide its HIPC assistance through a concessional rescheduling of arrears, over ten years with two years grace at zero interest. Such different initiatives can combine to make a strong impact on a country's indebtedness, though the coordination costs for the Ugandan government are probably significant.

Mozambique and Uganda, while similar in their dealings with the international donor community and their conflict histories, had very different treatments by the HIPC initiative. Mozambique received a larger share of debt relief both as a share of total debt and as a share of GNI in the original initiative and in the enhanced initiative. In the former, Mozambique was treated more generously while in the latter Uganda caught up somewhat in terms of receiving some substantial debt relief as well. The dimensions of all these treatments were exceeded by the terms agreed with the DRC.

Looking at the debt forgiven to Uganda and the grants this country received from abroad, it seems that debt relief was generally additional to other aid, although there were some exceptions in 1993 and 1998. The overall trend was an increase in the provision of grants in the first half of the nineties, with a slight decline after 1995, but an increase again after 1999. As in the case of Mozambique, debt relief in Uganda did not come along with an substantial increase of net resource flows (accounting for new debt and aid). This augurs badly for the “flow” effect of the HIPC initiative.

Overall, the case of Uganda shows how slow and painstaking the process of debt reconciliation can be for post-conflict countries even under comparable favorable institutional circumstances. In part, this is because the complexities of the negotiations bind scarce capacities. In part, this is because rules and institutions are very complex and each agreement covers only a small part of the problem.

### **Democratic Republic of the Congo: Fast but Unsustainable Action**

The Democratic Republic of the Congo (DRC) suffered several devastating wars in its recent history, with one conflict lasting from 1996 to 2001. This war resulted in 3 million deaths and affected the lives of up to 100 million people (Clément 2004). The DRC, formerly known as Zaire, is one of Africa’s most resource-rich countries which has suffered from domestic and international mismanagement and corruption. Western support for the regime of President Mobutu Sese Seko eventually dried up in the early 1990s. Mobutu was overthrown by Laurent Kabila in 1997, who in turn was assassinated in 2001. His son Joseph Kabila followed him into office and realigned the country with the multilateral donor community. The DRC continues to be characterized by ongoing political instability and extreme poverty. The DRC’s GNI per capita dropped from USD 1,479 in 1991 to USD 630 in 2001 (Table 8).

In the DRC, external debt rose significantly during the regime of President Mobutu. His regime relied profoundly on external financing to maintain itself in power (Ndikumana

and Boyce 2000). Between 1970 and 1994, the country borrowed over USD 9 billion abroad. Even though external borrowing slowed substantially after 1994, the DRC's external debt stock remained at a very high level, reflecting in part the sharp increase of arrears in the 1990s. Initially, the DRC's borrowing was mainly from private creditors. As the private creditors started to shorten their exposure to the country after the debt crisis of 1976, official borrowing increased in the 1980s. In 1981 the IMF provided the country with the largest credit to an African country in the IMF's history, and in 1987 another IMF credit was approved. The latter was granted under pressure from the US government and despite strong objections from senior IMF staff.

There were nearly no disbursements during the civil war. Nonetheless, by 2001 the DRC's external debt amounted to USD 11.7 billion, with arrears accounting for 70 per cent of the total (Table 8). According to the Congolese government, war-related expenditure and a sharp decline in the collection of revenue resulting from weakened state institutions resulted in a significant fiscal deficit, which had to be financed through the accumulation of domestic and external arrears. The overall deficit of the government, for example, amounted to 45 per cent of revenue in 1998 and 81 per cent in 2000. The increasing amount of arrears is also reflected in the dramatic change in the ratio of long-term to short-term debt.

Since early 2001, the DRC has made some progress towards peace. In contrast to other conflict-affected countries, the international community and in particular the IMF adopted quite a proactive and speedy approach to debt relief. In February 2001, an IMF mission visited Kinshasa and in December 2001 a meeting of donors, with the participation of a Congolese delegation, took place in Paris to gather support from the international community. Already at the beginning of 2002, the IMF sent a mission to negotiate a medium-term program that would be supported by a three-year arrangement under the Poverty Reduction Growth Facility. However, it will be shown below that this fast moving approach was not matched by progress on other economic, political and institutional fronts, thus squandering an opportunity to translate debt relief into peace building and sustainable development.

Debt reconciliation between the DRC and the international community began in 2001 during several joint IDA-IMF missions based on late 2000 debt statistics. Furthermore, a meeting of donors took place in Paris in December 2001 with the participation of a Congolese delegation. After the end of the war, it took one year to reach an agreement concerning the clearance of arrears. By end of 2003, the loan-by-loan debt

reconciliation process was completed with all of the DRC's multilateral creditors except the BDEGL. Given that the war had only ended in 2000, this was a remarkably fast process, which had been made possible also due to the good personal relationships of the national and international negotiators. Overall, about 83 per cent of the net present value of the DRC's total stock of external debt outstanding at end 2002 was reconciled by August 2003, when the HIPC decision point document for the DRC was finalized (Table 4).

To build good relations and prior to reaching a formal debt agreement, the DRC authorities committed to deposit SDR 100.000 per month starting in 2001 into an account of the DRC held with the Bank of International Settlements (BIS). These deposits continued to be part of the DRC's international reserves until their eventual use for arrear clearance. The account was closely monitored by the IMF. The amount chosen was relatively low given that the stabilization of the DRC's arrears to the Fund would have implied monthly payments of about SDR 1 million. However, in deciding on the amount of SDR 100.000 the IMF staff was guided by the readiness of the IMF's board to accept reduced payments by a post-conflict member in arrears, thus recognizing the DRC's limited debt service capacity. This unusual treatment required that the DRC was judged to be cooperating and that all other multilateral donors, to which the DRC was in arrears, took comparable action.

While these measures were implemented fairly quickly and with a high degree of flexibility shown by both sides, on the institutional side of debt management the DRC exhibited ongoing weaknesses in this period. The IMF Country Report 03/267 found that the principal agency charged with handling debt issues still did not have the technical and financial means to fulfill its mandate as of August 2003. The DRC lacked a clear process for the formulation of debt policies and debt statistics were not published.

The DRC hence represents a case where post-war credibility was built fairly quickly. However, the opportunities offered by this progress were subsequently not fully exploited. The DRC government failed to develop a coherent debt management strategy and capacity, thus missing out on further chances to mobilize international financial support for its urgent reconstruction needs. In part, this failure may be explained by the apparent lack of national capacity. Yet given the positive start to these negotiations, it should have been possible to build national capacity with donor support. In the end, the remarkable progress made on the initial phases of the debt management process was not

sustainable. This mirrors concerns expressed in the literature (Addison and Murshed 2003) that the willingness of a country and donors to implement debt relief is only a necessary but not a sufficient condition for converting debt relief into development, with strong state institutions being one of the other necessary ingredients for success.

## **6. CONCLUSIONS AND POLICY IMPLICATIONS**

We analyze the role of and the institutions for external debt in post-conflict developing countries. We first show that external debt in post-conflict countries exhibits different patterns and is more substantial than for non-conflict economies. There are other significant differences between conflict and non-conflict developing countries, such as the increased levels of uncertainty in the post-war period, the higher financial needs for reconstruction, the higher dependence on foreign aid, and the normative issue of odious debt. Furthermore, conflict countries as a group exhibit worse debt sustainability indicators than non-conflict countries. In light of these substantial differences it is surprising that we find that existing debt relief strategies by private, bilateral and multilateral lenders mostly do not take account of this special status of post-conflict economies.

One message following from our analysis is that clearing arrears with multilateral donors in the post-conflict period is key to normalizing relations with donors. However, this process is very fragile and requires strong political commitment by both sides, foresight and trust by the donors and relatively high institutional capacity by the borrower. Otherwise, even successful debt reconciliation may not yield successful post-conflict development, as was demonstrated for the case of DRC.

In Mozambique, Uganda and the DRC debt relief and grant flows did not behave as substitutes. Countries that received more debt relief also received more aid; Mozambique being the front runner. The HIPC debt relief for both Mozambique and Uganda appears to have been additional to aid. However, part of this story may be related to some countries in some years benefiting from their “moment in the sun”. That is, some countries may benefit from special, temporary circumstances of either a positive (an election) or a negative nature (a natural disaster), which forces the donors to grant above average debt relief and/or aid disbursements.

Debt for post-conflict economies has become multilateralised in recent years. Yet the HIPC initiative was not designed to benefit post-conflict economies quickly once their fighting ended. Given that the wars in Mozambique and Uganda had ended before the

HIPC initiative took effect, both countries could not benefit from the debt relief as quickly as the DRC could some five years later. In the cases of Mozambique and Uganda, it is not clear why the enhanced HIPC initiative required another period of track record of the recipient countries given that each had completed a track record both before and after the first decision point in the late 1990s. If these two successful developing economies are required to fulfill these stringent requirements, then it is clear that more vulnerable post-conflict economies will find it even more difficult to comply with HIPC conditionality. In particular, it is important to make cautious assumptions concerning the suitable level and the choice of debt sustainability indicators. Given the possible interdependency of peace and prosperity, taking a broader view on financing reconstruction is strongly advisable. We recommend for donors to consider granting debt relief even before the fighting ends, thus accelerating the effective relief. This will require new political commitments to advance planning in debt relief by donors to an extent that does not currently exist. Post-conflict countries should therefore receive special treatment under the HIPC initiative, with faster and deeper debt relief linked to broader policy conditionality. Specifically, sustainability criteria should be defined both quantitatively and qualitatively (including issues of peace sustainability), conditions could be forward looking instead of being backward looking (again including peace conditionality), and the track record could be shortened or abolished depending on individual circumstances and may even start during a war. Furthermore, both recipient and donor countries would require policy making capacity to deal with these issues. In short, we find that war-affected HIPCs currently are not well treated by the HIPC initiative as it does not account properly of their special needs and circumstances.

There is an imperfect regulatory framework in place at the moment at the global level concerning the adjudication of so-called odious debt, which admittedly is a normative issue. In the contexts of recent high-profile regime changes, such as the post-conflict economies of Afghanistan and Iraq, the focus of the debt sustainability analysis has increasingly shifted from the responsibilities of the borrowers towards the responsibilities of the lenders for ensuring that debt is used sustainably. We therefore propose to establish the policy instrument of “debt sanctions” to strengthen the ex ante regulatory framework for debt relief. An international institution such as the United Nations should be given the mandate to declare a regime odious and thus withdraw from future lenders the right to enforce debt repayments on debts contracted after that day. Institutionalizing such form of political rating on governments would signal to investors that lending unsustainably carries a high risk of genuine default and would



prevent war-mongering, kleptocratic or oppressive regimes from financing their activities with new loans. Arguably, the international donor community is not yet well prepared for such forms of conditionality and the types of comprehensive policies and monitoring it would require. However, from the point of view of poverty alleviation, growth and peace in developing countries, such new policy instrument merits a lot of attention.

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**Table 1a: Summary Debt Indicators, 2002**

	number of cases	debt/GNI (%)	debt/Export (%)	aid/GNI (%)
Debt/GNI (%)				
LICs (all)	38	127.3	432.7	15.4
LICs (no conflict)	18	116.0	328.0	13.2
LICs (in war)	3	116.4	1,292.1	11.2
LICs (post-war)	17	161.1	436.0	21.6

GNI = gross national income.

LIC = low-income country.

Sources: Global Development Finance and World Development Finance, World Bank and own calculations.

Note: Only severely and moderately indebted low-income countries for which data were available are taken into account.

**Table 1b: Composition of Public and Publicly Guaranteed Debt**

as percentage of total public and publicly guaranteed debt

Country-Group	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002
<b>Multilateral Creditors</b>													
conflict-affected (average)	20.1	21.2	26.1	24.3	25.7	27.5	28.8	30.4	31.3	35.0	35.5	38.3	40.8
no conflict (average)	28.5	30.3	33.5	35.1	36.0	37.3	38.2	40.2	40.9	41.7	42.4	43.1	45.8
<b>Bilateral Official Creditors</b>													
conflict-affected (average)	59	58	61	56	56	56	55	55	54	50	50	47	45
no conflict (average)	53	53	55	54	53	52	52	48	48	48	49	50	48

Sources: Global Development Finance, World Development Finance, World Bank, and own calculations.

**Table 2: Paris Club Terms**

Terms	Year of agreement	Debt cancellation?	Still in current use?
Classic terms		no, but longer repayment period	yes, standard treatment
Toronto terms	1988	up to 33.3%	no
Houston terms	1990	no, but longer repayment period	yes, for highly indebted lower-middle-income countries
London terms	1991	up to 50%	no
Naples terms	1994	up to 67%	yes, for highly indebted poor countries
Lyon terms	1996	up to 80%	no
Cologne terms	1999	up to 90%	yes, for countries eligible for the HIPC Initiative

**Table 3: Paris Club Reschedulings: Mozambique, Uganda, and DRC**

	Mozambique Cut off date: February 01, 1984			Uganda Cut-off Date: July 01, 1981			Democratic Republic of Congo Cut-off Date: June 30, 1983		
	Amounts treated in US\$ million	Amounts treated as percentage of total amount of debt	Terms of treatment	Amounts treated in US\$ million	Amounts treated as percentage of total amount of debt	Terms of treatment	Amounts treated in US\$ million	Amounts treated as percentage of total amount of debt	Terms of treatment
1980									
1981				40	5.69	classic terms	600	11.78	classic terms
1982				19	2.18	classic terms			
1983							1,490	27.93	classic terms
1984	142	9.87	classic terms						
1985							322	5.21	classic terms
1986							350	4.87	classic terms
1987	612	14.83	ad hoc	256	13.33	ad hoc	883	10.06	ad hoc
1988									
1989				90	4.13	Toronto terms	x	x	Toronto terms
1990	707	15.21	Toronto terms						
1991									
1992				38	1.30	London terms			
1993	440	8.44	London terms						
1994									
1995				110	3.07	Naples terms			
1996	663	8.76	Naples terms						
1997									
1998	x	x	Lyon terms	147	3.75	Lyon terms			
1999	1,860	26.66	Lyon terms						
2000				147	4.20	Cologne terms			
2001	2,800*	61.35	Cologne terms						
2002							8,980**	89.27	Naples terms

Notes

\* Out of the US\$ 2,800 million treated, US\$ 2,270 million were cancelled and US\$ 530 million rescheduled.

\*\* US\$ 4640 million were cancelled, and US\$ 4,340 million rescheduled. Cologne terms given for maturities falling due from July 2003 through June 2005.

x Data on the details of the reschedulings in these years are unavailable.

**Table 4: HIPC Relief: Mozambique, Uganda, and DRC**

	Original HIPC Initiative					Enhanced HIPC Initiative				
	Nominal Debt Service Relief			Decision Point	Completion Point	Nominal Debt Service Relief			Decision Point	Completion Point
	US\$ million	as percent of total debt	as percent of GNI			US\$ million	as percent of total debt	as percent of GNI		
Mozambique	3,700	44.6	101.0	April 1998	June 1999	600	8.5	17.4	April 2000	September 2001
Uganda	650	16.8	10.4	April 1997	April 1998	1,300	37.1	22.6	February 2000	May 2000
Democratic Republic of Congo	..	..	..	..	..	10,389	93.0	192.9	July 2003	Floating

\* Status as of March 2005

## Table 5: Debt Relief & Aid Grants: Mozambique, Uganda, and DRC

US\$ million, unless otherwise indicated

	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
<b>Mozambique</b>															
<i>total rescheduling</i>	0.00	343.20	141.40	375.60	134.20	135.70	218.90	186.70	114.30	229.00	469.40	1.60	268.90	0.00	0.00
<i>total forgiveness (incl. interest forgiven)</i>	0.00	1,174.10	236.70	23.50	35.80	63.30	322.80	130.80	223.10	27.90	535.50	46.20	2,556.00	34.80	83.40
<i>total debt relief</i>	0.00	1,517.30	378.10	399.10	170.00	199.00	541.70	317.50	337.40	256.90	1,004.90	47.80	2,824.90	34.80	83.40
<i>total debt relief as % of debt stock</i>	0.0	33.6	9.3	13.6	4.0	3.6	5.2	4.3	4.7	7.5	17.3	0.7	62.4	0.7	1.7
<i>total debt relief as a % of GNI</i>	0.00	65.39	16.48	23.75	9.38	10.03	25.40	11.88	10.49	7.01	26.61	1.38	90.24	1.02	2.03
<i>grants (incl. technical cooperation)</i>	672.13	841.48	1,001.08	920.29	860.93	876.20	1,003.15	630.57	680.13	824.44	781.60	898.80	822.20	1,871.68	829.69
<i>grants as percentage of GNI</i>	31.55	36.27	43.64	54.77	47.49	44.16	47.04	23.59	21.14	22.51	20.70	26.03	26.27	54.90	20.20
<b>Uganda</b>															
<i>total rescheduling</i>	28.80	4.50	6.40	91.80	34.40	0.00	172.00	0.00	0.00	158.40	18.40	37.50	0.00	1.20	19.00
<i>total forgiveness (incl. interest forgiven)</i>	0.30	51.20	1.00	14.40	156.40	6.90	40.50	0.00	0.00	626.70	11.00	189.10	33.30	128.30	39.70
<i>total debt relief</i>	29.10	55.70	7.40	106.20	190.80	6.90	212.50	0.00	0.00	785.10	29.40	226.60	33.30	129.50	58.70
<i>total debt relief as % of debt stock</i>	2.8	2.6	0.4	3.9	6.4	0.2	5.9	0.0	0.0	19.8	0.9	6.4	0.9	3.2	1.4
<i>total debt relief as a % of GNI</i>	0.56	1.32	0.23	3.83	6.02	0.18	3.73	0.00	0.00	12.03	0.49	3.94	0.60	2.26	0.95
<i>grants (incl. technical cooperation)</i>	264.15	348.35	419.67	454.75	381.32	439.76	547.71	467.44	492.23	483.00	489.11	658.73	512.30	576.81	694.04
<i>grants as percentage of GNI</i>	5.07	8.24	12.86	16.41	12.02	11.19	9.61	7.79	7.87	7.40	8.22	11.46	9.25	10.04	11.26
<b>Democratic Republic of Congo</b>															
<i>total rescheduling</i>	975.60	390.10	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	6.90	0.00	0.00	3,518.30	79.00
<i>total forgiveness (incl. interest forgiven)</i>	152.90	24.10	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	1.60	0.00	0.00	3,553.30	101.80
<i>total debt relief</i>	1,128.50	414.20	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	8.50	0.00	0.00	7,071.60	180.80
<i>total debt relief as % of debt stock</i>	15.43	4.58	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.01	0.00	0.00	83.13	0.91
<i>total debt relief as a % of GNI</i>	13.48	4.83	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.20	0.00	0.00	134.72	3.36
<i>grants (incl. technical cooperation)</i>	364.76	519.68	584.09	196.45	131.32	258.88	216.26	182.12	161.91	137.12	152.09	191.39	269.43	565.63	4,934.43
<i>grants as percentage of GNI</i>	4.36	6.06	7.01	2.39	1.32	5.05	4.43	3.37	2.84	2.36	3.52	4.89	6.03	10.78	91.63

GNI = gross national income.

Source: World Bank *Global Development Finance* database and own calculations.

Notes: Total forgiveness corresponds to the change in debt stock due to debt forgiveness or reduction, including principal and interest arrears forgiven.  
Total debt relief includes total debt rescheduling in addition to forgiveness.

**Table 6: Debt Summary – Mozambique**

US\$ million, unless otherwise indicated

	Last Pre-War 1984	First Post-War 1993	Most recent 2002		Last Pre-War 1984	First Post-War 1993	Most recent 2002
Total debt stocks	1,438	5,212	4,609	Debt indicators			
Long-term debt outstanding	1,354	4,859	4,039	Total debt / exports of goods and services (%)	673	1,402	363
Short-term debt outstanding	84	164	371	Total debt /GNI (%)	43	287	135
<i>of which interest arrears, official creditors</i>	4	145	243	Total debt service (% of GNI)	1	7	2
<i>of which interest arrears, private creditors</i>		3	2	Debt composition			
Principal arrears, official creditors	46	731	189	Multilateral debt/total debt (%)	4	15	32
Principal arrears, private creditors	1	49	2	Bilateral PPG debt/total PPG debt (%)	78.3	80.5	44.2
Total Debt Flows				Private PPG debt/total debt PPG (%)	17.1	3.0	0.1
Disbursements	834	186	270	Aid and GNI			
Disbursement multilateral %	0.6	77.5	89.1	Aid (% of GNI)	8	65	60
Disbursement bilateral %	75.3	20.3	10.2	Aid per capita (current US\$)	19	79	112
Disbursement private %	24.1	2.3	0.0	GNI, PPP (real 2002 million \$)	7,647	9,793	18,293
Net transfers on debt	817	20	41	GNI per capita, PPP (real 2002 \$)	565	652	990

PPG = public and publicly guaranteed debt.

GNI = gross national income.

PPP = purchasing power parity-adjusted.



**Table 7: Debt Summary – Uganda**

US\$ million, unless otherwise indicated

	Last Pre-War 1980	First Post-War 1989	Most recent 2002		Last Pre-War 1980	First Post-War 1989	Most recent 2002
Total debt stocks	687	2,177	4,100	Debt indicators			
Long-term debt outstanding	535	1,846	3,690	Total debt /exports of goods and services (%)	208	1,402	363
Short-term debt outstanding	63	105	153	Total debt /GNI(%)	43	287	135
<i>of which interest arrears, official creditors</i>	10	22	79	Total debt service (% of GNI)	1	7	2
<i>of which interest arrears, private creditors</i>	9	33	2	Debt composition			
Principal arrears, official creditors	30	51	200	Multilateral debt/total debt (%)	12	45	77
Principal arrears, private creditors	52	83	28	Bilateral PPG debt/total PPG debt (%)	39.6	28.7	10.5
Total debt flows				Private PPG debt/total PPG debt (%)	45.6	18.1	0.8
Disbursements	83	312	162	Aid and GNI			
Disbursement multilateral %	8.2	46.4	84.0	Aid (% of GNI)	9	9	11
Disbursement bilateral %	13.3	40.4	12.8	Aid per capita (current US\$)	9	27	26
Disbursement private %	78.4	13.1	3.3	GNI, PPP (real 2002 million \$)		16,288	33,819
Net transfers on debt	118	187	93	GNI per capita, PPP (real 2002 \$)	..	974	1,370

PPG = public and publicly guaranteed debt.

GNI = gross national income.

PPP = purchasing power parity-adjusted.

**Table 8: Debt Summary – Democratic Republic of Congo**

US\$ million, unless otherwise indicated

	Last Pre-War 1996	First Post-War 2001	Most recent 2002		Last Pre-War 1991	First Post-War 2001	Most recent 2002
Total debt stocks	10,840	11,519	8,726	Debt Indicators			
Long-term debt outstanding	9,285	7,587	7,391	Total debt /exports of goods and services (%)	130	..	..
Short-term debt outstanding	1,083	3,556	764	Total debt /GNI(%)	2	241	159
<i>of which interest arrears, official creditors</i>	585	2,997	409	Total debt service (% of GNI)	20	..	17
<i>of which interest arrears, private creditors</i>	108	178	53	Debt composition			
Principal arrears, official creditors	376	4,798	578	Multilateral debt/total debt (%)	20	18	28
Principal arrears, private creditors	674	488	482	Bilateral PPG debt/total PPG debt (%)	66.9	66.3	68.5
Total debt flows				Private PPG debt/total PPG debt (%)	9.4	6.4	3.9
Disbursements	3	0	415	Aid and GNI			
Disbursement multilateral %	0	0	98.7	Aid (% of GNI)	6	6	15
Disbursement bilateral %	100	0	1.3	Aid per capita (current US\$)	12	5	16
Disbursement private %	0	0	0	GNI, PPP (real 2002 million \$)	56,977	31,605	32,697
Net transfers on debt	0	0	0	GNI per capita, PPP (real 2002 \$)	1,479	630	630

PPG = public and publicly guaranteed debt.

GNI = gross national income.

PPP = purchasing power parity-adjusted.