WHO'S 'FREE RIDING'? A CRITIQUE OF THE WORLD BANK'S APPROACH TO NON-CONCESSIONAL BORROWING IN LOW-INCOME COUNTRIES

Celine Tan

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Abstract

This paper considers the current proposals by the World Bank to curb the potential for 'free riding' in relation to financial support and multilateral debt relief to low-income countries. Measures to address the 'free rider' issue will form a pivotal plank in the World Bank's future strategy towards low-income borrowing members and will also inform some of the International Monetary Fund (IMF)'s policies in this respect. This paper analyses the proposals in light of current trends in development financing policy and practice, particularly the shifting patterns of official and private financial flows to developing countries, and demonstrates the disjuncture between the conceptual approach of the Bank and Fund to the issue of 'free riding' and their operational practice over the past two decades. It is argued here that the Bank proposals are less motivated by a concern over the future debt sustainability of their low-income borrowers but by the *realpolitik* and financial exigencies facing the Bretton Woods institutions today. Consequently, the measures proposed are not only operationally flawed but represent instead new mechanisms to continue binding IDA countries to financing flows – and thereby financial discipline – by the Bank and the Fund during a time where these institutions are struggling to maintain their operational relevance and political legitimacy.

Keywords: Debt sustainability, debt relief, free riding, grants, IDA, IMF, non-concessional lending, World Bank

Contact Details:

School of Law,

University of Warwick

Coventry CV4 7AL

Email:Celine.Tan@warwick.ac.uk

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Introduction

The World Bank[1] is currently developing operational proposals to discourage what the institution perceives as the problem of 'free riding' in relation to World Bank financial support to low-income member states. 'Free riding', defined by the International Development Association (IDA), the Bank's concessional lending arm, as the 'cross-subsidization through IDA grants of other creditors offering non-concessional terms to grant-eligible countries' (IDA, 2006: para 2), is becoming an increasingly critical issue in the debate on debt relief and financing for low-income countries at the Bretton Woods institutions.

With the joint World Bank-International Monetary Fund (IMF) debt sustainability framework (DSF) now forming a vital plank in the assessment of IDA grant eligibility of IDA members, and with the anticipated increase in fiscal space created in countries eligible for debt relief, both under the existing Heavily Indebted Poor Countries (HIPC) initiative and the new Multilateral Debt Relief Initiative (MDRI)[2], the issue of non-concessional creditors benefiting from IDA financing has become a central concern for the institutions, notably the IDA.

The World Bank has presented its interest in the issue of 'free riding' as one primarily motivated by concern for the debt sustainability of member states, particularly those whose debt ratios are lowered upon the cancellation of multilateral and bilateral debt. Accordingly, the Bank notes in IDA's outline of modalities for the MDRI that Bank executive directors and IDA deputies have 'expressed concern that the [lower risk of debt distress] should not lead beneficiary countries to immediately begin re-accumulating debt levels that could become unsustainable' (IDA, 2005: para 33).

This paper considers the background to the World Bank's concern with 'free riding' behaviour and the Bank's proposals to deal with the issue, as outlined in its staff paper

[1] The term 'World Bank' and 'Bank' in this paper refers to both the International Bank for Reconstruction and Development (IBRD) and the International Development Association (IDA), with the term 'IDA' used where there is a need to denote the Association specifically.

[2] The MDRI, initially proposed by the G8 countries in July 200,5 is aimed at providing 100 percent cancellation of all debt owed by eligible countries to three multilateral institutions – the World Bank, the IMF and the African Development Fund (AfDF). Countries must reach HIPC completion point and fulfil other criteria to be eligible for relief under the MDRI. Implementation modalities are specific to each of the three institutions involved.

entitled 'IDA Countries and Non-Concessional Debt: Dealing with the 'Free Rider' Problem in the Context of IDA 14 Grants'[3] which was released in February this year (IDA, 2006). This paper challenges the premise of the IDA's proposals and argues against their operationalisation, particularly the plan to link the contracting of new financing from alternative sources by IDA countries to their eligibility for grant financing and the proposal to further limit countries in breach of 'concessionality benchmarks' to other official sources of financing.

It is argued here that these proposals do not create 'incentives to discourage non-concessional borrowing' and prevent the re-accumulation of debt, as suggested by the Bank (IDA, 2006: para 4), but are instead new mechanisms to continue binding IDA countries to financing flows – and thereby financial discipline – by the Bank and the Fund. This reflects a policy trend currently prevalent within the Bretton Woods institutions at a time when the institutions are struggling to maintain their rapidly diminishing relevance today, facing net negative inflows resulting from the sidelining of the institutions by middle-income developing countries and the graduation of low-income countries from their multilateral debt.

Thus, this paper argues that the proposals put forward by the World Bank (and peripherally by the IMF) to curb incidences of 'free riding' must be placed in the context of current developments in the global political economy, notably in the context of the shifting patterns of development finance flows and the growth and availability of new sources of development finance for developing countries. The overarching motivations of the Bretton Woods institutions must be kept in mind when considering the aforementioned proposals.

Section 1: 'Origins' of the 'Free Rider' Issue in Bank and Fund Operational Policy

The World Bank's current preoccupation with the issue of 'free riding' stems from the terms of financing under the IDA's 14th Replenishment, the process of which was

[3] This paper is available on file with the author.

completed in April last year, and which will apply to all IDA financing from 2005 to 2008.

IDA 14 introduced a new system for allocating grants[4] to IDA members which included an assessment of the countries' risk of debt distress as determined by the joint Bank and Fund debt sustainability framework. The final report of the 14th replenishment negotiations concluded that:

> …debt sustainability will be the basis for the allocation of rants to IDA-only countries in IDA-14 … under the new grant allocation system, the share of grants in total IDA financing will emerge from a country-by-country analysis of the risk of debt distress.
>
> Participants broadly endorsed the Joint Bank-Fund debt sustainability framework (DSF) as the analytical underpinning for the link between debt sustainability and grant eligibility … (IDA, 2005b: paras 70 – 71).

Debt Sustainability Framework

The DSF, approved by the Bank and Fund Executive Boards in 2005, is intended to assess countries' ability to sustain its debt burden and 'to reduce the accumulation of future debts to unsustainable levels' (Kappagoda and Alexander, 2004) and aimed at informing the financing policies of the Bank and the Fund in relation to their low-income members. The DSF calculates a country's capacity to absorb new borrowings based on countries' 1) indicative policy-dependent external debt thresholds; 2) debt sustainability analyses and associated distress tests; and 3) appropriate borrowing and lending strategy that limits the risk of debt distress (IDA, 2006: para 1; IMF and IDA, 2004a: para 2; IMF and IDA, 2004b: para 3).

[4] The practice of allocating grants instead of loans to borrowing member states was only introduced under the 13th Replenishment although under IDA 13, grants were allocated on a 'multiple, special purpose criteria' which applied to all borrowers (with a cap of 40 percent) without distinction with regards to debt service (IDA, 2005: para 70; Kappagoda and Alexander, 2004: para 1). As a result, 'the level of grants in IDA 14 will be an outcome of [the DSF] and not predetermined as in IDA 13 when a cap of 40 percent was placed for each country' (Kappagoda and Alexander, 2004: para 3).

The IDA deputies, in their negotiations for its14th replenishment, adopted the 'first pillar' of the DSF as the conceptual framework on which to assess an IDA member's level of debt distress in determining the allocation of funds to each members, namely in the determination of the 'grant-loan' mix of financing, with utilisation of the 'second pillar' contingent upon the development of its operational guidelines by the Bank and the Fund (IDA, 2006: para 1; IDA, 2005b: para 73).

In other words, the IDA will use the debt threshold analysis 'to determine grant eligibility among its borrowers, with countries at a high risk of debt distress receiving primarily grant financing from IDA' (IMF and IDA, 2004a: para 4). A central element of this analysis is the linking of 'the risk of debt distress to the quality of policies and institutions in low- income countries', taking into account 'countries' policies and institutions as well as their vulnerability to exogenous shocks' in the evaluation of debt sustainability (IDA, 2004: para 4).

Under the DSF, a country's vulnerability to debt distress is calculated using three debt ratios, using a) the net present value (NPV) of public and publicly guaranteed external debt to the country's gross domestic product (GDP); b) the ratio of this debt to exports; and c) the ratio of debt service on this debt to exports (Kappagoda and Alexander, 2004; Oddone, 2005: 5). Debt ratio thresholds are established for each of the three country clusters determined by countries' performance under the Bank's Country Institutional and Policy Assessment (CPIA)[5], with countries grouped according to their ranking as either 'poor', 'medium' or 'strong' performers (IDA, 2004: para 8, Table 1). The matrix table looks as follows:

Performance Category	**Debt to Debt-Service Thresholds (%)**		
	NPV of debt-to-GDP	NPV of debt-to-exports	Debt service-to-exports
Weak (CPIA <3.25)	30	100	15

[5] The CPIA is an evaluation of World Bank borrowing members' current country and institutional framework. For each of its 136 borrowers, the Bank 'performs an annual CPIA rating that produces an overall performance ranking for each borrowing government … based on assessments of each country's governance as well as its economic, structural, social and public reform policies' (Alexander, 2004). Countries are rated in accordance with their performance in 16 criteria, grouped into four clusters – 'economic management', 'structural polices', 'policies for social inclusion and equity' and 'public sector management and institutions' – and the overall score is derived from the average of ratings for each cluster (World Bank, 2005: paras 1 – 16). The CPIA informs the Bank's financing and technical assistance portfolio for each country, feeding into both the Country Assistance Strategies (CAS) for all borrowers and the performance-based allocations (PBAs) for IDA borrowers. Only the ratings for IDA borrowers are publicly disclosed (ibid: para 16).

Medium (3.25<CPIA<3.75)	40	150	20
Strong (CPIA>3.75)	50	200	25

Source: IDA, 2004

Countries' risks of debt distress are then calculated by comparing their relevant thresholds to those established in their country grouping and risk is classified using a 'three category, 'traffic light' system' with 'green light' signalling a low risk of debt distress, 'yellow light' signalling medium risk of debt distress and 'red light' signalling a high risk of debt distress (IDA, 2006: para 8; IDA, 2004: Box 1; Oddone, 2005: 5).

IDA 14's Grant Allocation System

Under IDA's new allocation system, countries with a 'green light' – with indicators below the threshold – are considered sufficiently capable of undertaking more debt in the form of concessional lending so countries are allocated 100 percent credits (IDA, 2006: 8; Oddone, 2005: 5). Countries with a 'yellow light' – with debt ratios at the limit of the thresholds – are allocated a 50/50 mix of grants and credits while countries whose debt ratios exceed the threshold – 'red light' countries – are deemed unsuitable for any further debt and are therefore allocated 100 percent grants (ibid).

One of the central objectives of the DSF is to link policy and institutional performance of countries, including in areas such as governance and structural reform, to the assessment of debt sustainability and, consequently to reward 'good' performers with more flexible modes and relatively higher volumes of financing. Countries with 'good policies' therefore are considered at lower risk of debt distress and are therefore considered much better equipped to handle more loans while countries with 'bad policies' are considered at high risk of debt distress and should not be given any more loans but grants. Hence, a 'country with low risk of debt distress, however, should be in a position to obtain more of its resources in the form of loans, implying higher nominal transfers for a given grant-equivalent' (IMF and IDA, 2004: para 43).

However, the Bank and Fund do not view the financing implications of the DSF as either 'rewarding' or 'punishing' high risk countries (IMF and IDA, 2004b: paras 42 – 43). Instead, the Bank and Fund are of the view that:

> Under this framework, countries with sound policies would receive a mix of loans and grants that would be consistent with their policy performance and their risk of debt distress. Provided a country's policies are considered appropriate, the legacy of a high debt burden or vulnerability to shocks would not be a justification for denying it resources. Instead, *the overall allocation of grant resources … would need to be based on policies and other relevant criteria* (ibid, emphasis added).

Consequently, the DSF and the IDA's new grant eligibility system will prevent high-risk countries (with presumably a poor policy and institutional environment) from receiving more financing as compared to a 'strong' performer or country with low risk of distress, even though these countries will receive more 'concessional' financing in the form of grants rather than repayable loans.

A calculation by the European Network on Debt and Development (Eurodad) suggests that while 'the worst performers get the cheapest money, namely IDA grants', this discount is abated by a 20 percent upfront charge on all grant financing, leading to a hypothetical situation where '[a] country which would have received US$ 500 million in loans, will, if classified as a 'poor performer' by the [international financial institutions], receive only US$400 million in grants' (Oddone, 2005: 8; see also Kappagoda and Alexander, 2004: para 46).

This significant decline in concessional financing, according to Eurodad, will exacerbate existing resource gaps in low-income countries with the likelihood of forcing countries 'to either turn to less concessional – or even market-based – finance' to close the resource gaps or to 'cut essential public services' (Oddone, 2005: 8).

Grants and 'Free Riding'

It is this ironic situation, coupled with the fact that grant-eligible countries will see their debt sustainability indicators improve as a result of contracting less debt, which has led to the IDA's concern over the 'free rider' issue. In its paper considering the financing terms of IDA 14, the Bank notes that '[a] possible side effect of the provision of IDA grants to

countries with a medium or high risk of debt distress is that these countries 'space for borrowing' from other sources – including export credit agencies – may expand' (IDA, 2004: para 16). The Bank acknowledges that the contraction in financing flows to 'yellow' or 'red light' countries under the new grant allocation system may result in countries expanding 'non-concessional borrowing in the wake of a reduced share of credits in their IDA portfolios' (ibid).

This, according to the Bank, may result in the increase in the risk of debt distress for countries concerned, but equally as importantly, lead to other creditors taking advantage of the IDA's financial 'subsidies' to these countries. It notes that 'if the provision of IDA grants frees up space for increased borrowing from other sources, then IDA, would, in effect, be subsidizing other lenders at the expense of its future financial strength' (ibid). This concern over its financial future speaks volumes about the Bank's real reason for placing primacy on the issue of 'free riding', as will be discussed further below).

Consequently, donor countries had, during the IDA replenishment process, called on the Bank staff to develop specific proposals to deal with the 'free rider' problem, to be presented to the Executive Board by the end of the 2005 financial year (IDA, 2005b: para 74). Specifically, the Bank was called upon to devise a mechanism 'whereby a country could cease to be eligible for grants if its government or other public sector entities contract or guarantees new loans from alternative sources of financing which threaten to defeat the debt sustainability objective that IDA grants are intended to achieve' (ibid). The aforementioned staff paper is a response to this request and was considered by the IDA executive directors at an informal meeting in March this year.

'Free Riding' and Debt Relief

Since the request for proposed modalities on linking incidences of 'free riding' with grant financing, the imperative to curb such 'free riding behaviour' has increased with the inception of the MDRI and, while the paper does not address the 'free rider' issue in the context of debt relief, it is expected that further proposals developed from the paper will apply to countries eligible for such relief under the MDRI, as alluded to by the aforementioned IDA staff paper on 'free riding' (IDA, 2006), by the IDA's paper outlining the implementation modalities for the MDRI (IDA, 2005a); and by Bank

president Paul Wolfowitz in his statements to the International Monetary and Financial Committee (IMFC) and Development Committee at the Bank and Fund spring meetings this year.

For the IDA, the potential for debt relief qualifying countries to contract new, non-concessional loans is very real as 'their debt ratios will be brought down to much lower levels post-MDRI relief' and 'will, in most cases, be below that of most middle-income countries' (IDA, 2005a: para 43 – 45). With their debt indicators well below the thresholds established by the DSF, the IDA considers that debt cancellation 'significantly amplifies the potential scope for irresponsible borrowing (and lending) behaviors' (ibid: para 45).

Both the Development Committee and the IMFC, the political oversight committees of the two institutions, addressed the problem of debt re-accumulation due to non-concessional borrowings by HIPC and MDRI-eligible countries in their respective spring meeting communiques (Development Committee, 2006: para 7; IMFC, 2006: para 12).

However, only the Development Committee specifically referred to the issue of 'free riding', linking it once again with its future financial viability, requesting that the Bank and Fund further refine the DSF to 'avoid accumulation of unsustainable debt' and, 'in this context, 'to further elaborate and implement an effective approach to deal with the 'issue of 'free-riding' where non-concessional lenders may indirectly *obtain financial gain* from IDA's grants and debt forgiveness' (Development Committee, 2006: para 7, emphasis added).

This suggests that the IDA's interest in the issue may reside more in the institution's concern over its financial future than a genuine concern for debt sustainability and the need to meet resource gaps in low-income countries. Moreover, the proposals outlined in the staff paper and considered in the next section would involve greater scrutiny by the international financial institutions (IFIs) and the official development financing community over external financing choices of countries, reflecting the Bretton Woods institutions, notably IDA's, interest in maintaining continued relevance among, if not control over, developing countries.

Section II: IDA Proposals for Anti-'Free Riding' Measures

Efforts by the World Bank to design measures to curb 'free riding' risks in the context of IDA financing are, as noted in the previous section, driven by two objectives as stated by the institution. Firstly, a concern over the debt sustainability of IDA borrowing members resulting from the undertaking of new non-concessional lending and the accumulation of non-concessional debt; and, secondly, but more importantly, institutional unease about the potential financial benefit reaped by non-concessional official and commercial creditors at the expense of the Association's future financial viability.

Consequently, the Bank is condemnatory of 'non-concessional lenders [who] obtain financial gain from IDA's debt forgiveness, grants and concessional financing activities without paying for it … because it means that creditors, rather than the IDA recipient country, are receiving at least part of the benefit of IDA grants, and the development effectiveness of IDA is thereby reduced' while at the same, 'countries indebtedness would not decline' (IDA, 2006: para 7).

For the Bank, the potential for 'free riding' by non-concessional lenders is expected to increase with the implementation of the grant allocation system, and debt relief, discussed above, as fiscal space is freed up in grant or debt relief-recipient countries and the risk of default by these countries on new borrowings is reduced.

Although grant-eligible countries under the DSF and IDA grant allocation system are at medium or high risk of debt distress, the Bank fears that 'high debt ratios do not necessarily deter other creditors from providing non-concessional debt' as 'the prospects for repayment are improved by the overall reduction in a country's debt obligations represented by IDA grants' (ibid: paras 9 – 10)[6]. The creditworthiness of these countries thus increases in private financial markets with the reduction in debt stock.

[6] According to the staff paper, 33 percent of public and public guaranteed debt of 31 countries classified as 'high risk' of debt distress was non-concessional with only six countries – Angola, Cameroon, Democratic Republic of Congo, Cote d'Ivoire and Sudan – accounting for 88 percent of the non-concessional debt stock for this group of countries (IDA, 2006: para 9).

The Bank also expects the incentives for non-concessional lending to increase with debt relief measures under the MDRI and the graduation of countries from an IMF programme – in this case, the Poverty Reduction and Growth Facility (PRGF) – the presence of which has deterred non-concessional borrowings due to conditionalities on minimum concessionality of newly contracted loans for countries undergoing a PRGF operations. As countries begin freeing themselves from the Bretton Woods institutions, it appears that the institutions are developing new measures to continue binding countries to these institutions.

Two-Fold Response

The Bank's proposal to address the problem of 'free riding' in IDA countries rests on two pillars: 1) Increasing surveillance by the IDA, the IMF and other bilateral and multilateral creditors of countries' borrowings, including broadening the acceptance of the DSF as an analytical framework for financing policies and deepening borrower reporting requirements in existing and new financing agreements; and 2) Linking the non-concessional borrowings by countries to disbursements of official financing, concessional or otherwise – the Bank terms this as creating 'incentive' structures but, as discussed below, these proposals can be more appropriately termed 'punitive' measures.

1. Increasing Surveillance of Borrowers

According to the Bank, the potential prevalence of 'free riding' by non-concessional lenders 'stems from the fact that there is no institutional framework either for a formal creditor coordination process or for the prevention of serious breaches of concessionality benchmarks by opportunistic commercial lenders' (IDA, 2006: para 23). The IDA sees the problem of official creditor cooperation as a major factor in contributing to the accumulation of non-concessional debt by client countries, notably the lack of coherence between creditor lending policies towards these countries, enabling countries to contract further loans without adherence to minimum thresholds of debt sustainability or concessionality benchmarks for new borrowings.

This is worsened, according to IDA, by the limited monitoring of countries' new borrowings by official creditors and the IFIs and the lack of formal or informal linkages

with the borrowers' breach of concessionality and debt sustainability thresholds with lending policies of the creditors. As a result of inadequate surveillance of countries' borrowing strategies and the lack of policy coherence among the creditors, countries are able to contract new non-concessional loans without jeopardising their existing or future concessional financing arrangements. To redress this, the Bank is proposing measures for increased oversight of countries' borrowing policies through a combination of multilateral and bilateral measures.

a) Creditor Coordination

Firstly, the Bank is urging greater coordination among official creditors, including the development of a formal mechanism to ensure a collective response from official creditors or at least, 'enhanced creditor coordination around a common approach to concessionality' to discourage borrowers from undertaking non-concessional lending, thereby reducing the risk of 'free riding' and risk of further debt distress (IDA, 2006: para 23).

The IMF already plays this gatekeeping role with respect to PRGF countries by constituting, as a performance criteria under the programme, a condition that countries adhere to minimum thresholds of concessionality (established by the IMF) when contracting new loans. Consequently, 'the presence of an IMF program has been a deterrent for non-concessional borrowing' (IDA, 2006: para 10). Not only do PRGF countries risk jeopardising IMF resources by non-compliance with concessionality benchmarks but they also risk the loss of other financing flows from creditors which link their lending to an IMF programme when their PRGF goes 'off track' (the Fund's 'signalling' role).

The Bank is proposing that the DSF forms the 'analytical basis for a common approach to concessionality' and 'serve as a coordinating tool among creditors' in order to 'achieve a common understanding of overall concessionality for low-income borrowers' (IDA, 2006: para 23 & 25 – 26). It is hoped that this will inform the lending policies of creditors, leading to creditors withholding loans if a country's debt portfolio exceeds the concessionality limits of the country concerned. Paris Club creditors have already agreed to used the IMF's Debt Sustainability Assessments in the context of Paris Club

reschedulings and the African Development Fund (AfDF) has adopted the DSF as the basis for its grant allocation system (ibid: para 26).

The need to establish a common creditor approach to concessionality is crucial, according to Bank, particularly at a time when low-income countries are graduating from IMF and when 'the interest of countries' in the IMF's new non-financing Policy Support Instrument (PSI)[7] has not been established (ibid: para 10). The Bank proposes using the IMF's concessionality threshold on new borrowings in PRGF programmes as the minimum benchmark for this coordinated approach. The IMF considers loans to be concessional if there is a grant element of at least 35 percent based on 'currency-specific commercial interest reference rates (CIRRs)' (IDA, 2006: Box 1).

The Bank also recommends the adoption of the IMF's 'loan-by-loan definition of concessionality' – used by the Fund to judge compliance with the aforementioned concessionality conditionality – to be used as 'an *indicative* baseline on which to identify actual instances of free riding' (ibid: para 15). This approach assesses *each* new loan contracted by the borrowing country for degree of concessionality – as opposed to an *aggregate* approach which assesses the overall degree of concessionality of countries' new borrowings – thereby enabling easier detection of instances of 'free riding' (ibid: para 15 – 16). Although not recommending that such a minimum concessionality benchmark serve as a formal conditionality for IDA assistance, the Bank suggests that it be 'used to flag the need for an internal discussion about an appropriate IDA response' (ibid: para 15).

b) Greater Scrutiny of New Borrowings

The 'loan-by-loan' definition of concessionality, if adopted by the IDA and other bilateral and multilateral financiers, requires greater monitoring of new borrowings by the

[7] The PSI, introduced by the IMF in October 2005, is a non-lending policy instrument which is designed for countries which do not want or need Fund financial support. The instrument is voluntary and enables the Fund to monitor and evaluate the economic policies of the country involved, similar to its role under a traditional Fund programme such as the PRGF. As this device would be utilised as a Fund endorsement of member policies for the purposes of signalling 'economic health' to other creditors and donors, countries would have to comply with Fund conditionalities on structural and macroeconomic policy reform in the same manner as it would a conventional Fund programme but without the possibility of withdrawal of funds. Currently Nigeria and Uganda have adopted the PSI and Tanzania will do so upon the completion of its PRGF in August. See for example, IMF (2005). The PSI therefore effectively makes the Fund a credit ratings agency vis-à-vis low-income countries !

client countries in order for these creditors to assess breaches of concessionality and detect instances of 'free riding'. A quarterly 'loan-by-loan accounting' of all new public sector loans contracted or guaranteed by countries undergoing an IMF programme is already part of the countries' reporting obligations to the Fund (IDA, 2006: para 15).

Meanwhile, the general conditions in IDA financing agreements include an obligation on the part of the recipients to furnish to IDA all such information as IDA reasonably requests on the 'financial and economic conditions in its territory, including its balance of payments and its external debt' (ibid: para 8; IDA, 2005c: Article IV, Section 5.01). The Bank's Operational Policy 14.10 on 'External Debt Reporting and Financial Statements' also provides that countries provide quarterly reports detailing 'information on each new commitment of a public or publicly guaranteed debt received during the period' (IDA, 2006: para 18; also World Bank, 1999: para 3(b)).

The Bank is proposing that the reporting requirements under OP 14.10 be strengthened compel countries to provide the requisite data as well as for the instituting of additional reporting criteria, requiring IDA borrowers to notify the Association of 'any planned non-concessional borrowing' beyond its current *ex-post* reporting required under OP 14.10 (ibid: para 31).

The staff paper has therefore proposed that all new IDA grant agreements 'include a covenant which would require a country to notify IDA of any planned non-concessional borrowing at least 3 months in advance of contracting such borrowing' (ibid: para 31). This would allow the IDA to tailor an appropriate response to what it may perceive as incidences of 'free riding' or if the debt contracted will lead to further risk of debt distress.

2. Linking Non-Concessional Borrowing to Concessional Financing

For the Bank, increased scrutiny of low-income countries' non-concessional borrowings and greater creditor coordination, as outlined above, can only deter incidences of 'free riding' if there is a link between the assumption of such debt by such countries and concessional financing from bilateral and multilateral financiers. As such, the IDA staff

paper argues that these efforts 'need to be combined with an immediate focus on borrowers' behavior', namely financial 'incentives' to discourage countries from 'engaging in non-concessional borrowing' (IDA, 2006: para 30).

For IDA grant-eligible countries, the Bank is proposing that countries be made to forfeit some of their concessional financing if they do not adhere to the concessionality benchmarks established by the IDA, either institutionally or in concert with other bilateral and multilateral financiers. As such, the recommendation of the staff paper is to reduce the nominal grant allocation of IDA borrowers breaching minimum concessionality thresholds (ibid: paras 30 – 38). This is preferred to the other option of varying the terms of the assistance given to the affected countries by adjusting its concessionality back to credit level and to suspend future grant financing to the countries as it is argued that this would increase the countries' risk of debt distress (ibid: paras 32 – 33).

The proposal outlined in the IDA staff paper is, for the IDA to reduce nominal grant allocations to countries 'with confirmed breaches of the concessionality benchmark' by 20 percent (ibid: para 35). The reduction will bring the grant allocations down 'by the present value of repayments under a regular IDA credit', thereby eliminating the subsidy of the IDA 14 grant allocation system which transfers to grant-eligible countries 'more IDA resources in present value terms than what would be required to ensure cost equivalence between a grant and a regular IDA credit' (ibid: para 37).

Therefore, it is proposed that for 'small and occasional breaches' of concessionality thresholds, countries would face a 40 percent reduction in grant allocations (20 percent on top of the initial 20 percent discount under the grant allocation system – see discussion in Section II) (ibid: Box 1). This reduction will be determined on a case-by-case basis by the IDA management, taking into account the seriousness and the size of the new non-concessional borrowing relative to the country's IDA allocation, the merits of the loan in question, and the country's debt carrying capacity' (ibid: para 36). For 'more serious or prolonged breaches', the IDA may apply higher reductions on countries' grant allocations or applying these discounts for a number of years, and in the most serious cases, it is proposed that 'Management could consider disengaging from the country' (ibid: paras 36 – 37).

Additionally, the paper suggest that where non-concessional borrowing may indicate 'related governance problems', this may be 'captured by IDA's performance-based allocation system', resulting in further cuts as a consequence of 'lower performance-based allocations' (ibid: para 36). The Bank hopes that these proposals may provide deterrents to IDA countries which seek out non-concessional borrowing and thus reduce the incidences of 'free riding' by minimising the demand for such loans.

Section III: Critique of IDA Proposals

The preceding two sections have outlined the origins of the 'free rider' problem in World Bank and IMF operational policy, namely in their financing support to highly indebted, low-income countries, and IDA proposals for resolving the problem, at least in relation to grant-eligible IDA borrowers. These proposals are expected to be refined in the period leading up to the Bank and Fund annual meetings in September and may be further elaborated to take into the potential of 'free riding' under the MDRI, as alluded to in the discussion above.

This section evaluates the issue of 'free riding', as problematised by the Bank (and to a limited extent, the Fund) and the Bank's proposals to redress the problems in the context of IDA member countries.

This critique of the Bretton Woods institutions' approach to the issue of 'free riding' is centred on two grounds: 1) the incoherence and inconsistency of the Bank and Fund's conceptual problematisation of the issue of 'free riding' in the context of development financing; and 2) the operational deficiencies of the proposed modalities for dealing with the 'free rider' question in relation to development financing policies and practice.

Underpinning these arguments is the overarching critique of this paper that the concern of the Bank and the Fund on the issue of 'free riding' and the accumulation of non-concessional debt by their borrowing members and the attendant proposals to redress the problem, are driven less by a considered disquiet about the ability of countries' debt

sustainability than about the financial and policy relevance of the Bretton Woods to developing member countries in today's global economy.

1. Problematisation of non-concessional loans ignores historical practice

Central to World Bank and IMF's arguments for measures to address the 'free rider' issue in the context of development financing is the concern that the institutions may be subsidising the exercise of imprudent borrowing and lending, notably, that fear that non-concessional creditors may take advantage of the grant and/or debt relief-eligible country's prospect of future grants and MDRI relief. The increased creditworthiness of countries coupled with the potential graduation of some countries from IMF programmes and thus, IMF restrictions on non-concessional borrowings, is perceived as a lucrative incentive for non-concessional lenders and imprudent borrowers alike to enter into non-concessional loan contracts, therefore creating the potential for 'free riding' by non-concessional creditors.

The Bank and Fund argue that the lower debt burdens of grant and debt-relief-eligible countries lead to two potential problems: a) 'an incentive to overborrow' on the part of the country involved resulting from IDA's new allocation system which disburses more grants to highly indebted countries; and b) the willingness of non-concessional creditors to finance unproductive investments with the security of knowing the grant and debt relief would enable the country to service its debt (IMF and World Bank, 2006a: para 49).

This problematisation of non-concessional financing as giving rise to the potential of 'free riding' demonstrates institutional amnesia on the part of the World Bank and the IMF in the context of their financing policies in at least two regards. Firstly, it ignores the historical objective of official development finance, including that of concessional financing, as providing a catalyst for private finance, a role that is still pursued by both institutions today. Secondly, and relatedly, it also conveniently disregards other existing policy and practice of the Bank and Fund which work to effectively subsidise private financial flows to developing countries. There is therefore a disjuncture between the Bank and Fund's treatment of the issue of 'free riding' and their traditional exhortation of public finance serving as facilitators of private capital flows.

a) Catalytic role of official development finance

The International Bank for Reconstruction and Development (IBRD) – the original 'World Bank' – was initially established to facilitate capital investments and assist in the reconstruction of post-war economies. Former Bank general counsel Ibrahim Shihata noted that under the Bank's Articles of Agreement, the institution plays two main statutory roles: a) as 'a *financier and promoter* of investment of capital, especially private foreign investment, for reconstruction and productive purposes in member countries' and b) as '*a financier* [that is] a guarantor of/or a participant in 'loans and other investments' made by *private foreign* investors and a direct lender of funds to finance or facilitate productive purposes on suitable conditions 'when private capital is not available on reasonable terms' (Shihata, 2000: 230; see also IBRD Articles of Agreement, Article 1).

There was therefore a consensus among the Bank's founding members that the institution '*would not compete with private investors* but would provide finance only when there was unavailability of private financing on reasonable terms (Akyüz, 2006: 491 – 492, emphasis added). According to Akyüz, '[t]he rationale for World Bank lending was not simply the inadequacy of private capital for financing rapid reconstruction and meeting the needs of developing countries but also concern that the terms of private financing would not be appropriate for the conditions prevailing in the borrowing countries' (Akyüz, 2006: 492). The purpose for such public financing was also to provide credit to countries until they are able to draw upon capital markets for their external financing needs but that such financing would be accessed by countries' creditworthiness and on market-based terms, including market-based interest rates.

The rationale for such lending shifted with the advent of the IDA and the provision of long-term concessional highly credit to low-income developing countries under the auspices of providing finance to meet countries' 'developmental requirements on terms which are more flexible and bear less heavily on the balance of payments than those of conventional loans' (IDA Articles of Agreement, Article 1). This shift in focus also reflected the Bank's increasing association with the private sector and the development of the Bank's role as a stimulator for private financing flows, primarily through market-

friendly structural adjustment programmes and non-financing activities (see Akyüz, 2006: 494 – 495; Shihata, 2000: 231, Rodrik, 1995).

While the success of the catalytic role of multilateral financing is questionable[8], the Bretton Woods institutions have nonetheless relied upon this rationale for the expansion in their mandate and for their policies on access to, the design and terms of financing to client member states. Shihata acknowledged that the expansion in the Bank's activities over the period since its inception 'relied primarily on its role as facilitator and promoter of investment and encourager of development' and this has allowed it to pursue policies under the auspices of creating an 'enabling environment' for foreign investment and private capital (Shihata, 2000: 231).

Over the years, especially since the onset of the debt crisis in the 1980s, there has been what Woodward terms as a 'deliberate paradigm shift' by the IMF and the World Bank to support the facilitation, by public financing, of private capital flows as the primary source of development finance for developing countries (see Woodward, 1998: 6 -7). Consequently, for the Bretton Woods institutions, the purpose of multilateral financing shifted to essentially one that was facilitative of private foreign capital flows, leading to a corresponding shift in the operations of the Bank and the Fund, most notably, the inception of structural adjustment lending and the pro-market conditions attached to such financing (ibid).

The institutions have promoted such open-door policies on the justification that these policies and lending from the Bank and Fund increase the creditworthiness of borrowing countries in private capital markets, enabling countries to eventually graduate from official development financing. For example, proponents of this view have held that by 'financing projects that private lenders find too risky, multilateral development banks mobilize private capital by improving the risk-return profiles of private investment' and as 'risk-return profiles of projects depend on the overall policy environment' of the country involved, the use of conditionality may lead to improvements in policymaking as well as institutional capacity (Akyüz, 2006: 498).

[8] Akyuz and Rodrik argue that empirical evidence does not support this role (Akyuz, 2006: 500; Rodrik, 199522 – 27).

The relief of indebted countries from the burden of unsustainable external debt servicing and debt stock under the HIPC initiative and the MDRI respectively was also premised on the assumption that debt cancellation will not only free up fiscal space for 'poverty reducing' expenditures but also to increase creditworthiness of countries to borrow from private sources to meet developmental targets. As the Bank's Independent Evaluation Group (IEG) has noted – 'Commercial financing will be essential in the long run for expanding HIPC countries' exports and growth' (World Bank, 2006a: para 8).

Given this history of Bank and Fund policy and practice, it is difficult to understand why the institutions are so particularly concerned with the issue of 'free riding' in the context of new non-concessional borrowings by its members. While it is acknowledged that imprudent borrowing should be discouraged in the context of future debt sustainability, the rationale that the fiscal and borrowing space of countries freed up by grant allocations and debt relief will give rise to the potential of 'free riding' by non-concessional creditors is at odds with the traditional practice of the Bank and Fund.

The conventional view of the Bank and Fund of official development financing – with its element of public subsidy – as the facilitator of private finance contradicts the institutions' current approach to the adoption of non-concessional debt by client countries. It appears as if the Bank and the Fund are now *competing with private capital* and even with alternative non-concessional official financing, such as export credit agencies, for the business of client countries as they see their own roles diminishing in the wake of recent developments.

b) Inconsistent 'subsidy' arguments

As discussed above, the Bank and Fund have also expressed concern over the subsidisation of non-concessional creditors through the delivery of grant financing and debt relief through the reduction of debt default by grant and debt relief-eligible countries at the cost of the institutions', particularly the IDA's, financial strength. The primary driver for measures to curb 'free riding' behaviour by non-concessional creditors on the part of IDA is the fear that while the IDA will lose resources as a result of lost reflows from credit repayments as a result of the shift from loans to grants to eligible

countries and debt relief under the MDRI[9], non-concessional creditors, including commercial lenders as well as official sovereign lenders will benefit financially from the same developments.

However, this is again inconsistent with the policy and practice of the Bank and the Fund over the last couple of decades, in particular, the subsidisation of the private sector and commercial creditors through financing policies. Since the inception of the International Finance Corporation (IFC) in 1956 and the Multilateral Investment Guarantee Agency (MIGA) in 1988, the World Bank Group has worked closely with the private sector to facilitate private capital flows to developing member states. The IFC provides loans to private investors in developing countries while the MIGA provides guarantees for commercial finance and investment in these countries. This direct support for the private sector is aimed at reducing the risks encountered by private finance when investing in developing countries and to 'mobilise commercial flows to these countries rather than to provide finance directly' (Woodward, 1998: 6).

The IMF has also been heavily criticised for its policy of prioritising international capital at the expense of the economic and financial needs of its client countries through not only its espousal of unbridled deregulation, liberalisation and privatisation policies in structural adjustment countries, but also, more importantly, through the bailouts of commercial creditors in their financial 'rescue' packages to countries experiencing financial crises. These bailout operations were designed, *inter alia*, to 'keep countries current on their debt repayments to private creditors', creating a problem of 'moral hazard' – increasing the probability of irresponsible lending – and aggravating market failures by cushioning the risk of private creditors in the event of a financial crisis and debt default in developing countries (Akyüz, 2006: 498; Akyüz, 2005: 30).

Accordingly, Akyüz argues that 'bailouts undermine market discipline and encourage imprudent lending since private creditors are not made to bear the consequences of the risks they take' (Akyüz, 2005: 30). Instead, the Bretton Woods institutions have been complicit in the build-up of unsustainable debt of developing countries via their lending practices over the 1980s and 1990s. As Sachs has noted:

[9] Although this is limited to ancillary costs as compensation for the cost of IDA's debt relief will be made by IDA donors under regular IDA replenishment procedures (IDA, 2005a: para 35).

> Following the initial onset of the developing country debt crisis in the early 1980s, many developing countries borrowed heavily from multilateral sources in order to finance debt servicing to private creditors, thereby shifting the balance of debt from private to public creditors (Sachs, 1998 in UNCTAD, 1998: 128).

Consequently, there is very little difference in the 'free ride' accorded by these bailout operations to private creditors and the 'free ride' that the Bank and Fund are worried will be given to non-concessional lenders to grant and debt-relief-eligible countries. If the Bank and Fund were unduly concerned with private creditors benefiting from public money, and with the impact this has on the debt sustainability of countries, the institutions should move towards designing orderly debt workouts[10] for countries facing short-term or prolonged financial crises, including for official debt. This would enable a standstill on unserviceable debt on a more equitable basis rather than the current ad-hoc debt relief mechanisms which continue to keep countries on a short-leash to these institutions and their major shareholders (see for example, Akyüz, 2005: 30 – 31).

The above discussion once again demonstrates the inconsistency in the Bank and Fund's approach to the issue of 'free riding' in the context of non-concessional borrowings by low-income countries and the disjuncture between the institutions' critique of the issue and its problematisation and the Bank and Fund's track record in financing policy and practice.

2. Operational difficulties with IDA proposals

Aside from fundamental flaws in the conceptual premise framing the issue of 'free riding' in non-concessional borrowings, there are several operational difficulties with the IDA's design of measures to curb such behaviour by commercial creditors and the assumption of unsustainable loans by IDA countries. The three main criticisms of the proposed measures are centred on the punitive nature of such a course of action which shifts the burden for an effective debt management and external resource mobilisation strategy on the highly indebted country.

[10] Proposals for these workouts have included the now-shelved Fund-initiated Sovereign Debt Restructuring Mechanism (SDRM) and other proposals along the lines of national bankruptcy laws (see Akyüz, 2005: 30 – 31).

While the Bank considers such measures as 'incentives to influence borrowers' behavior' (IDA, 2006: para 24), these proposals espousing a common creditor approach to concessionality and the linking of non-concessional borrowings to the volume of concessional official finance read more like punitive deterrents for borrower countries. These measures imply increased financial oversight of the public finances and debt management policies of client countries by the Bank, Fund and other official creditors and greater control over what is a sovereign right of countries to enter into external financing agreements. The IDA proposals are aimed at imposing further conditions on the use of concessional resources, even when the dwindling volumes of these resources have created, and will create as a result of further cuts, the necessity for countries to seek alternative sources of financing.

a) Proposals focus on borrower rather than creditor responsibility

The IDA proposals focus inordinately on borrower behaviour rather than on the creditor liability. The proposals call for the establishment of greater creditor coherence and agreement on minimum concessionality benchmarks but fall short of calling for anything more than an informal arrangement. It also does not provide for creditor accountability for the contraction of non-concessional loans by affected countries, even if the loan is a bilateral credit arrangement and the official creditor is the state or organ of the state that is party to the IDA or other multilateral surveillance arrangement.

As Eurodad has pointed out in their comment on IDA's proposals, there is an iniquity in the design of measures which result in the borrower bearing the burnt of punitive measures for breaches of concessionality thresholds and the creditor bearing no responsibility (Oddone, 2006). While the borrower assumes the 'punishment' of reduced aid flows as a result of contracting a non-concessional loan which exceeds the minimum concessionality benchmark, the creditor assumes little, if any, of the losses, protected by the financing agreement entered into for the loan which guarantees its repayments by the country regardless.

The IDA proposals are targeted at the demand side of non-concessional financing and not at the supply side of such financing and even the effectiveness of these measures are

questionable. The Bank admits that there may be cases where it has 'little leverage to reduce instances of free riding, even with strong disincentives', notably in cases 'where IDA allocation is very small relative to available non-concessional financing sources, such as are available for mineral-rich countries' (IDA, 2006: para 38).

However, it is hoped that these punitive measures linking IDA disbursements to non-concessional borrowings may deter countries from undertaking non-concessional loans if similar measures are adopted by other official creditors or 'if other donors take these IDA measures as a signal for their own grant programs' (ibid). IDA is therefore advocating for other official creditors to withdraw concessional financing from countries which IDA have identified as having breached concessionality guidelines and/or where incidences of 'free riding' have been detected.

In this manner, resource-strapped countries are further penalised for trying to access financing for development while at the same time, being subjected to tighter conditions for access to existing financing and reduction in official resources, while creditors act with impunity and are not subjected to similar disincentives for providing non-concessional financing.

This is even more acute for commercial creditors who 'free ride' as they are less subject to the peer pressure that sovereign creditors may be subjected to under the auspices of the Bank and Fund or Paris Club coordination mechanisms to assume some responsibility for concessionality breaches. The IDA recognises that the 'mere adoption of a common approach to concessionality is unlikely to prevent free riding by opportunistic lenders' as evidenced by the instances of the creditor litigation in the context of the HIPC countries (IDA, 2006: para 29). Most commercial creditors have failed to commit their share of HIPC relief and 'more than a few have initiated litigation against HIPCs to recover debt', winning awards of at least US$586 million in nine HIPC countries as of 2005' (World Bank, 2006a: para 2.6).

The HIPC experience has also demonstrated that a 'common' mechanism that is designed and driven by one set of creditors – the IFIs, led primarily by the Bank and the Fund and their major shareholders – and imposed on another set of creditors (namely non-Paris Club creditors, and commercial lenders), will not be effective in achieving

policy consensus and uniformity in delivery of commitments because of the perception of partiality (see Greenhill and Pettifor, 2002; see also World Bank, 2006a: paras 2.1 – 2.8).

Similarly, under the IDA proposals, it is not only the Bank and the Fund who are setting the concessionality benchmarks to be adhered to by other creditors but these institutions are also assessing country's compliance with such benchmarks and debt sustainability thresholds under the DSF. It is therefore unlikely, and unsurprisingly so, that these measures would be adopted by other official creditors (and less so by commercial creditors) aside from possibly the Paris Club creditors who also represent the major shareholders of the Bank and the Fund.

b) Exacerbating resource gaps

The proposal to link grant eligibility with the breaches of concessionality benchmarks in new borrowings by IDA countries will further exacerbate resource gaps in these countries. As discussed in section 1, the new allocation system under IDA 14 which provides only grants instead of credits to highly debt distressed countries will result in countries receiving fewer resources. Meanwhile, for debt relief-eligible countries, implementation of MDRI may also imply further cuts in official development assistance as 'even with full additionality, *new IDA commitments* to most eligible HIPC countries would decrease over the IDA 14, since debt service forgiven is netted out of new commitments' (IDA, 2005a: para 31). In the context of an overall decline in official flows to developing countries, including in official development assistance (ODA), IDA measures will further limit countries' access to external financing by circumscribing their ability to contract non-concessional loans and/or reducing the volumes of their official financial inflows.

The staff paper does not consider the reasons why countries are turning to non-concessional borrowing as a source of external financing, notably the decrease in and volatility of ODA flows and the onerous terms attached to official financing, especially from the IFIs. As suggested by Eurodad, the IDA has failed to consider the costs associated with conventional financing sources, including inappropriate economic conditions attached to such financing, which has prompted IDA countries to seek

alternative income streams, including from other official sources such as China (see Oddone, 2006; also Eurodad, 2006).

The volatility of aid flows as a revenue stream for developing countries has been well-researched and documented with empirical work suggesting that aid volatility 'exceeds that of other macroeconomic variables, such as GDP or fiscal revenue' with aid flows being contingent upon the political commitments of donor countries and with large temporal gaps between budgeted commitments and actual disbursements (United Nations, 2005: 112- 116). This volatility is exacerbated by aid conditionality, including the need for IMF approval by most official creditors and specific conditions required by donors (ibid: 116), including criteria under IDA's complex performance-based allocation system.

In spite of these considerations, the Bank prefers to assign fault with countries which exceed the Bretton Woods institutions' concessionality benchmarks, arguing that reductions in grant volumes are necessary and consistent with the Millennium Development Goals (MDGs) 'since governments who take on irresponsible non-concessional borrowing are usually not taking into account what is best for the country's long-term poverty reduction goals' (IDA, 2006: para 35).

Moreover, not only does IDA fail to acknowledge its own complicity in countries' sourcing for alternative sources of financing through its grant allocation framework and other aid practices, it does not adequately address the impact of proposed measures on countries involved. Although the Bank acknowledges that 'affected countries may attempt to compensate for their reduced IDA allocations by seeking further non-concessional financing from other creditors' (ibid: para 39), it does not provide solutions to this problem, assuming that countries will have to seek more appropriate financing elsewhere or reduce government expenditures as a result of grant cutbacks.

It is interesting to note here that the Fund is not fully supportive of the IDA's proposals to link concessional financing with breaches of concessionality thresholds by countries, preferring a focus on improved monitoring and strengthened debt management strategies in low-income countries. The Fund's recent review of the DSF argues that measures by 'a subset of donors, such as IDA' to reduce financing volumes to 'countries

that borrow excessively on commercial terms' is a '*less preferable approach*' to addressing the issue of debt sustainability (IMF, 2006: para 50, emphasis added).

c) Flawed assessment modalities

The anti-'free riding' measures outlined by IDA in its paper are premised upon an underlying assumption that borrowing countries and their lenders are not equipped to assess the relative risks of their non-concessional financing. There is a paternalism which underpins the Bank and Fund's approach to debt sustainability, particularly in relation to the accumulation of non-concessional debt by low-income countries, which assumes that only the Bretton Woods institutions have the capacity to assess a country's debt sustainability and ability to assume further financial obligations instead of the country itself or international capital markets.

Implicit in the paper is that financial markets do not make competent assessments of countries' debt sustainability or if they do make rational choices to lend to highly distressed countries, such lending must be premised only on the improved repayment prospects guaranteed by the overall reduction of debt obligations as a result of IDA grants and debt relief (see for example, IDA, 2006: para 10). Correspondingly, countries are not entrusted with the task of managing their own debt, having to be reigned in by IDA disincentive measures and IMF conditionality in order for them not to fall into future debt distress. And yet, the efficacy and appropriateness of modalities for assessing debt sustainability and concessionality of new borrowings under the auspices of the Bank and Fund remain questionable.

Ownership of the DSF resides with the Bank and Fund and not their borrowing members. The modalities of assessing debt sustainability under the DSF remain driven by the Bretton Woods institutions with little input from borrowing member governments. Although countries are made to supply critical financial information about their debt status and debt contraction plans, the design of measures on how to deal with breaches of debt thresholds and concessionality benchmarks for new borrowings remain the purview of the Bank and the Fund using their own criteria for judgment.

Furthermore, as various commentators have argued, the concept of 'debt sustainability' itself remains 'a highly ambiguous and manipulatable … political notion' (Callaghy, 2003: 212). Quoting a western creditor official, Callaghy has pointed out that debt sustainability assessments are more art than science with the political determinants of such evaluations as contingent upon the final outcomes as the actual figures determining the level of debt distress (ibid: 212 – 213).

The DSF methodology remains undeveloped with only the modalities completed for the first pillar of the framework (see section 1). The DSF has been subjected to a host of negative critique (see for example, Alexander, 2004; Kappagoda and Alexander, 2004; Northover, 2004; Oddone, 2005), the details of which, particularly with regard to specific econometric data and methodology, are outside the scope of this paper.

However, one of the chief criticisms levelled at the DSF worth highlighting here is the fact that the debt sustainability thresholds are based on the 'quality' of the countries' social, economic and even political governance institutions and policies, as assessed by their CPIA rankings[11]. The Bank and Fund view the institutional and policy environment as key factors influencing the debt sustainability levels of countries, arguing that '[c]ountries operating in a weaker institutional and policy environment are likely to experience debt distress at significantly lower debt ratios, as such countries tend to be more prone to misuse and mismanagement of funds and less capable of using their resources productively' (IMF and IDA, 2004b: para 25).

Aside from the questionable decision to include policy and institutional indicators into a debt sustainability assessment, commentators have also expressed serious misgivings over the adoption of the CPIA as 'a central determinant of future creditworthiness' (Northover, 2004: 5). The CPIA index has been criticised for its partiality of its assessments – relying on the subjective judgments of World Bank staff – and the lack of empirical evidence and rigour of the criteria upon which such evaluations are based (ibid; also Alexander, 2004:). As such, the reliance on 'a weak analytical tool' (Northover, ibid) as forming a significant part of the DSF raises questions about the viability of the DSF itself as a mechanism for evaluating the debt distress of countries, and subsequently, for determining the concessionality limits of their new borrowings.

[11] See discussion in section 1 for details on the CPIA.

Conclusion

Measures to address the 'free rider' question will form a pivotal plank in the World Bank's strategy towards low-income borrowing members and will also inform some of the IMF's policies in this respect. This paper has considered the proposals in detail, placing the measures proposed by IDA in relation to the DSF, IDA's grant allocation system and IDA 14's replenishment terms as well as with regard to debt relief under the MDRI. This paper has further analysed the proposals in light of current trends in development financing policy and practice, particularly the shifting patterns of official and private financial flows to developing countries, and the demonstrated the disjuncture between the conceptual approach of the Bank and Fund to the issue of 'free riding' and their operational practice over the past two decades.

There appears to be significant inconsistency in the general policies espoused by the Bretton Woods institutions and their problematisation of the issue of non-concessional borrowing by grant and debt relief-eligible low-income countries. This incoherence must be placed within the context of developments in the current global political economy and the diminishing relevance of the Bank and the Fund to many developing countries today. Such a contextualisation will help explain why these institutions are deeply concerned with the potential for non-concessional lenders (and perhaps concessional creditors in due course) to assume benefits, if any, of IDA grants and debt relief under the HIPC initiative and the MDRI.

The World Bank's own research in the recently released annual *Global Development Financing (GDF)* report 2006, notes that the net official flows of grants and loans have continued to decline in 2005 for the fourth consecutive year and while net disbursements of ODA has risen dramatically, most of this reflects Paris Club debt relief to Iraq and Nigeria (World Bank, 2006b: 7). The report notes that net official outflows from developing countries came to US$71.4 billion, primarily from large repayments of middle-income countries to the IMF and large prepayments to bilateral creditors (ibid). Due to repayments by Indonesia, Russia, Argentina, Brazil and Turkey in last year, gross

lending by the IMF has declined from about US$30 billion in 2002 and 2003 to only US$4 billion in 2005 (ibid).

Middle-income countries are also much less reliant on financial flows from official northern creditors for financing needs, especially financial support from multilateral institutions. While official lending flows have decreased, net flows of private capital – in the form of bond issues, bank lending and portfolio equity among others – to developing countries have increased dramatically, peaking at US$491 billion in 2005, the highest level on record, as middle-income countries' creditworthiness on the international capital markets continue to improve (World Bank, 2006b: 2 & 4).

The growing wealth of these countries have also resulted in the emergence of another pattern in global financial flows – rapidly increasing capital flows among developing countries. These 'South-South flows' have facilitated capital inflows to low-income countries as private capital from middle-income countries seek investment in these countries with South-South foreign direct investment (FDI) flows constituting 36 percent of total FDI flows to developing countries in 2003, up from 16 percent in 1995 (ibid: 1; 107 – 108). Middle-income countries, notably Brazil, Chile, China, India, South Africa and Thailand, have also emerged as aid donors, however marginal, providing concessional financing (two percent of total ODA), as well as non-concessional export credits, to low-income countries, mostly in sub-Saharan Africa (ibid: 109, Box 4.1). China accounted for more than half of concessional lending from developing countries from 1994 to 2004 according to the *GDF (ibid)*.

Given these developments, it is clear that the Bretton Woods institutions are becoming increasingly sidelined in the global economy today. As middle-income countries continue to seek alternative sources of financing for development and economic growth and with more low-income countries graduating from IMF programmes, the Bank and Fund are increasingly anxious about their role in their traditional base of developing countries and their financial future. In addition to such international economic developments, internal policy shifts, notably that of IDA's move towards grants from loans, and debt relief initiatives threaten the financial strength of the institutions and provide the institutional impetus to design methods to maintain both their relevance to and control over their borrowing members.

Therefore, while the development of the new non-financing PSI at the Fund may serve to continue binding low-income countries which may otherwise have graduated from Fund programmes after the conclusion of their PRGF operations, the Bank's proposals to curb what it perceives as the 'free riding' potential of non-concessional borrowings by IDA members may be similarly viewed as a means of maintaining Bank control over external financing resources of these countries.

While concern over the debt sustainability of its member countries is warranted, the measures outlined by the Bank and the conceptualisation of the problem of 'free riding' are inconsistent with previous and existing Bank policy and practice and indicates a deeper motivation than concern over the risk of debt distress. Instead, the measures appear to seek to curtail the right of countries to seek alternative sources of financing, with the Bank viewing non-Bank lenders, official or otherwise, as not only potential competitors for the business of low-income countries but also as threats to the financial integrity and political hegemony of the Bank.

Ultimately, all these measures fail to address the critical twin problems of the debt overhang and resource gap faced by many low-income countries. Instead, they reflect the institutions' (and their major shareholders') efforts to keep these countries on a short leash vis-à-vis external financing and the lack of political will to commit to a sustainable and equitable programme of debt relief and concessional financing that is not contingent upon the political whims of developed countries but focused instead on a systematic overhaul of the currently deficient international financial architecture. Any proposals outlined by the Bank (and the Fund) to address the issue of 'free riding' and non-concessional borrowing by member states must therefore be analysed in light of these considerations.

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Centre for the Study of Globalisation and Regionalisation

University of Warwick
Coventry CV4 7AL, UK

Tel: +44 (0)24 7657 2533
Fax: +44 (0)24 7657 2548
Email: csgr@warwick.ac.uk
Web address: http://www.csgr.org