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The subject of debt relief for low income and highly indebted countries has risen to the fore of public debate in recent months. I review a brief history of major debt relief for low-income countries including the recent HIPC initiative and I discuss some factors that should be taken into consideration that would impact the usefulness of debt forgiveness on the affected countries. Finally, I conclude that debt relief is effective only in certain circumstances and needs to be applied with care.

Introduction

Many politicians and notable persons have recently recommended debt relief for low-income countries carrying large amounts of external debt. The G7 group of countries, the United Kingdom and the Paris Club[1] of creditors have advocated for debt relief over the past few months. These calls have increased in the wake of the recent tsunami disaster in December 2004. These requests are in addition to the World Bank and International Monetary Fund's (IMF) Heavily Indebted Poor Country (HIPC) initiative that was started in 1996. Some of these recent requests have suggested 100 percent debt relief for the affected countries.

Debt relief is the reduction or absolute forgiveness of debt payments from one country to its creditors. Debt relief has grown in prevalence since the first significant use in the 1980s by many middle-income Latin American countries. Middle-income countries have realized significant benefits because of debt relief and were able to reenter the credit markets within a relatively short timeframe after the application of debt relief. However, a number of countries continue to struggle with their outstanding debt. These countries were caught in a continuing cycle of rescheduling debt payments and receiving additional loans to make debt service payments. Sub-Saharan African countries in particular continue to experience high debt levels in combination with low economic growth resulting in a cycle of unsustainable debt.

There are different forms of financial aid available for a donor wishing to assist a low or middle-income country. Debt relief is one form of financial assistance often provided to developing countries. Aid can take the form of direct aid or cash grant supplied for a specific or general purpose, debt relief or other assistance transfers. Debt relief is a potentially useful form of assistance for those countries with major outstanding loans to creditors. A major question that is still being debated is the effectiveness of debt relief as a form of assistance to low and middle-income countries. That question is the subject of my examination.

[1] The Paris Club is an official group of creditors comprised of 19 industrialized high-income countries. The countries of Austria, Australia, Belgium, Britain, Canada, Denmark, Finland, France, Germany, Ireland, Italy, Japan, the Netherlands, Norway, Russia, Spain, Sweden, Switzerland and the United States belong to the Paris Club.

Evolution of the External Debt Crisis

Many low[2] and middle-income[3] countries began to borrow heavily in the 1970s and 1980s to fund development projects, reduce poverty and increase economic growth. Low-income countries primarily borrowed from public institutions including governments, export credit agencies and multi-lateral lenders (e.g., World Bank, United Nations Development Program, etc.). Lower-income countries tended to have limited access to private sources because of their lack of financial resources and current economic status and so relied more heavily on public institutions for debt. High-income country governments established export credit agencies to promote the export of products to other nations including developing countries. Middle-income countries with more stable finances typically borrowed from commercial banks located in developed countries.

Both low and middle-income countries began to have problems making debt service payments in the early 1980s. Difficulties in paying debt were primarily due to regional conflicts, adverse economic shocks, reduced export earnings, high interest rates and poor financial management by the national governments. Most of the indebted poor countries usually had low rates of foreign direct investment (FDI) and a limited source of exports to supply themselves with foreign currency. These factors imposed relatively small limits on the amount of foreign debt that the country could service. External debt became a particularly difficult burden for low-income countries that were also grappling with poverty and development issues.

Pre-HIPC Debt Relief

Middle-income countries were among the first to receive assistance when their debt became unserviceable. Most debt to middle-income countries was held by commercial banks. Private lenders began reducing the amount of loans outstanding to low and middle-income countries as they realized the extent of their exposure.

The World Bank took action after the difficulty of paying debts became obvious in Latin America in the early 1980s. The World Bank instituted Structured Adjustment Lending (SAL) followed by the IMF's Structural Adjustment Facilities (SAF) and Enhanced Structural Adjustment Facilities (ESAF) in 1986 and 1987, respectively. Some heavily indebted countries used the SAF and ESAF plans 68 times between 1986 and 1994.

Other creditors, including the Paris Club, began to reschedule debt flows to be paid over a longer term instead of the short run. The debtor countries began to utilize new lending by multi-lateral institutions and additional credit from export agencies to maintain economic stability and service some of the debt.

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[2] World Bank definition. Low-income countries are those countries with a gross national product (GNP) of $745 or less in 2003 and are usually concentrated in Sub-Saharan Africa and Asia-Pacific. Sixty-one countries with a total population of 2.5 billion people met this definition in 2003.

[3] Ibid. Middle-income countries are those countries with GNP between $745 and $9,206 per capita. Sixty-five countries with a total population of 2.7 billion met this definition in 2003.

Debt flow rescheduling involving the Paris Club and debtor nations occurred 81 times between 1976 and 1988. Debt service payments were shifted to the future and allowed indebted countries to realize short-term cash flow relief. The debt flow rescheduling combined with country finances harmed the developing countries. Heavily indebted countries, especially those in Latin America, experienced limited or negative economic growth after the onset of the debt crisis during the 1980s. The limited growth has generally been attributed to the additional debt burden carried by the developing countries.

The provision of debt relief often came with attached conditions. These conditions usually required the recipient country to implement financial reforms advocated by international institutions (e.g., the World Bank and IMF). Paris Club debt relief terms often included clauses requiring the debtor to seek similar debt rescheduling and payment terms from other creditors. This was done to promote equity among the different creditors and was intended to ensure that no single creditor bore a disproportionate share of the debt relief.

United States Treasury Secretary Brady recommended the Brady Plan in 1989. The purpose of the plan was to reduce the debt stocks of heavily indebted poor countries with cooperation between commercial banks and the debtor nations. The plan largely targeted private and commercial lenders and proposed several mechanisms for relief including debt swaps, debt for equity and refinancing. Many middle-income countries took advantage of the facilities offered by commercial banks and other lenders in the Brady Plan.

The Brady Plan was a success for the middle-income countries that had large commercial loans outstanding. External debt stocks became more manageable and middle-income countries experienced economic growth by the early to mid 1990s. However, the Brady Plan had a very limited effect on low-income countries because of their low reliance on commercial debt.

The “Toronto terms” of 1988 were the first major structured effort to administer debt relief efforts to the heavily indebted poor countries. The terms allowed debtor countries to select from a menu of debt reduction options intended to reduce their debt by up to one third of net present value. The options included rescheduling the debt over 25 years at current market rates with a 14-year grace period, cancellation of one third of the debt with the remaining debt rescheduled over 14-years with an eight-year grace period or rescheduling the debt at below-market rates over 14 years with an eight year grace period. Twenty countries used the Toronto terms to reschedule debt between 1988 and 1991.

Relief from the Toronto terms was satisfactory for only a few years. Further debt reductions efforts were proposed in 1991 through the “London terms.” The London terms increased relief to 50 percent of outstanding debt net present value. Twenty-six countries rescheduled debt using London terms through 1999.

The “Naples terms” in 1994 increased relief to affect 67 percent of debt net present value. Thirty-four countries used the Naples terms to reschedule their debt flows through the middle of 1999.

In 1996 the World Bank and IMF started the HIPC initiative to address the large outstanding external debt stocks of low-income developing countries. In 1999 the initiative was enhanced to provide more oversight of reforms and faster debt relief. The HIPC initiative is currently ongoing and will be addressed in the next section.

In 2000 several interested parties including non-governmental organizations, religious groups and world leaders joined together in Jubilee 2000 to call for full debt relief for heavily indebted poor countries. The United Kingdom recently recommended a 100 percent debt write-off and has gained the support of the G7 countries.

The HIPC Initiative

Presently, the World Bank and IMF are actively engaged in the HIPC initiative that was begun in 1996. The aim of the HIPC initiative is to reduce debt levels in highly indebted countries and redirect the newly available funds toward productive development efforts. The primary focus of the monies would be poverty reduction, healthcare, education and other social services. The debt relief is intended to be sustainable in the long-term because the country would realize economic growth due to governance reforms and a lower proportion of their budget dedicated to debt service payments.

The average HIPC has at least a ten-year history of rescheduling debt, has high levels of debt, has low per capita income and very little likelihood of consistently servicing their external debt without financial assistance. Most of the HIPC countries are located in sub-Saharan Africa. Countries with these characteristics are prime candidates for the HIPC program.

Thirty-eight countries are currently eligible for the HIPC debt relief initiative. Debt reduction has been approved for 27 countries of which 23 are located in Africa. Countries must meet eligibility criteria in order to be considered for the HIPC program. The criteria includes having unsustainable debt levels, implementation of and commitment to government reform policies, and development of a Poverty Reduction Strategy Paper (PRSP) with input from multiple stakeholders (e.g., non-governmental organizations and other entities that can provide useful technical assistance and support).

Unsustainable debt is identified by the ratio of a country’s external debt exceeding a threshold of debts compared to exports or, in certain circumstances, fiscal revenues. If the country makes significant steps towards debt relief the World Bank and IMF executive bodies will vote on the country’s eligibility for the HIPC initiative. This point in time is referred to as the decision point and the country can begin to realize some debt relief from public lenders. However, to receive further and full debt relief under the HIPC program the borrower is required to continue their progress in government reforms, maintain economic stability and implement the PRSP. Fourteen countries have reached the decision point as of mid 2004 and are guaranteed to receive the full amount of debt relief in the HIPC initiative.

The initiative was reviewed in 1999 and enhanced to provide greater oversight and improved criteria. The Enhanced HIPC initiative is expected to eventually benefit almost 40 low-income countries. Countries are expected to reduce their external debt to 150 percent of their exports or 250 percent of government revenues at the conclusion of the HIPC program.

The cost of this debt relief initiative is estimated to be approximately $55 billion in 2003 net present value terms. Bi-lateral and multi-lateral creditors share the cost of the debt relief almost equally. Debt service payments for the 27 approved countries decreased by half compared to exports and government revenues between 1998 and 2004. Debt service payments have been reduced on average by approximately one third and represent half of the average debt service payments of other developing economies.

Major Debt Relief Delayed

Prior to the HIPC initiative debt relief had been a patchwork of uneven commitment and actions. There have been several reasons proposed for the lack of attention given to debt relief. One major argument for the delayed implementation of debt relief focuses on multi-lateral lenders inability to agree on a mechanism for debt relief and that the poor countries were relatively unimportant in the global financial system (Seriux and Sami 2003). The heavy debt burden carried by the poor countries, most of whom were in Africa, had no appreciable economic effect on the richer developed countries so there was no immediate need for debt relief action.

I largely agree with this argument. Multi-lateral lenders required consensus in order to begin a comprehensive process of debt relief. Lacking such consensus the problem was allowed to grow and only limited short-term solutions were proposed and acted upon. These short-term solutions were simply to institute concessional lending and reschedule debt. Moreover, the success of middle-income countries that were able to revive their economies and substantially reduce their debt stocks in the face of similar problems might have convinced high-income countries to offer only limited help.

Bi-lateral lenders, usually individual countries and their agencies, had concerns about the growing debt stocks in poor countries but were likely reluctant to act in the absence of multi-lateral leadership. This reluctance to act did not extend to the commercial banks that had large outstanding loans with middle-income countries.

Action needed to be taken by the developed countries when middle-income countries began to experience difficulties repaying debt. Middle-income countries owed substantial sums to commercial interests in the developed economies. Significant defaults or repudiation of debt could have created a cascading economic crisis in the banking sectors of many nations. Multi-lateral and bi-lateral lenders quickly implemented mechanisms to assure the eventual repayment of significant amounts of the outstanding debt.

The Fragile Panacea

Heavily indebted poor countries on average have external debt stocks at least equal to their country GDP. This can act as a significant drag on the economy and continue to keep the country poor. Debt relief can provide many benefits to these poor countries in addition to lowering debt payments.

Debt relief can be used to spur economic growth and alleviate poverty. Low-income economies primarily rely on export-generated funds to service their debt and provide public services. A reduction in debt service payments frees up funds in the short-run that can be used for other important purposes.

In many instances these funds have been used to implement and maintain poverty reduction programs and, most recently, to comply with elements of the HIPC initiative. The poverty reduction programs have focused on providing access to healthcare, sanitation, running water, roads and rural networks for the poor. These actions help to attract foreign investment and improve the strength of the economy.

Debt relief can be used to implement better governance reforms. Countries can be reluctant to implement government reform in the absence of any tangible incentive. Debt relief can serve as an incentive to change public policy and improve fiscal management. However, the imposition of policies from a source external to the country's government can be a source of embarrassment to the recipient government and cause resentment in the population.

Debt overhang has been widely discussed in economic literature as a tremendous detriment to heavily indebted countries. Debt overhang is a product of high debt stock combined with low foreign exchange reserves of the poor country. The overhang promotes reduced savings and investment growth. Foreign investors and local citizens invest outside of the country creating capital flight because of the country government's higher taxes and reduced discretionary spending. Countries that managed to realize economic growth with a debt overhang would assume that the benefits of such growth would accrue to the creditors of public debt as the country made higher debt service payments. This cycle would continue and serve to act as a disincentive to invest in the country and discourage growth.

Debt relief should theoretically increase economic growth, reduce the debt overhang effect on investment and the national economy and reduce uncertainty in debt repayment (Addison, Hansen and Tarp 2004). However, debt overhang may have limited or no impact on heavily indebted poor countries. Debt overhang may not be a useful rationale for implementing debt relief because net transfers of aid (including debt relief) continued to be positive to poor countries over a period of high debt stocks (Birdsall, Claessens and Diwan 2003 and Bird and Milne 2003). This contrasts with Latin American countries in the 1980s when those countries experienced significant reductions in net aid transfers and suffered limited economic growth.

High debt levels have a negative impact on a country's economy. A study indicated that a country with average indebtedness that doubles their debt levels experiences reduced annual per capita growth (Pattillo, Poirson and Ricci 2000). The findings indicated that high debt lowered the efficiency of private investment in the country. Additional studies focusing on the Latin American debt crisis of the 1980s suggested that high debt service levels reduced social spending on healthcare (Cornia 1994) and education (Reimers 1990). Reducing the debt burden on developing countries could release funds for social purposes that would have otherwise been used to service the large external debt stocks.

Debt relief has several benefits to indebted countries. However, there are also other factors that should be considered before implementing this type of assistance for developing countries.

Debt relief is not free money and often comes with attached conditions such as government reform. Countries should pursue good governance policies at all times, however if debt relief programs insist that the recipient increase spending for "good" public purposes (e.g., poverty reduction, healthcare) this could require the government to incur budget deficits, make reductions in other areas or seek additional financing via grants or debt from donor nations. Thus the receipt of debt relief needs to maintain a delicate balance between enabling sustainable ability to service debt and prudent governance.

Direct aid through conventional methods might be a better use of resources rather than forgiving debt. Debt relief mechanisms have been used for over two decades with poor indebted countries and have had limited impact on improving their economies thus far. Direct aid targeted for projects and technical assistance might have a more beneficial impact on the host country. The HIPC initiative and other similar cooperative mechanisms are likely the best opportunity to support poverty reduction and economic growth via debt relief.

Debt relief may prolong budget reforms in the host country. If the host country is not required or unable to implement budget reforms to gain debt relief there is no incentive to change public policy. Poor governance, including fiscal mismanagement and corruption, continue to occur in governments that are prospective recipients of relief from their debt burdens. Adverse economic shocks could easily reveal the weakness in country reforms if such reforms are only superficial and focused on meeting HIPC criteria. One of the major goals of the HIPC initiative is to reduce debt to sustainable levels; however, there is no guarantee that debt relief will be sustainable in the long-term. The IMF and other authors concur with this assessment.[4]

Many bi-lateral and most commercial lenders have chosen not to participate in the HIPC initiative. The HIPC initiative may be perceived to be a World Bank and IMF activity. Debt relief would be more effective if there is cooperation among outstanding creditors either through the HIPC initiative or other cooperative facilities.

There may be some rationale for only using significant debt relief in dire circumstances (e.g., natural disasters). Countries faced with a cataclysm that requires significant expenditures on infrastructure, food, water and the provision of emergency services is a potential candidate to default on its debt. Relieving the debt burden in these instances would provide temporary respite from adverse economic shocks.

Conclusion

When debt relief is continually ineffective it leads to a circular pattern of rising debt levels, an inability to service the debt and then the borrowing country seeks relief from its loans. Additional debt is used to fund needed infrastructure projects and pay debt followed by an inability to fully meet debt service payments. This realization is quickly acknowledged and met with a request from either the donor or borrower to implement additional debt relief. This process has essentially been repeated in several low-income countries for decades.

Debt relief has proven useful for the middle-income countries (especially Latin America) that have realized substantial economic growth in the aftermath of the debt crisis. However, this relief was principally related to private debt that, if significant

[4] See the IMF document "Status of Implementation of the Enhanced HIPC Initiative and Update on Financing of PRGF and HIPC Operations and Subsidization of Post-Conflict Emergency Assistance." See also Sun (2004).

defaults occurred, would have had noticeable financial consequences on the major developing countries. The possibility of major instability in the finance sector of the developed countries prompted action to deal with the debt crisis.

Debt relief is not a cure-all for countries burdened with high amounts of external debt. There are many factors that need to be considered when providing debt relief to poor countries.

Debt relief should be used carefully and targeted where it can do the most good. Donor countries should avoid providing substantial aid because of political pressure or other desires without specific criteria or application for the freed up funds. Country policies may have had little effect on the provision of assistance or debt relief by donor countries. In many instances debt levels and aid increased in the absence of a reform agenda (Birdsall, Claessens and Diwan 2003).

The HIPC initiative appears to have made significant gains in poverty alleviation for the affected countries. However, several African countries have shown uneven commitment to government reforms and other criteria deemed necessary by the IMF and World Bank to successfully continue in the HIPC program. The HIPC initiative works cooperatively with prudent fiscal and public policy. Careful monitoring with consistent and appropriate application of fiscal and public policy standards will be necessary to ensure that debt relief is targeted to those countries that are seriously pursuing government reforms and economic growth strategies.

Debt relief should go to countries meeting minimum measurable criteria in specific areas (e.g., good governance, economic freedom, etc.). Debt relief can be useful for low-income countries if they are tied to observable and measurable milestones and reforms. The HIPC initiative is a good example of linking reforms to reducing debt levels. Debt relief is likely to have limited effect in the absence of any metrics or reform provisions.

Debt relief is a tool of development assistance and should be used in conjunction with other tools. Conventional financial assistance in the form of grants has and continues to be larger than debt relief provided to recipient countries (in dollar terms). Government reforms, commitments from the government, donor agencies and technical assistance should be used in concert with debt relief efforts. This type of coordination among all of the stakeholders will achieve the best results in reducing poverty and facilitating economic growth.

Generic calls of debt relief for all poor countries should be resisted because it is likely to have minimal effect if debtor countries are unwilling or unable to implement reforms in governance, public, fiscal and monetary policy. There are likely to be advocates for debt relief regardless of a country’s circumstances.

The HIPC initiative is the most useful and comprehensive debt relief action taken to date for poor indebted countries. However, given the history of poor countries the possibility of limited or temporary results still exists making debt relief a fragile panacea for the heavily indebted low-income countries.

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