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Debt Cancellation for Somalia:

The Road to Peace, Poverty Alleviation and Development

Policy Brief



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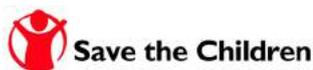
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Acronyms

AfDB:	African Development Bank
DPO:	Development Policy Operation (of the World Bank)
DSA:	Debt Sustainability Analysis
DSF:	Debt Sustainability Framework
ECF:	Extended Credit Facility
FCAS:	Fragile and Conflict Affected Situations
FGS:	Federal Government of Somalia
HIPC:	Heavily Indebted Poor Country
IDA:	International Development Agency
IFI:	International Financial Institutions
IMF:	International Monetary Fund
MDRI:	Multilateral Debt Relief Initiative
NDP:	National Development Plan
NDS:	New Partnership for Somalia
NPV:	Net Present Value
PRSP:	Poverty Reduction Strategy Paper
SCF:	Standby Credit-Facility
SMP:	Staff Monitored Program
TSF:	Transitional Support Facility
TWG:	Technical Working Group
UCT:	Upper Credit Tranche

I. Introduction

This brief advocates for an accelerated and full debt relief process¹ such that Somalia:

- Receives full debt cancellation² so that resources can be channelled to vast humanitarian, reconstruction and development needs rather than debt servicing; and
- Can access currently blocked grants and concessional loans for new public investments that will stimulate private sector investment and broader human development.

The brief aims to increase awareness of how Somalia's external debt impacts the country's access to resources that are critical for economic recovery and socioeconomic development. Key topics include:

- The historical context and current status of Somalia's external debt problem;
- The debt relief process and Somalia's engagement in the process;
- The level of debt relief required for Somalia and the country's ability to pay residual debt service obligations post-debt relief;
- Reasons to accelerate the process; and
- Recommendations for decision-makers to accelerate and maximise debt relief for full debt cancellation

Overall, the brief seeks to enhance the impetus for Somalia's external creditors to move towards expedited and full debt cancellation.

1 The debt relief process includes the separate but interlinked processes of arrears clearance, HIPC Initiative, MDRI and beyond-HIPC debt relief (explained in Section IV).

2 We define full debt cancellation for Somalia as the maximization of debt relief through the IFI arrears clearance process, HIPC Initiative, MDRI and beyond-HIPC debt relief such that the country is relieved of all of its current debt stock and future post-HIPC debt servicing.

II. Background and Context

As a result of protracted armed conflict, Somalia is one of Sub-Saharan Africa's most troubled and underdeveloped countries. Following the collapse of the central government in 1991, the country has been plagued with violent conflict and insurgency, extreme and widespread poverty, acute food shortages, weak governance and political instability, economic underdevelopment, human rights abuses and recurring natural disasters such as droughts and floods. Somalis to date lack essential security services, healthcare, education and safe drinking water, and have very limited employment opportunities. The Federal Government of Somalia (FGS) has meagre resources to meet the country's pressing needs.

The parliamentary and presidential elections in 2012 led to renewed international recognition of the FGS and its constructive re-engagement with the international community. This, however, led to the inheritance of external debts accumulated by Somalia's former governments, leaving the country with the status of being a heavily indebted poor country with an external debt of US\$ 4.6 billion (as of end 2017), including sizeable arrears to bilateral and multilateral creditors. Consequently, the country's external debt overhang and its large stock of arrears restrict it from accessing critically needed financial resources from the international community, which are essential for the reconstruction and development of Somalia.

At the London Somalia Conference on May 11, 2017, following the New Deal for Somalia Brussels Conference in 2013, the international community renewed its political

and financial commitments to Somalia under the New Partnership for Somalia (NPS). The NPS seeks to promote peace and stability, foster economic development, engender political reform, improve governance and scale-up humanitarian assistance. The NPS is informed by Somalia's National Development Plan (NDP) 2017-2019.

Achieving the NPS and NDP objectives requires Somalia and its development partners to address major development challenges facing the country, such as stimulating economic recovery, improving governance and reducing poverty. This is made difficult by the fragile fiscal positions of the FGS and subnational administrations with an extremely narrow domestic revenue base (chiefly relying on customs duties collected at airports and seaports) and very limited access to budget and project grants. This severely constrains the country's ability to address development challenges. Donor assistance is primarily humanitarian focused for relieving immediate needs, with minimal longer-term investment, such as for economic infrastructure and broader social development assistance.

Somalia's long and protracted armed conflict has destroyed physical, human, and institutional capital, meaning recovery and poverty alleviation efforts are immense and cannot be addressed solely through grants, but must be augmented with substantive additional resources. However, Somalia's external indebtedness remains a roadblock to receiving concessional loans and additional grants. Without such resources, Somalia is severely constrained in achieving NPS and NDP objectives, such as poverty alleviation and economic development.

III. Origins and Status of Somalia's External Debt Problem

The story of Somalia's current external debt problem must be embedded in its historical context. Since independence, Somalia's past governments contracted loans from bilateral and multilateral creditors to finance various political, economic and social objectives. Most of the external debt was used to fund the former government's ambitious Public Investments Program and to provide balance-of-payments support³. A significant portion of the debt was also used to finance the government's military expenditures from the 1960s through to the late 1980s, including years of civil war⁴.

During the 1980s, Somalia faced difficulties servicing debt, resulting in the government concluding two rescheduling agreements with the Paris Club, an informal group of creditor governments of wealthy industrialized countries who convene to negotiate with countries facing external debt problems. By 1990, Somalia's outstanding external debt rose to 277% of GDP⁵. When the central government collapsed in 1991,

the country began to accumulate arrears on its external debt obligations.

26 years later and Somalia's external public debt is estimated to be US\$ 4.6 billion⁶ (as of the end of 2017). Somalia has a total of 27 known creditors that are divided into three categories: multilateral, Paris Club and non-Paris Club with 32.8%, 53.8% and 13.4% owed to each respectively (see Figure One)⁷. The country's top five (5) largest creditors are the US (~22%), Italy (~13%), France (~9%), the World Bank (~11%) and the International Monetary Fund (IMF) (~7%)⁸. It is important to note that Somalia's external debt data are estimates, as the government continues to reconcile and validate its current external debt database with creditors⁹.

As for debt cancellation or rescheduling negotiations, so far, China has provided Somalia with full debt cancellation on its claims¹⁰ and Saudi Arabia has rescheduled its claims on Somalia as of 2016, rescheduling approximately US\$ 106 million in claims¹¹.

3 Mubarak, J.A. 1996. From bad policy to chaos in Somalia: How an economy fell apart. Westport, Greenwood Publishing Group, p.81.

4 For a more detailed account of Somalia's military expenditures prior to the outbreak of the civil war, see Fitzgerald, N.J. 2002. Somalia: Issues, History and Bibliography. New York, Nova Science Publishers, p.62-75.

5 Mubarak, J.A. 1996. From bad policy to chaos in Somalia: How an economy fell apart. Westport, Greenwood Publishing Group, p.16.

6 Somalia's external debt data is updated on a yearly basis. As Somalia has not taken on new loans since 1991, the country's external debt data does not change significantly year-on-year, with only currency-related adjustments, minimal accruing debt service (>90% of Somalia's debt is in arrears), late/penalty interest on external debt arrears accruing, and no debt servicing being made by Somalia.

7 Based on estimates provided to the IMF by the Federal Government (see IMF Country Report No. 18/212)

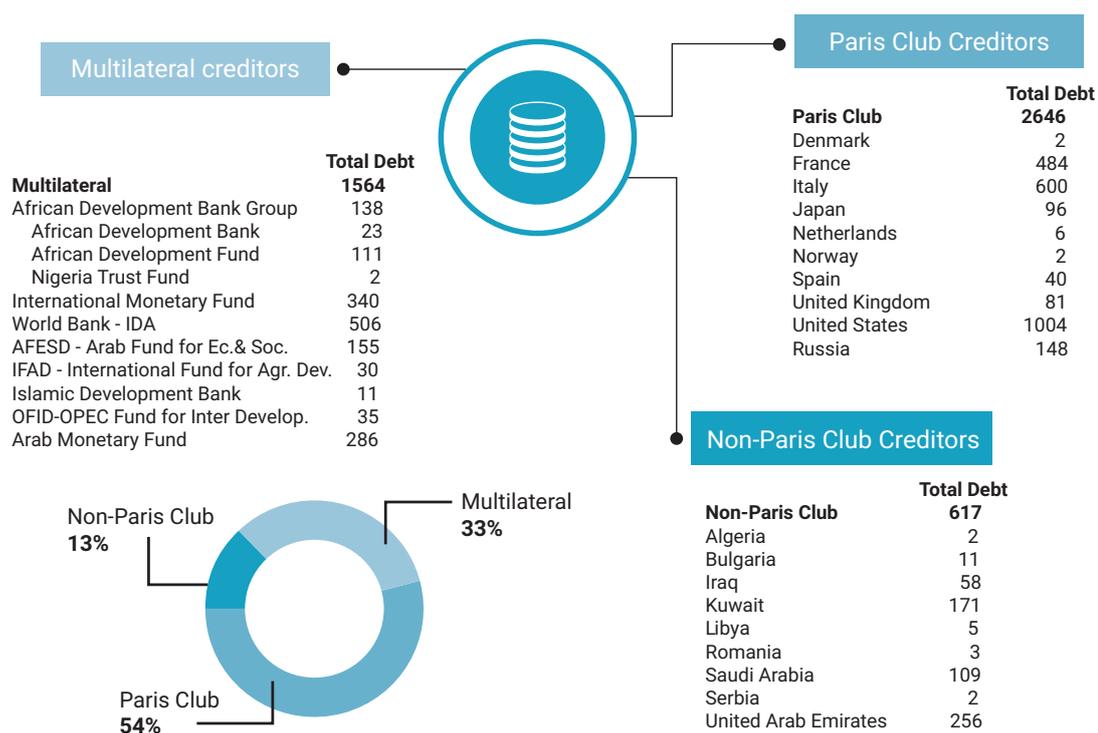
8 *ibid.*

9 To date, the Somali authorities have not initiated the exercise to reconstruct external commercial debt.

10 See IMF Country Report No. 15/208.

11 See IMF Country Report No. 18/55.

Figure 1: Somalia's External Debt at End-December 2017



Most external creditors are cognisant of the FGS' challenges and do not expect to receive payment on past and current debt obligations until there is a resolution of Somalia's external debt problem through debt relief processes. This expectation, on the part of Somalia's external multilateral and bilateral creditors, is evident in the formation of the Somalia Technical Working Group (TWG) on External Debt. The Somalia TWG, co-chaired by the FGS, the IMF and the World Bank, invites all bilateral and multilateral creditors to participate on a voluntary basis. The Somalia TWG on External Debt serves as an informal platform whereby Somalia and its creditors exchange information on the country's external debt, discuss issues pertaining to Somalia's progression in the debt relief process, take stock of the country's track record of reforms, and identify any capacity gaps that can be addressed so as to help facilitate the country's progression through the debt relief process¹². To date, there have only been two

meetings of the Somalia TWG on External Debt, with one taking place alongside the IMF-World Bank Annual Meetings in 2013 and the other alongside the IMF-World Bank Spring Meetings in 2015.

The majority of the Somalia's population (~67%)¹³ was born well after the 1980s civil war, receiving scant benefit from what Somalia's US\$ 4.6 billion external debt was used on, such as development projects whose impact has not been sustained, due to destructive armed conflict. It is unreasonable to saddle the current generation with these debts and even more problematic when these debts also restrict access to critically needed grants and concessional resources.

In this context, there is a clear case for debt cancellation and the expeditious resolution of Somalia's external debt problem, so that the current population can benefit from access to additional grants and concessional loans.

12 See African Development Bank Addendum to Somalia Country Brief 2013-2016 < https://www.afdb.org%2Ffileadmin%2Fuploads%2Fafdb%2FDocuments%2FProject-and-Operations%2F2013-2015_-_Somalia_-_Addendum_to_Country_Brief.pdf&us-g=A0vVaw2lis2-7bGSgcbZosK0iTA>

13 See UNESCO <http://uis.unesco.org/country/SO> for total population of Somalia by age group. 67% represents the total number of Somalis aged 24 years or younger.

IV. Processes for Resolving Somalia's External Debt

Somalia can resolve its external debt problem through the following interlinked debt relief processes:

- (A) Arrears Clearance;
- (B) Heavily Indebted Poor Country (HIPC) Initiative;
- (C) Beyond-HIPC Debt Relief; and
- (D) Multilateral Debt Relief Initiative (MDRI).

These processes are discussed below.

A. Arrears Clearance

In fragile and conflict-affected situations (FCAS), one of the main challenges that countries may face is the buildup of arrears after years of non-payment to International Financial Institutions (IFIs)¹⁴. In the case of Somalia, the size of arrears owed to IFIs is sizeable, with the country owing approximately US\$334 million to the IMF, US\$ 315 million to the World Bank and US\$ 102 million to the African Development Bank (AfDB) as of end-June 2017¹⁵.

For Somalia to normalise relations with IFIs and progress towards debt relief, the country needs to first clear arrears owed to IFIs. Not doing so will be a roadblock towards broader debt relief and will prevent the country from accessing IFI grants and concessional loans.

To assist countries owing arrears to IFIs, IFI Executive Boards can decide to use internal resources to support arrears clearance operations. These resources can only be utilised for arrears clearance when the prospects of qualifying for the HIPC Initiative are high. To be eligible for arrears clearance, a country must owe arrears to IFIs, be grandfathered into the HIPC Initiative as of end-2006 and must not yet have qualified for the HIPC Initiative¹⁶.

For the foreseeable future, the Somali Government will be unable to clear its arrears using its own resources, and should thus be eligible for IFI arrears clearance support based on the aforementioned eligibility criteria. Nevertheless, the IFIs will make their own assessment on Somalia's capacity to repay its arrears to determine the country's eligibility for arrears clearance support.

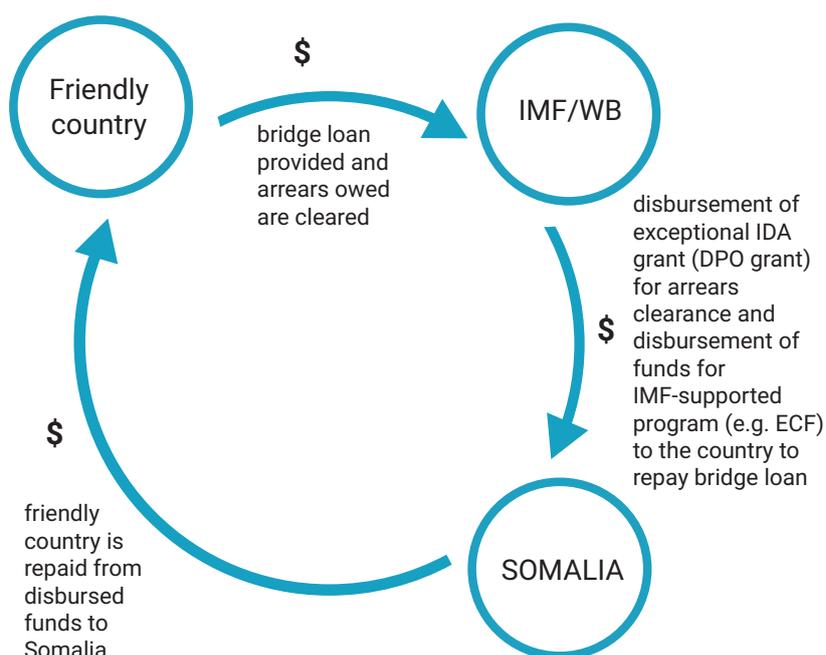
The clearance of arrears is coordinated between IFIs and counts towards the execution of debt relief on their part. However, each IFI has its own criteria to determine if a country qualifies for exceptional arrears clearance support. Typically, the arrears clearance eligibility criteria include, among other IFI-specific criteria, the country's demonstration of:

14 The International Monetary Fund, World Bank and regional development banks such as the Inter-American Development Bank, the Asian Development Bank and African Development Bank.

15 See Review of Overdue Financial Obligations to the Fund and Further Review Following Declaration of Ineligibility (July 9, 2018) < <https://www.imf.org/en/Publications/Policy-Papers/Issues/2018/07/09/pp072017-review-of-the-funds-strategy-on-overdue-financial-obligations>>. The arrear amounts stated above were calculated from SDR amounts provided in the report using 30 June 2017 US\$/XDR exchange rate, as the amounts stated in SDR were as of end-June 2017.

16 See IDA's Further Elaboration of a Systematic Approach to Arrears Clearance (2007).

Figure 2: How Somalia's IMF and World Bank arrears would be cleared



1. Progress in its re-engagement process with the international financial community, particularly cooperation with the IMF;
2. Long-term debt sustainability, meaning the country is close to qualifying for the HIPC Initiative (essentially closer to relieving its debt burden and not falling back into arrears); and
3. Substantive effort to settle or have a plan in place for arrears clearance through either mobilising domestic or donor resources.

The preferred IFI approach to arrears clearance is to conduct IFI arrears clearance operations simultaneously to avoid discriminatory preference. However, it is also possible to sequentially clear IFI arrears, if agreed among IFIs. Although IFI arrears clearance occurs before the clearance of non-IFI multilaterals, a country nearing IFI arrears clearance is encouraged to normalise (clear arrears) with other multilaterals¹⁷.

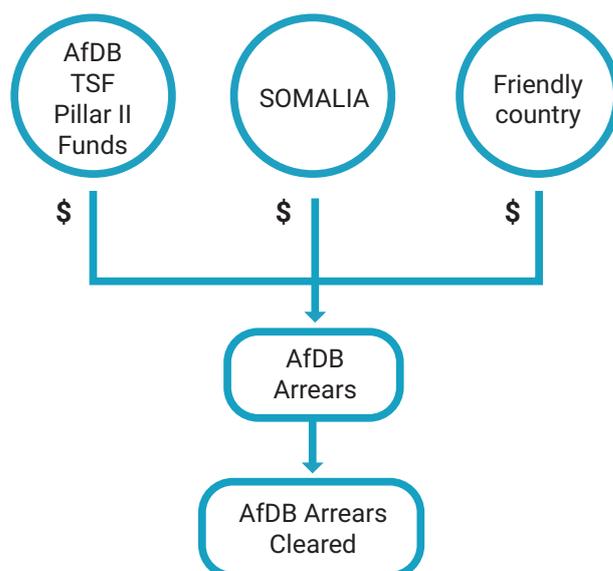
As per the policies of the IMF and the World Bank, should a member country be unable

to clear arrears with domestic resources, a 'friendly' country (or multiple) can step in to provide a bridge loan that will cover the arrears owed. The IMF and World Bank arrears clearance operation is structured in such a way that shortly after funds from the bridge loan are provided, the 'friendly' country will be promptly repaid from IFI resources. In the case of the IMF, a loan would be used and for the World Bank, a Development Policy Operation (DPO) grant would be disbursed through the Bank's exceptional arrears clearance support. Figure Two illustrates how an arrears clearance operation would work for both institutions.

For the AfDB, its guidelines for arrears clearance stipulates that arrears are to be cleared through a tripartite burden sharing arrangement between the country in arrears, the AfDB and a 'friendly' donor country (or multiple) (see Figure Three). In past FCAS cases, the AfDB was flexible in requiring the debtor to contribute a 1% symbolic payment, while the AfDB provided approximately two-thirds from the Arrears Clearance Window (Pillar II) of the Transitional Support Facility

¹⁷ The grant element of arrears that are rescheduled to normalize financial relations with non-IFI multilaterals is counted towards their participation in the HIPC Initiative

Figure 3: AfDB Arrears Clearance Process



(TSF) and the remaining amounts covered by the ‘friendly’ donor country.

Clearance of IFI arrears is critically important for Somalia, as it would unlock fresh lending and a higher allocation of grant resources from the World Bank and the AfDB¹⁸. Moreover, the IFI arrears clearance process is closely tied to the HIPC Initiative, and is a pre-condition for progressing to the second stage of the initiative, as it would enable Somalia to enter into an IMF-supported program of Upper Credit Tranche (UCT) quality and thus develop a track record of performance (explained in more detail later).

B. Heavily Indebted Poor Country (HIPC) Initiative

The HIPC Initiative was launched in 1996 by the IMF, the World Bank and the Paris Club to relieve the debts of HIPCs to sustainable levels. The HIPC Initiative is significant in that it is the only internationally agreed upon framework for providing comprehensive debt relief to low-income countries qualifying under the initiative, and also serves as the

framework for coordinating debt relief efforts between IFIs, multilaterals, Paris Club, non-Paris Club and commercial creditors.

In 1999, the HIPC Initiative was revamped into the Enhanced HIPC Initiative, offering broader, deeper and faster debt relief than its predecessor, and to a larger number of countries¹⁹. The Enhanced HIPC Initiative also differs from its predecessor through its linkage of debt relief with poverty alleviation, making it a condition that eligible countries formulate and implement a poverty reduction strategy paper (PRSP) that outlines specific government interventions and/or policies that aim to alleviate poverty in the country²⁰.

The HIPC process consists of two stages: (i) the HIPC prequalification stage and (ii) the HIPC qualification stage.

i. HIPC Prequalification Stage

During the prequalification stage, a country must first meet a number of criteria to qualify as a HIPC-eligible country. The country must be among the list of approved

18 For both the World Bank and AfDB, concessional lending may be restricted for the short-to-medium term post-arrears clearance, as Somalia would be categorized by the World Bank as a grant-only country. Similar treatment may also be applied to Somalia by the AfDB.

19 Schier, H. 2007. *Towards a Reorganisation System for Sovereign Debt – An International Law Perspective*. Leiden, Martinus Nijhoff Publishers.

20 See Debt Relief Under the Heavily Indebted Poor Countries (HIPC) Initiative <<https://www.imf.org/en/About/Factsheets/Sheets/2016/08/01/16/11/Debt-Relief-Under-the-Heavily-Indebted-Poor-Countries-Initiative>>

countries assessed to meet the income and indebtedness criteria that were grandfathered into the HIPC Initiative in 2006. The country must also be designated by the World Bank as only able to access loans from the International Development Agency (IDA) (the World Bank's concessional-lending arm). Somalia is classified as an IDA-only country and was grandfathered into the HIPC Initiative in 2006.²¹

In working towards reaching the qualification stage of the HIPC process, a country must reconcile and validate its external debt data and strengthen its debt management capacity. With technical assistance from the AfDB and cooperation by Somalia's external creditors, the FGS is currently completing the reconstruction, reconciliation and validation of its external debt database in a validation round²². The FGS has also taken steps to strengthen debt management capacity with support from the AfDB.

To transition from the HIPC pre-qualification stage to the qualification stage, a country needs to develop a PRSP through a consultative process, clear arrears or have a strategy in place to do so (discussed in Section IV (A) above), and have the IMF and World Bank conduct an assessment to determine the level of relief required to bring debt to sustainable levels. Through a consultative process, the FGS is working towards developing its second NDP 2020-2024, one of sequential five-year development plans aligned with the FGS' Vision 2040. Once completed²³, the government intends on using the NDP 2020-2024 as the basis for its PRSP.

As a condition to qualify for HIPC debt relief, a country must also establish a track record of reform and sound policies through IMF and World Bank-supported programs to showcase capacity to prudently utilise resources that would be unlocked through the debt relief process. For countries in arrears that endeavour to move through the pre-qualification stage of the HIPC Initiative, such as Somalia, they are eligible to obtain financing from IFIs prior to arrears clearance through pre-arrears clearance grants²⁴ from the World Bank and AfDB to help address urgent needs (see Box 1).

In practice, to qualify for the HIPC Initiative, a country is required to have implemented a minimum six-month track record of reform and sound policies through an IMF-supported program of UCT quality²⁵. Essentially, this means that a government needs to implement an IMF program with stringent conditionalities that will be a litmus test of the government's commitment and capacity to implement policies that will, in the IMF's view, rectify the balance of payments problem.

In the context of the HIPC Initiative, IMF-supported programs that count towards a country's track record include the IMF's Extended Credit Facility (ECF) and the Standby Credit Facility (SCF). However, for countries in arrears with the IMF (often FCAS countries like Somalia), ECF and SCF programs are out of reach on account of arrears owed to the IMF. Instead, the norm has been to enter into an informal IMF Staff Monitored Program (SMP) to begin the process of reforms and sound policy implementation. In the case of

21 Based on the country's IDA-only status and end-2004 debt burden indicators. See Table 5. Status of HIPC Initiative Implementation and Ring-Fencing at End-2006 of the IMF and World Bank Heavily Indebted Poor Countries (HIPC) Initiative and Multilateral Debt Relief Initiative (MDRI) – Status of Implementation and Proposals for the Future of the HIPC Initiative, November 8, 2011.

22 See IMF Country Report No. 18/55.

23 The first draft of the NDP 2020-2024 is required to be developed by March 2019 as a structural benchmark of SMP III (see IMF Country Report No. 18/212).

24 Here, the term pre-arrears clearance grants are meant to refer to grants provided prior to arrears clearance. It should be noted that the financial assistance provided by the World Bank to countries in arrears is termed "pre-arrears clearance grant".

25 In the original HIPC Initiative, countries were required to have implemented an UCT-quality program for at least three years prior to Decision Point. To quicken the process to Decision Point, countries are required to show, at a minimum, a six-month track record of strong performance under an IMF-supported program.

countries that owe arrears to the IMF, less stringent SMPs are often recommended due to existing 'overdue financial obligations'

and the institutional and political capacity challenges to implement a definitive UCT-quality program.

Box 1: IFI Resources Available for Somalia During the Pre-Decision Point Period

The existence of arrears for FCAS countries is often a barrier to re-engagement with IFIs. To support the re-engagement of countries owing arrears to IFIs, the World Bank and AfDB have established financing windows through their concessional lending arms (IDA and ADF respectively) to provide limited, but critical resources to these countries²⁶.

For the World Bank, the process of obtaining a pre-arrears clearance grant requires the approval of its Board of Executive Directors, as countries in non-accrual status (countries owing external debt arrears) are restricted from accessing finances²⁷. The requirements for obtaining a pre-arrears clearance grant from the World Bank include: (i) good performance towards socio-economic recovery; (ii) existence of sizeable and protracted arrears to the World Bank; (iii) progress in re-engaging with the international financial community, with evidence of positive net resource transfer and creditor cooperation to ensure that resources are not withdrawn from the country; and (iv) evidence that resources for reconstruction and development are insufficient. The granting of a pre-arrears clearance grant often indicates that a country is nearing IFI arrears clearance and Decision Point.

At the sidelines of the 2018 IMF-World Bank Annual Spring Meetings, a high-level roundtable for Somalia was held, wherein the World Bank indicated that a pre-arrears clearance grant proposal was being developed to be submitted to the World Bank's Board of Executive Directors for approval, signaling that the government is making gains on its reform agenda²⁸.

In addition to a pre-arrears clearance grant from the World Bank, the AfDB also provides resources to countries in arrears prior to arrears clearance under the TSF, with resources coming from the ADF. The TSF is organised into three pillars, with grants from Pillar I (Supplemental Support) financing resilience building activities, Pillar II (Arrears Clearance) financing the AfDB's contribution to arrears clearance (discussed in Section IV (A)), and Pillar III (Targeted Support) financing capacity-building and technical assistance activities. Given Somalia's arrears situation, the AfDB has been able to tap into TSF grant resources from Pillar I and III to support ongoing projects in Somalia²⁹.

In the short-term prior to reaching Decision Point, Somalia will need to maximise its use of pre-arrears clearance grants from the World Bank and AfDB, so that the country can initiate and implement critical development projects to build institutional capacity, enhance resilience, embark on poverty reduction, improve critical infrastructure and create an enabling environment for private sector development.

26 See IDA's Further Elaboration of a Systematic Approach to Arrears Clearance (2007); and the AfDB's Operational Guidelines for the Implementation of the Strategy for Addressing Fragility and Building Resilience in Africa and for the Transition Support Facility, December 2014.

27 IDA's Further Elaboration of a Systematic Approach to Arrears Clearance (2007).

28 See Report of the Secretary-General on Somalia (S/2018/411) to the Security Council. < [29 See African Development Bank Somalia Country Brief 2017-2019 < \[11\]\(https://www.afdb.org%2Ffileadmin%2Fuploads%2Fafdb%2FDocuments%2FProject-and-Operations%2FSomalia-Country_Brief_2017-2020.pdf&usg=AOvVaw3bmzs- rVg-JxDSpS6naNG9K></p></div><div data-bbox=\)](https://www.securitycouncilreport.org%2Fatf%2Fcf%2F%257B65BFCF9B-6D27-4E9C-8CD3-CF6E4FF96FF9%257D%2Fs_pv_8259.pdf&usg=AOvVaw1dvTRvAs4KzLzTvK8kWriH></p></div><div data-bbox=)

It is important to note that on a case-by-case and exceptional basis, the IMF's Executive Board has the discretion to qualify a country for the HIPC Initiative in programs other than the ECF and SCF. These programs include the Rapid Financing Instrument, Rapid Credit Facility, Rights Accumulation Program and the SMP, if the country is deemed to have met the standards of UCT conditionality (as was the case of Liberia that had implemented a six-month SMP with UCT conditionality)³⁰.

The implementation of an IMF-supported program that meets UCT conditionality serves to provide the IMF's seal of approval, strongly signalling to creditors that the country is ready to move towards the Decision Point of the HIPC Initiative. This is articulated in a Preliminary HIPC Document prepared by the IMF and World Bank submitted to their respective Executive Boards six months in advance of Decision Point. The Decision Point is the point in which the Board of Executive Directors of the IMF and World Bank qualify a country for debt relief.

It is important to note that as part of the arrears clearance and HIPC process, the IMF and World Bank require that a country's external creditors provide financing assurances³¹ for debt relief prior to reaching IFI arrears clearance and the Decision Point, which largely occur concurrently. Obtaining financing assurances for debt relief may require external creditors, especially some Paris Club creditors, to legislate and budget for debt relief operations. The IMF and World Bank require these assurances in advance of arrears clearance to ensure that there is momentum for sufficient debt relief prior to Decision Point and to inform a prospective IMF-supported program (such as ECF) that

is to take place after IMF arrears are cleared and Decision Point is reached. Once sufficient financing assurances of participation in the HIPC Initiative are obtained from external creditors, the IMF and World Bank prepare the Decision Point Document that outlines the level of relief to be provided by each external creditor and the conditionalities for Completion Point. If external creditors (like the Paris Club) are unable to provide such assurances, it can delay and hamper the preparation of a Decision Point Document and thus prevent the country from reaching Decision Point³².

At the Decision Point, a cut-off date for the treatment of external debt is applied, typically at the end of the prior fiscal year from the date in which Decision Point is reached. Examples of two post-conflict countries that have achieved a track record of strong performance leading to Decision Point, which could serve as case studies for Somalia are Liberia and Afghanistan (see Box Two and Figure Four).

Somalia is making progress in implementing economic and financial reforms and has performed well under the preceding two IMF SMPs (SMP I and II completed in April 2017 and April 2018 respectively) and renegotiated the SMP III in May 2018. However, it should be noted that SMP III would not meet the standards of a UCT-quality program, meaning that Somalia's performance under SMP I-III does not count towards the country's track record of strong performance required to reach the Decision Point.

The 'light' nature of the current SMPs does not rule out the possibility of Somalia achieving the requirements to reach Decision Point. A best-case scenario for Somalia would be to

30 See Bal Gunduz, Y. and Crystallin, M. 2014. Do IMF Supported Programs Catalyze Donor Assistance to Low-Income Countries? IMF Working Paper, WP/14/202. Washington, DC: International Monetary Fund.

31 Under the framework, HIPC-eligible countries are encouraged to obtain financing assurances of at least 70% of HIPC-eligible debts prior to reaching Decision Point so as to encourage the country to obtain as much debt relief as possible from creditors. A country that is well under this threshold will have a hard time in making the case to reach Decision Point, as there isn't the "critical mass" for debt relief.

32 See Hurley, J. The Paris Club: Will the United States Be Asked to Leave? Center for Global Development. < <https://www.cgdev.org/blog/paris-club-will-united-states-be-asked-leave>>

follow a route similar to that taken by Liberia to reach Decision Point. In this scenario, IMF staff and FGS officials could revise the policy conditionalities of SMP III to meet the standards of a UCT-quality program (subject to the approval of IMF and World Bank Executive Boards) during the First Review of SMP III in the last quarter of 2018. With strong performance over the remaining six-month period, Somalia could be looking at reaching Decision Point in June or July of 2019.

The efforts of the FGS during the current prequalification stage of the HIPC Initiative showcase the government's commitment to

reform implementation and the resolution of its external debt problem³³.

At the conclusion of the Decision Point, creditors would lock-in the amount of debt relief to be provided at the completion of the HIPC qualification stage. As discussed in Section IV (A), prior to or at Decision Point, IFI arrears would be cleared, opening the door to IDA and ADF³⁴ grant resources to Somalia. Arrears clearance would also allow the country to enter into an IMF-supported program (such as ECF) needed to reach Decision Point, with the country also possibly benefiting from residual IMF resources after repaying the bridge loan.

Box 2: Afghanistan and Liberia's Progression Towards HIPC Decision Point

For Afghanistan, the sequence of events prior to Decision Point were as follows:

- Clearance of IFI arrears in February 2003
- IFI arrears clearance was completed outside the framework of the HIPC Initiative through a donor trust fund, as Afghanistan was not part of the countries originally included in the HIPC Initiative;
- Implementation of SMPs from 2004-2006;
- Agreement on a three-year Poverty Reduction Grant Facility (PRGF)-supported program (predecessor of the ECF program) in June 2006;
- A track record of strong performance under the PRGF for one-year;
- Officially met the eligibility criteria for the HIPC Initiative in April 2007; and
- Reached Decision Point in July 2007;

For Liberia:

- Agreement on SMP I in April 2006;
- Successful implementation of SMP I and agreement on SMP II in April 2007;
- IMF and World Bank Executive Boards agree that SMP II meets the conditions of a UCT-quality program during the First Review of SMP II in December 2007;
- World Bank and AfDB arrears cleared on December 2007;
- Decision Point reached and IMF arrears cleared on March 2008;

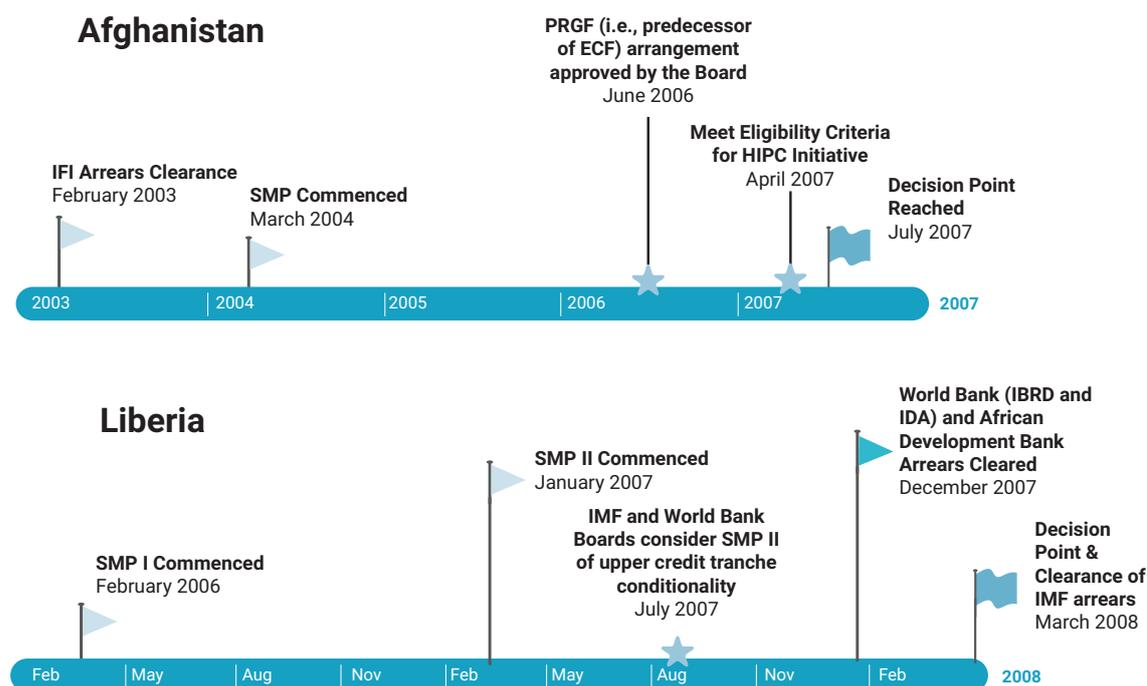
The activities surrounding the point at which Liberia reached the Decision Point is perhaps unique among HIPCs and set a precedent for the following reasons:

- IMF arrears clearance operation and Decision Point occurred almost in unison;
- IMF and World Bank Executive Boards utilised their discretion in determining that Liberia's SMP II satisfied the UCT conditionality required to reach Decision Point, showcasing a great deal of flexibility in the judgment of compliance with UCT conditionality for an SMP.

³³ For details of the government's reform achievements, see Table 2 of the IMF Country Report No. 18/212 for SMP II and Table 1 of the IMF Country Report No. 17/204 for SMP I.

³⁴ The African Development Fund (ADF) is the concessional financing window of the AfDB. The AfDB is its non-concessional financing window.

Figure 4: Timeline of Afghanistan and Liberia's Progression Toward HIPC Decision Point



ii. HIPC Qualification Stage

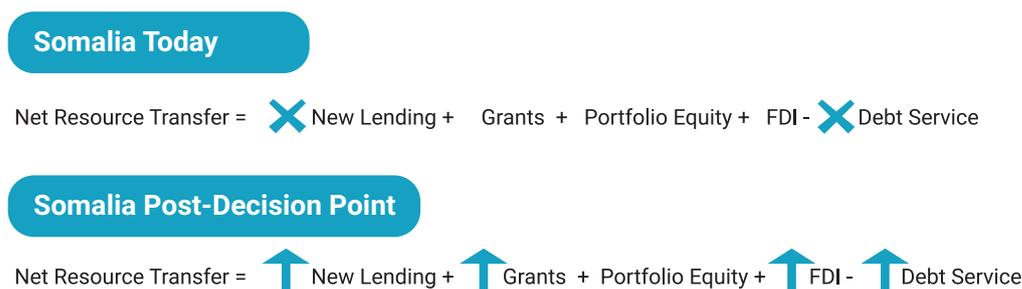
Upon completing the pre-qualification stage of the HIPC Initiative, Somalia would reach the Decision Point, thus qualifying the country for debt relief. At this point, the country would receive interim debt relief³⁵ from the IFIs on current and future debt service obligations up until the country graduates from the HIPC Initiative. At Decision Point or shortly thereafter, a country has Paris Club debts rescheduled on highly concessional terms³⁶ and is encouraged to seek similar terms from multilateral and non-Paris Club creditors, thus helping to normalise relations with its external creditors. If Somalia normalises relations with Paris Club, non-Paris Club and multilateral creditors, the country can technically resume financial relations and receive concessional loans and additional

grants from external creditors. At Decision Point under the HIPC framework, Somalia would need to timely and regularly service debt to Paris Club, multilateral and non-Paris Club creditors up until it completes the HIPC Initiative, which is made easier by Somalia entering highly concessional rescheduling agreements. However, this brief argues for Somalia not to be burdened with any debt servicing throughout the debt relief process. This is a way to ensure greater positive net financial transfers, meaning that there are greater inflows of grants and loans than debt servicing outflows. If debt servicing remains, any debt relief may only result in newly available resources then being diverted to debt servicing, thus not benefitting Somalia's peace and development efforts (see Figure Five).

³⁵ Interim relief from the IFIs would result in zero debt servicing to IFIs until the country reaches its Completion Point. To extinguish debt servicing for a country during this period, the IFIs essentially pay debt service that falls due to HIPC or MDRI trust funds, thereby ensuring that the country does not fall into arrears and that the financial integrity of IFIs are not compromised.

³⁶ At Decision Point, the Paris Club provides Cologne flow reschedulings (90% reduction in NPV terms of debt coming due from Decision Point to the end of the HIPC Initiative).

Figure 5: Net Resource Transfer for Somalia Today Versus Post-Decision Point³⁷



The importance of reaching Decision Point must be emphasised. Achieving this milestone will provide Somalia with new financing and the level of debt relief provided by creditors will then be determined. If this milestone is reached, there will be clarity on Somalia’s external debt situation, with the country normalising its financial relations with external creditors and the international financial community anticipating the eventuality of irrevocable debt relief. Such clarity and positive anticipation may help the country attract foreign direct investment (FDI) and encourage greater domestic private investment, as the private sector will gain access to important financing facilities.

Once Somalia reaches Decision Point, the country would then work towards reaching the Floating Completion Point of the Enhanced HIPC Initiative. This is the point at which external creditors provide irrevocable debt relief and requires the completion of the following conditions:

1. Continuation of an IMF-supported program to maintain macroeconomic stability (for no more than three years as per the framework of the Enhanced HIPC Initiative);
2. Implementation of completion point triggers (conditionalities) agreed between the FGS and the IMF and World Bank prior to Decision Point³⁸; and
3. Implementation of a PRSP for at least one year.

As a country is approaching the completion of the aforementioned conditions, the IMF and the World Bank prepare a Completion Point Document to be submitted to their Executive Boards, requesting graduation of the country to Completion Point of the HIPC Initiative, thereby granting irrevocable debt relief by external creditors.

C. Beyond-HIPC Debt Relief

After the country reaches the Completion Point of the HIPC Initiative and receives the HIPC-prescribed debt relief, external creditors can provide additional relief that goes beyond the HIPC Initiative. The beyond-HIPC debt relief is provided by external creditors on a voluntary basis and is outside the scope of the HIPC Initiative.

Considering Somalia’s unique situation, particularly weak capacity to service debt and the country’s onerous humanitarian, reconstruction and development needs, external creditors must provide beyond-HIPC debt relief in the order of 100% debt cancellation to ensure Somalia does not service any old debts in the post-HIPC period (see Figure Seven in Section IV for details on post-HIPC residual debt and debt servicing). Although all HIPCs would like 100% debt cancellation, Somalia stands out as being at a particularly critical juncture, where full debt cancellation is paramount. Relative political stability has emerged from extreme fragility, while humanitarian and development needs

³⁷ The X denotes that as of today Somalia is not receiving new lending and is not servicing any external debt obligations. The upward arrow denotes that post-Decision Point, Somalia would likely receive new lending and greater grants and FDI and would have to service debt obligations as a result of rescheduling with external creditors.

³⁸ The Completion Point Triggers are articulated in the Decision Point Document.

are some of the most acute in the world. Full debt cancellation will maximise available domestic and international resources essential for the country's reconstruction and development, with likely peace dividends that will solidify recent progress.

D. Multilateral Debt Relief Initiative (MDRI)

The MDRI was established in 2005 to provide deeper debt relief to eligible low income countries. Under the MDRI, four multilateral institutions, namely the IMF, the Inter-American Development Bank, the World Bank and the AfDB, agreed to cancel 100% of their debt claims for countries that have reached the Completion Point of the HIPC Initiative. Typically, MDRI relief is granted simultaneously with irrevocable HIPC relief once a country reaches the Completion Point. In contrast to the HIPC Initiative, MDRI utilises a fixed cut-off date in its treatment of multilateral debt relief shown in in Table 1 below.

Table 1: MDRI Cut-Off Dates

	Cut-Off Dates
IMF	end-2004
World Bank	end-2003
African Development Bank	end-2004
Inter-American Development Bank	end-2004

For Somalia, MDRI would entail the cancellation of the remaining post-HIPC debts of the AfDB and World Bank, but would not cover the residual post-HIPC debts owed to the IMF. This is because a new loan would be provided to Somalia to clear IMF arrears and would be well past the IMF's MDRI cut-off date of end-2004 (referred

to in Table One). Therefore, Somalia would likely still have remaining debt obligations to the IMF after Completion Point. Liberia was in a similar situation. To address this dilemma, the IMF Executive Board provided flexibility by mobilising IMF resources to settle the post-HIPC residual debts of Liberia through an 'MDRI-like' debt relief operation, again setting a precedent similar to the exceptional process applied to reach HIPC Decision Point (see Box Two and Figure Four). The case of Liberia could serve as an effective model for Somalia, whereby the IMF Executive Board could approve an 'MDRI-like' debt relief operation on an exceptional basis to write-off residual post-HIPC debt service obligations to the IMF³⁹.

Box Three and Figure Six provide an optimistic timeline for Somalia's progression through the debt relief process (arrears clearance, HIPC Initiative, beyond-HIPC debt relief, and MDRI) as explained in Section IV.

Somalia's Residual Obligations Post-Debt Relief and Its Ability to Pay

For countries reaching the Decision Point, the IMF and World Bank apply a set of rules (HIPC Initiative rules) used to assess the level of HIPC debt relief required to bring the country to debt sustainability. To determine the level of HIPC relief required to make a country's debt sustainable, the IMF and World Bank conduct a HIPC Debt Sustainability Analysis (DSA). Under the HIPC DSA, two debt sustainability thresholds or targets are used: debt-to-exports of 150% (export window) and debt-to-revenue of 250% (fiscal window). A country can only qualify under one of the two windows.

³⁹ The debt relief case of Liberia is unique among countries that had qualified for HIPC debt relief in that it was the first country that did not have any MDRI-eligible debt, but received MDRI-like relief. Six countries that did not have any MDRI-eligible debt - Afghanistan, Comoros, Côte d'Ivoire, Guinea, Haiti and Togo - did not receive MDRI relief nor MDRI-like relief/beyond-HIPC debt relief from the IMF. In fact, Guinea and Côte d'Ivoire had fully repaid their debts by the time they had reached their Completion Points. Liberia's case is made more unique by the fact that the financing that covered both HIPC and MDRI-like relief were mobilised by contributions from 102 IMF member countries arising from a partial distribution of balances in the IMF's First Special Contingent Account (a precautionary account that is used to cover overdue obligations to the Fund).

If a HIPC DSA were to be conducted for Somalia, the country would qualify for the export window, but would not qualify for the revenue window. Although Somalia would obtain substantially higher relief under the HIPC Initiative's revenue window, the country would most likely not meet the two fiscal/openness criteria required for eligibility under the revenue window (30% exports-to-GDP target and the 15% revenue-to-GDP target, based on an average of three years of actual data). In practical terms, this means that since the HIPC Initiative is premised on

putting a country back on the path of debt sustainability, Somalia's debt-to-exports ratio would need to be reduced from the current ratio of 480%⁴⁰ to 150% after the application of traditional debt relief on bilateral debts.

In addition to HIPC relief, a country can also receive additional relief through MDRI and beyond-HIPC debt relief provided by external creditors. Since the establishment of the HIPC Initiative and MDRI, IFIs and Paris Club creditors have given countries 100 per-cent relief after Completion Point.

Box 3: Possible IFI Arrears Clearance, HIPC, MDRI and Beyond-HIPC Debt Relief Timeframe

In an optimistic scenario (akin to the case of Liberia), assuming that SMP III is revised to meet UCT conditionality during the first review of the SMP slated for the final quarter of 2018, Somalia could potentially reach Decision Point in mid-2019. On average, it took a period of 49 months for HIPC countries to reach their Completion Point from the time of Decision Point⁴¹. Of the 36 HIPC countries that have reached Completion Point, five countries (Bolivia, Burkina Faso, Central African Republic, Mozambique and Tanzania) managed to reach their Completion Points in less than two years⁴². Somalia could reach its Completion Point in a similar timeframe.

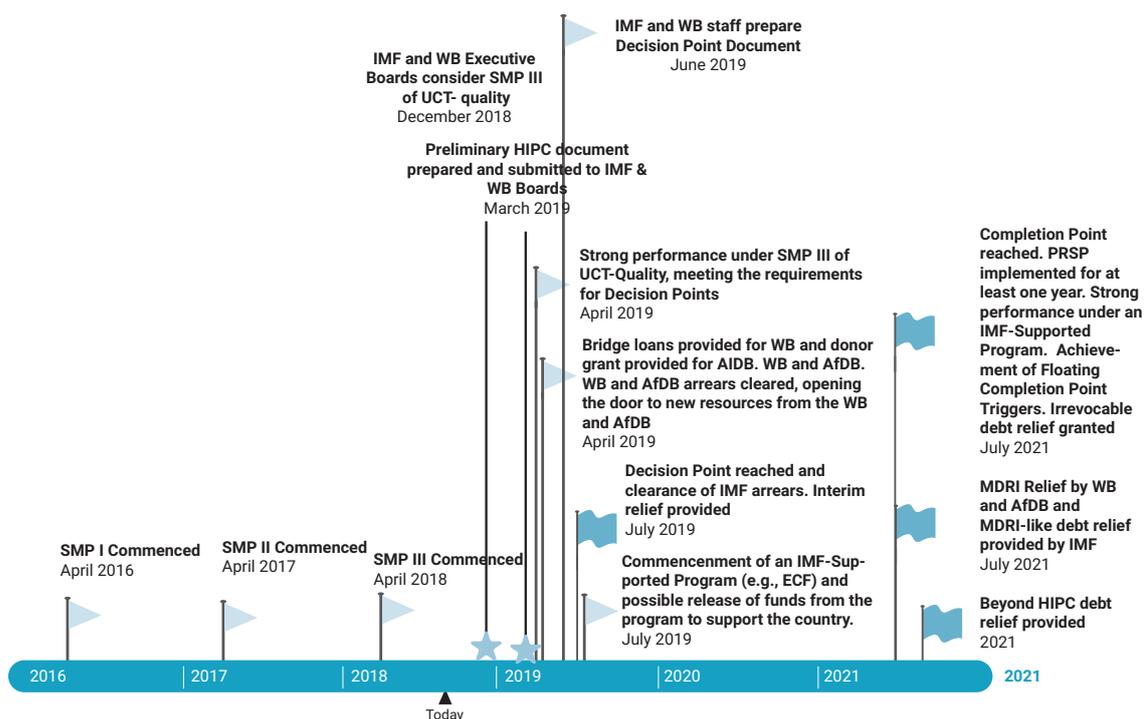
A best-case HIPC and MDRI timeframe scenario for Somalia is presented below (see Figure Six). This may be an optimistic scenario, but it is possible. If Somalia's bilateral partners mobilise the necessary political will, through their seats at the boards of the IMF and the World Bank, it can lead to them exercising flexibility in their assessments and declaring Somalia's readiness for Decision Point and eventually Completion Point. For the short-term in Somalia, the key milestones to reach are arrears clearance and Decision Point, as this will allow the country to regain access to much-needed resources and would set the level of relief to be provided by external creditors. Thus, expediting this process is critical.

40 Calculated based on data from IMF Country Report No. 18/212. The exports of goods and services used to calculate the debt-to-export ratio was based on a three-year backward average from 2015 to 2017.

41 Based on information provided in the IMF and World Bank HIPC Initiative and MDRI – Statistical Update, August 4, 2017 (see Table AIII4. HIPC Initiative and MDRI: Committed Debt Relief and Outlook).

42 Ibid, Table AIII4. HIPC Initiative and MDRI: Committed Debt Relief and Outlook.

Figure 6: Best-Case Debt Relief Timeline for Somalia



Following the HIPC approach to debt sustainability, MDRI and beyond-HIPC, a clearer picture emerges of what Somalia's future debt servicing may look like after completing these processes, detailed in Figure Seven.

Applying certain assumptions⁴³, Figure Seven shows that Somalia's external debt could decline from US\$ 4.6 billion to US\$ 400 million if HIPC and MDRI relief occur alongside additional beyond-HIPC debt relief from Paris Club creditors and MDRI-like debt relief from the IMF post-HIPC. The remaining US\$ 400 million would be residual debts owed to non-Paris Club creditors and non-IFI multilateral creditors. The debt-to-export ratio would be approximately 42%; well under the HIPC debt sustainability threshold

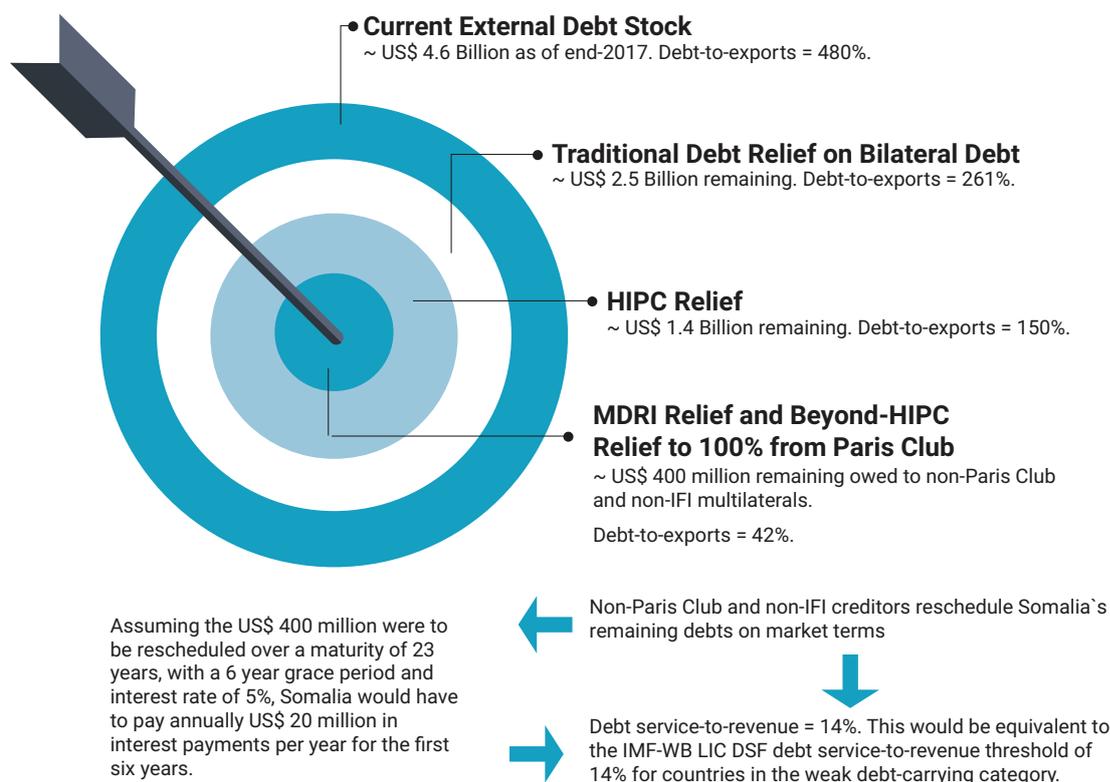
of 150%. Typically, non-Paris Club creditors and non-IFI multilateral creditors would reschedule the remaining debt on commercial terms, as rescheduling on concessional terms would be additional relief not required under the HIPC framework. Any additional relief or cancellation on the part of non-Paris Club creditors and non-IFI multilateral creditors would be solely at the discretion of those creditors. Assuming that there is no further debt cancellation or concessional rescheduling by these creditors, Somalia would be looking at servicing US\$ 20 million per year for the first six years⁴⁴.

The US\$ 20 million annual debt service obligations would be equivalent to ~14% of government revenue based on end-2017 revenue figures and thus equivalent to the

43 For ease of conducting the exercise, Somalia's total debt stock (US\$ 4.6 billion) was taken to be the Net Present Value (NPV) of debt, which is a reasonable assumption as most of the debt is in arrears (>90%) and hence the NPV would be slightly less than the current face value ~US\$ 4.6 billion. Figuring out the country's actual NPV of debt would require loan-by-loan information to which the government is privy to. To carry out this exercise, an assumption was made that Somalia would reach Decision Point by 2018 so as to allow the use of end-2017 external debt data for the exercise. Other assumptions were that IFIs would go to 100% relief (through MDRI and MDRI-like debt relief operations) and that Paris Club creditors would provide beyond-HIPC relief to cancel remaining post-HIPC residual debt. The data used for this exercise (2015-2017 export data (of goods and services), end-2017 external debt data, and domestic revenue data was obtained from the IMF Country Report No. 18/212.

44 Assuming it is rescheduled on Paris Club Naples terms (23-year maturity with 6-year grace period). The discount rate of 5% used for the IMF-World Bank Debt Sustainability Framework for Low-Income Countries was used as a proxy for the market interest rate for this analysis.

Figure 7: Relief Provided to Somalia Under the Debt Relief Process and Residual Debt Obligations



14% debt service-to-revenue threshold (for weak debt-carrying capacity countries) of the IMF and World Bank's Revised Debt Sustainability Framework (DSF) for Low Income Countries. This means that Somalia's debt service burden relative to government revenues during the post-debt relief period would be at the maximum threshold, and any additional new loan obligations arising from normalising relations with external creditors would cause the country to be above the IMF and World Bank suggested debt service-to-revenue threshold. This reality demonstrates the need for further debt relief.

In 2017, the FGS raised approximately US\$ 143 million, which amounts to about US\$ 11 per capita⁴⁵. The FGS' revenue-to-GDP ratio (estimated at 2% as of end 2017⁴⁶) is well below the 14.7% average of its neighbours in the East African Community⁴⁷. Additionally, economic activity in the country remains

fragile, with potential shocks resulting in lower collected revenue and thus causing Somalia to breach the debt service-to-revenue threshold and being categorised as in high risk of debt distress.

Possessing such a high debt service-to-revenue ratio would be a significant burden on Somalia, given the government's weak fiscal position and capacity to raise domestic revenues. Moreover, domestic revenues used to service post- HIPC debts would mean fewer resources would be deployed to Somalia's immense humanitarian, reconstruction and development needs.

Considering the above realities, full cancellation of Somalia's debt is the only viable, sustainable option moving forward. Anything less means Somalia's fiscal position will remain fragile and potential peace and development gains will be at risk.

45 Based on the IMF's estimated population for Somalia of 13 million.

46 Based on IMF Staff estimates see IMF Country Report No. 18/212.

47 See <<http://eac.opendataforafrica.org/ykresze/taxes-to-gdp-ratio-in-ratio>>.

V. Accelerating and Maximising the Debt Relief Process

Having established the importance of full debt cancellation, this brief will now look at why accelerating the process is also critical.

(i) An Accelerated Debt Relief Process will front-load new resources for urgent reconstruction and development needs

The stakes are incredibly high for the FGS and its international partners, as the government engages in peace and state-building efforts, after a long period of statelessness and armed conflict that has resulted in minimal service delivery, poverty, persistent humanitarian crises and the destruction of infrastructure, human and institutional capacity. The financing needs required to address these problems are immense and urgently needed, yet scarce available resources exacerbate Somalia's fragility. To address Somalia's urgent financing needs, front-loading of resources made possible by an accelerated debt relief process will help tackle urgent reconstruction and development needs.

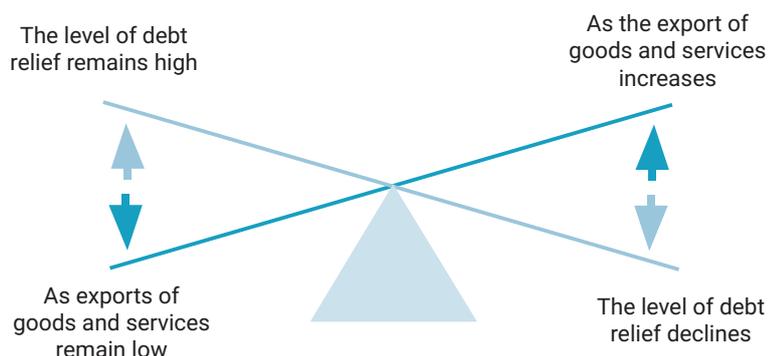
If the debt relief process is accelerated in a way that Somalia clears arrears to IFIs and completes the HIPC process quickly, it can enable development partners to provide timely and significant assistance to implement and achieve the objectives of the NPS and Somalia's NDP. Moreover, a speedy debt relief process will help expedite the normalisation of relations with other external creditors, unlocking further resources for public and private investment.

Upon embarking on an accelerated debt relief process, Somalia will be required to strengthen its institutional capacity to be in a better position to absorb front-loaded resources emanating from the process. If there are prospects for an accelerated debt relief process, it will encourage Somalia, the World Bank, the AfDB, and other development partners to maximise the utilisation of potential resources, including pre-arrears clearance and development partner grants that would be used to strengthen the absorptive capacity of the country. This includes strengthening the legal and regulatory framework for tackling corruption (including establishing and operationalizing anti-corruption institutions), so that resources are not misused or misappropriated but are put to effective and efficient use by the government. In addition, this would also entail strengthening the institutional and technical capacity of the government to develop and implement a sound development strategy to ensure the most appropriate allocation of resources that can lead to inclusive economic growth.

(ii) An Accelerated Debt Relief Process Can Maximise the Level of Relief Granted and Minimise Post-HIPC Debt Service

Dragging out the debt relief process would be costly for Somalia. Sluggish progression through the debt relief process, specifically in reaching the IFI arrears clearance and Decision Point milestones, can lower the level of debt relief provided to Somalia that would be determined by a HIPC DSA.

Figure 8: Inverse Relationship between the Level of Relief and Export Performance



An increase in year-on-year exports would also decrease the debt-to-exports ratio, meaning that the amount of relief would decline as the external debt of a country would come closer and closer to debt sustainability (debt-to-export ratio nearing 150%). Figure Eight demonstrates how debt relief⁴⁸ provided to a country moves inversely with export performance. Therefore, it is critically important for Somalia to clear IFI arrears and meet the conditionalities for Decision Point as quickly as possible so that the country receives the maximum amount of HIPC debt relief attainable.

To illustrate the above, consider the following scenario. If Somalia were able to reach Decision Point in the year 2019 (best-case scenario), 2016-2018 export data would be used. Alternatively, if decision point were reached in 2022 (a bad-case scenario) 2019-2021 export data would be used. Assuming that export performance increases year-on-year, then the amount of relief provided in 2019 would be significantly higher than in 2022. Therefore, reaching Decision Point earlier rather than later can maximise the level of debt relief that Somalia would receive.

An accelerated IFI arrears clearance and HIPC process not only serves to maximise the level of debt relief granted to Somalia, but also minimizes post-HIPC debt service. The simplistic analysis illustrated in Figure Seven, indicated that Somalia would service US\$ 20

million. In the event that exports improve in the future and there is a delay in reaching the Decision Point, there is the risk that post-HIPC debt servicing on old debts increases significantly, diverting resources from urgent peace and development needs. Such an outcome would go against the spirit and objectives of the HIPC and MDRI Initiatives that seek to reduce the debt burden of low income countries so that resources could be prudently spent on poverty alleviation and development.

Reaching the Decision Point earlier rather than later is also in the interest of Paris Club creditors and IFIs. Paris Club creditors and IFIs, typically and historically, have provided 100% debt relief post-Completion Point through the granting of HIPC-prescribed relief, MDRI relief and beyond-HIPC debt relief of the residual debts remaining post-HIPC. As the HIPC process becomes delayed and exports rise, there is the possibility that the level of debt relief prescribed declines, increasing the burden of IFIs and Paris Club creditors to provide higher levels of MDRI and beyond-HIPC debt relief.

(iii) An Accelerated Debt Relief Process Can Have a Positive Impact on Economic Recovery and Growth by Minimising the Debt Overhang Effect

An external debt overhang can impede economic growth because of the following effects:

⁴⁸ Based on the HIPC framework for debt sustainability.

- Debt servicing reduces public investment and consequently discourages private investment; and
- Private sector actors (both domestic and foreign) may perceive an external debt overhang as an anticipated future tax liability (implicit tax), thus reducing investment and ultimately private sector development.

It can be argued that the aforementioned affects do not hold for Somalia because: (i) the FGS is not currently servicing any debt; and (ii) private sector actors (both foreign and domestic) are aware that Somalia's existing debt overhang is 'fictitious', because given the likelihood for debt relief, there are minimal expectations for the government to repay this debt. However, this fails to account for the fact that Somalia's debt overhang, though not a debt service burden, restricts the country from receiving financial resources that would be channelled towards increased public investments, which would bring in greater private investment. The argument also fails to take into consideration the possibility that both prospective domestic and foreign investors may be reluctant to make significant investments until there is clarity on the debt issue, such as reaching the Decision Point. Essentially, Somalia's external debt problem increases investment risk, deterring investors. Domestically, Somalia's external debt overhang would make it difficult for Somali-based businesses to obtain financial resources from the international financial system.

This analysis is supported by empirical studies that have shown evidence of the negative effect that a debt overhang has on economic growth⁴⁹. Hence, the position of this brief for accelerated and full debt cancellation.

(iv) An Accelerated Debt Relief Process can Enhance the Government's Legitimacy and Efficiency

The provision of debt relief (and thus access to new financial resources) can help bring legitimacy and credibility to a government, especially one tasked with the immense challenge of reconstruction. A key challenge facing the FGS is to restore the relationship between state and society, a task that is made more difficult by the protracted period of time where this relationship was, for the most part, non-existent.

For almost two decades, Somalis have not received basic public services, undermining any public-state relations. Debt relief will expedite the expansion of public services, thus rebuilding public-state relations. Tangible and demonstrable development results will then help re-establish the government's legitimacy and credibility with citizens. An improved relationship between state and society would create an environment conducive to reconciliation, peace-building and socioeconomic development. Conversely, a protracted debt relief process will in turn slow the improvement of the delivery of basic social services and development-oriented projects, likely contributing towards societal dissatisfaction with the state. This can then advantage actors looking to undermine the efforts of the government and the international community.

The government's fiscal position and lack of access to additional external resources make it extremely difficult to deliver its part of the social contract. Hence, it would be prudent for both the international community and the FGS to accelerate Somalia's debt relief process to unlock new resources that can be used to alleviate poverty and provide

49 For studies that have found support for the debt overhang hypothesis, see Sachs, J. and Kenen, A. 1990 A Cross-Country Analysis of the Effects of a Heavy Debt Burden on Economic Growth, the World Bank; Cohen, D. 1993. Low Investment and Large LDC Debt in the 1980s. *American Economic Review*, 83(3), pp.437-449; Fosu, A.K. 1999. The External Debt Burden and Economic Growth in the 1980s: Evidence from Sub-Saharan Africa. *Canadian Journal of Development Studies*, 20(2), pp. 307-18; Clements, B.J., Bhattacharya, R. and Nguyen, T.Q. 2003. External debt, public investment, and growth in low-income countries. Washington, D.C., International Monetary Fund.

demonstrable services to Somalis. In doing so, the risks of renewed armed conflict and extremism, humanitarian crises, fresh displacements and migration would be reduced, moving the country forward and helping it to escape the conflict trap⁵⁰.

Further, it must be noted that the debt relief process involves certain costs for Somalia. This includes heavy administrative and management costs associated with implementing an IMF SMP and possibly an ECF program in the future. In both the current SMP and preceding SMPs, the government has invested a significant amount of time and resources in the planning and implementation aspects of the program; technically, administratively and managerially. In the short-term, this can be justified as a means of coming closer to full debt cancellation. However, a lack of progress in reaching Decision Point would increase the drain on the government, which has shown a great deal of commitment and

effort to the process thus far. A protracted process can also result in 'reform fatigue'⁵¹ setting in, where growing scepticism of debt relief and associated conditionalities of the FGS officials would be counterproductive to the reform agenda.

Summing up, there is a need for resolute concerted action by Somalia's partners to swiftly move the country towards arrears clearance and Decision Point of the HIPC Initiative. Reaching these milestones in the shortest possible timeframe would be in the interest of Somalia, its external creditors and development partners, as it can motivate the government to commit to and implement more meaningful reforms in the pursuit of debt relief and the unlocking resources for development.

Accepting that accelerated, full debt cancellation is the best way forward, the following are some key issues and recommendations to realising that direction.

50 Reform fatigue refers to a condition whereby government officials become cynical and exhausted of ongoing reform efforts.

51 For further details on the conflict trap, please see Collier, P. Elliot, V.L., Hegre, H., Hoeffler, A., Reynal-Querol, M. and Sambanis, N. 2003. *Breaking the Conflict Trap: Civil War and Development*. Washington, DC: World Bank.

VI. Key Issues and Recommendations

Key Issue 1: Peace, Security and Political Stability

For Somalia, an accelerated debt relief process will be contingent upon the country making gains in peacebuilding and in enhancing the security and political stability of the country.

Recommendations:

- a) The FGS and subnational administrations should step up efforts to tackle insecurity, foster reconciliation and peacebuilding, pursue inclusive politics and democratization, and improve relations between the FGS and subnational administrations.
- (b) Somali civil society actors should increase support for peacebuilding, reconciliation and democratisation efforts.
- (c) The international community should scale-up efforts to support security and the political and social stabilization of the country.

Key Issue 2: Political Support for an Accelerated Debt Relief Process

The decisions of the IMF, World Bank and AfDB Executive Boards in the arrears clearance and HIPC processes are generally political in nature, and thus political support can help speed up the process. Therefore, Somalia needs champions to accelerate the debt relief process (see Annex I for a list of key stakeholders related to Somalia's debt relief process).

Recommendations:

- a) The FGS should seek champions to help accelerate the debt relief process and should also lobby countries sitting on the Executive Boards of IFIs to accelerate the debt relief process for full debt cancellation.
- b) Somalia's private sector and civil society actors should lobby FGS institutions to exert all efforts to accelerate the debt relief process for full debt cancellation.
- c) United Nations, Paris Club, G7, European Union, African Union and Arab League Member States friendly to Somalia should lobby their Executive Directors sitting on the Boards of IFIs to accelerate the debt relief process for full debt cancellation.
- d) International private sector and civil society actors friendly to Somalia should lobby their governments to accelerate the debt relief process for full debt cancellation.

Key Issue 3: Timely Resources and Scaled-up Technical Assistance to Accelerate the Debt Relief Process

For Somalia, due to the sizeable arrears owed to the IMF and World Bank, the process of IFI arrears clearance is a roadblock to broader debt relief. The progression towards IFI arrears clearance and Decision Point may be delayed or hampered if there is an insufficient amount of financial resources to clear IFI arrears, inadequate technical assistance to the FGS and a failure to secure financing assurances from external creditors for their

participation in the HIPC Initiative. Therefore, to speed up the debt relief process, Somalia needs to enhance its capacity to implement debt relief conditionalities and to build its absorptive capacity such that the country can effectively utilise resources arising from debt relief.

Recommendations:

a) The Federal Government of Somalia should:

- Prepare an arrears clearance strategy and begin to engage friendly countries to provide a bridge loan to cover IMF and World Bank arrears and a grant to cover AfDB arrears;
- Mobilise and maximise resources (pre-arrears clearance grants from IFIs and development partner grants) to enhance its technical and institutional capacity in order to perform strongly under the current SMP and prepare for the possible eventuality of a revised SMP III of UCT quality; and
- Mobilise and maximise resources to develop capacity to implement development projects, enabling appropriate and effective absorption of resources flowing into the country as a result of debt relief.

b) The IMF should:

- Earmark resources for the clearance of Somalia's arrears;
- Expedite the process of reaching HIPC Decision Point by agreeing to an SMP of UCT-quality for the latter half of SMP III; and
- Scale up its technical assistance to support capacity development, and policy development and implementation to ensure that the government performs strongly under an SMP of UCT-quality.

c) The World Bank should:

- Ensure that resources for arrears clearance are set aside for Somalia; and
- Scale up its technical assistance

and capacity-building support for the preparation of a PRSP and implementation of the current SMP III.

d) The African Development Bank should:

- Ensure that resources in the TSF Pillar II are set aside for clearance of Somalia's arrears; and
- Provide technical assistance and capacity development through its TSF Pillar I and III to enhance the capacity of the government to implement development programs and projects, and to also provide gap-filling assistance for the purpose of the SMP;

Paris Club, non-Paris Club and multilateral creditors should ensure that they can provide the IMF with financing assurances for debt relief well in advance of arrears clearance and decision Point to avoid delays in Somalia's debt relief process.

Key Issue 4: Full Debt Cancellation for Somalia

The HIPC Initiative will not result in full bilateral debt cancellation from all creditors. Therefore, efforts will need to be made to secure an agreement from all of Somalia's 27 known creditors for full debt cancellation. As the provision of debt relief by creditors under the HIPC framework is not compulsory, Somalia will also need to engage and convince external creditors on a bilateral basis to secure full debt cancellation. In the case that the HIPC process becomes protracted and Somalia's economic situation improves over the years, the level of debt relief granted under the HIPC framework may decline, leaving Somalia with a higher amount of debt to service. The prospects of Somalia servicing post-HIPC bilateral debts in the future must be avoided.

Somalia does not have any MDRI-eligible IMF debts. Therefore, the residual IMF claims on Somalia after Completion Point may need to be serviced. Additionally, multilaterals other than the World Bank and AfDB will have

external debts remaining post-HIPC, as they are only required to provide enough relief to make Somalia's debt sustainable. This would mean that the remaining creditors would reschedule the residual debts, adding an additional fiscal burden to the FGS and shifting scarce resources away from peace, reconstruction and development.

Recommendations:

- a) Federal Government of Somalia should aim and lobby for full debt cancellation

of its bilateral and multilateral debts.

- b) Paris Club, Non-Paris Club and non-IFI multilateral creditors should provide beyond-HIPC debt relief for any residual post-HIPC debts to ensure full debt cancellation.
- c) IMF should seek approval from its Executive Board to secure additional resources to cover the residual IMF debts post-HIPC for Somalia, as has been done in the case of Liberia through an MDRI-like debt relief operation.

Annex 1

Key Stakeholders in the Debt Relief Process

National Stakeholders

This includes the FGS, subnational administrations, Somaliland and the Somali people. Given that the FGS is the internationally recognised government of Somalia, it is the counterpart of external creditors and has inherited the pre-civil war debts of the former governments. As such, the FGS, namely the Ministry of Finance, Central Bank of Somalia, and Ministry of Planning, Investments and Economic Development will be tasked with implementing and coordinating debt relief associated conditionalities throughout the debt relief process.

Multilateral Creditors

IMF: Alongside the World Bank, the IMF plays a leading role in the process of debt relief and is Somalia's fifth largest creditor. Throughout the process, the IMF will play a key role in helping Somalia in its efforts to establish strong performance under SMPs while at the same time surveying the macroeconomy. Obtaining the seal of approval from the IMF on an IMF-supported program will move Somalia towards Decision Point and eventually Completion Point. Moreover, the IMF is also critical in the IFI arrears clearance process, which requires the Fund and the Somali government to determine the modalities through which arrears owed to the IMF would be cleared.

World Bank: The World Bank also plays a leading role in the debt relief process and is Somalia's fourth largest creditor. In the HIPC Initiative, the World Bank takes a lead role on issues related to poverty reduction. The World Bank is also a key player in the arrears clearance process.

African Development Bank: The AfDB has supported Somalia in its bid for arrears clearance and debt relief. It is also a key player in the arrears clearance process.

Paris Club Group of Creditors: The Paris Club is fundamental to the debt relief process and is particularly important as it holds the most substantial portion of Somalia's estimated external debt (~ 54%).

G7 Group of Countries: Based on FGS estimates, Somalia's external creditors that are part of the G7 group of countries (France, Italy, Japan, the UK and the US) hold approximately 49% of Somalia's external debt. This group of countries is very influential on the Boards of Executive Directors of the World Bank, IMF and AfDB.

European Union (EU): The European Union includes five of Somalia's external creditors (Denmark, France, Netherlands, Spain and Italy) that hold ~25% of Somalia's external debt. Recently, the EU Representative for Foreign Affairs, Federica Mogherini, called for the acceleration of debt relief for Somalia.

Arab League: The Arab League includes six of Somalia's non-Paris Club creditors (Algeria, Iraq, Libya, Kuwait, Saudi Arabia and the UAE), together hold ~13% of Somalia's external debt. The FGS is currently engaged with the Arab League.

Bilateral Creditors

United States: The United States is the largest shareholder of the IMF and the World Bank, and is the largest non-regional shareholder of the AfDB. As such, it holds significant influence over these institutions, especially the IMF and World Bank. The United States is Somalia's largest creditor, holding ~22% of Somalia's debt.

United Kingdom: Given the role of United Kingdom as the penholder for Somalia on the UN Security Council, it is taking a leading role among the international community on issues relating to Somalia. It is also one of Somalia's external creditors.

About the Debt Cancellation Advocacy Working Group:

To help Somalia tackle its external debt problem as a means of helping the country address its humanitarian and development challenges, a diverse group of non-governmental organizations (NGOs) that work in Somalia have come together to offer support to the people of Somalia and its government in their bid for expeditious and full debt cancellation. This Debt Cancellation Advocacy Working Group is under the banner of the Somalia NGO Consortium.

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