

Comment on Tony Addison: Debt relief: The development and poverty impact

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The paper by Tony Addison gives a good overview of the state of affairs with respect to debt relief and the issues that are still problematic. Addison shows that successive and ever larger rounds of bilateral and multilateral debt relief have reduced the problems for a selected group of countries, but not for all and it is not sure that debt relief is now sufficient to bring these countries onto a sustainable growth and development path. I would agree that the still problematic issues include the relationship between debt relief and aid flows, and that the impact of debt relief also deserves discussion. But debt relief in the context of international aid architecture is a complicated issue, and it is hardly possible to deal with all aspects in one paper. For a discussant this is a fortunate circumstance, since it allows me to expand and elaborate on some of these issues.

First, I would like to shed some new light on the problems and challenges identified by Addison: the relation to aid flows and the impact of debt relief. And secondly I would like to elaborate on some other problematic issues of the aid and debt architecture, such as the dangers of continued lending, and the conditionality attached to debt relief.

1. Debt relief and the international aid architecture

1.1. Adverse selection

Addison rightly points to the possibility that debt relief, if financed from fixed aid budgets, leads to an undesirable redistribution of aid among recipient countries: countries with higher debts will receive more aid (including debt relief) at the cost of countries with lower debts that may be equally in need of aid. This creates the possibility of “moral hazard” among recipients of debt relief: if the non-repayment of debts is “rewarded” by forgiveness, countries may engage in new

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borrowing without bothering about the fact that they may not be able to repay.

In fact, there is some evidence that the situation may be worse. Not only are countries with high debts receiving more debt relief, but countries with high debts proved to receive more total aid flows, including debt relief (Birdsall et al., 2003; Marchesi and Missale, 2004). This “defensive lending” or “defensive granting” is probably caused by the dual role of the IMF in the international aid architecture. An IMF agreement is the basis for all debt relief and for a substantial part of aid flows, namely all programme aid (aid that is not attached to projects, thus budget support or balance of payments support). But the IMF is also a creditor, so it has an interest in new aid flows, especially the freely spendable ones, with which old debts can be repaid. The creditor role and the gatekeeper role for international finance are difficult to combine, and the combination leads to more IMF programmes in highly indebted countries than would be justified. It may even provoke “adverse selection” in the allocation of aid. Birdsall et al. (2003) also show that more aid went to countries with relatively worse policies according to the World Bank’s CPIA (Country Policy and Institutional Assessment).

1.2. Moral hazard

In addition to the concerns on adverse selection and moral hazard among debtor countries, current and past debt relief mechanisms may also raise concerns on redistribution among *creditors* and on moral hazard on the *creditor side* (see also IOB, 2003; Dijkstra, 2004). During the late 1980’s and the 1990’s, many heavily indebted low-income countries did not pay on all their outstanding debts, but they usually serviced their debts to the multilateral institutions with priority. Other debts, those on commercial loans, bilateral aid loans and bilateral commercial loans (export credit insurance) were serviced to a much lower extent. In the eight countries studied in an international debt Policy and Operations relief evaluation by the Dutch Evaluation Department IOB, the volume of new loans exceeded the value of debt relief received during the 1990’s. About 80 per cent of the new lending to the governments of these eight countries came from the multilateral institutions: IMF, World Bank and regional development banks. These institutions could continue lending to non-creditworthy countries because they did not suffer the consequences of non-repayment themselves. In fact, the multilateral institutions were bailed

out by the other creditors and mainly by bilateral donors. Bilateral donors helped finance this continued flow of new loans in various ways: first they made these concessional loans possible by transferring grant money to the ESAF (now PRGF-HIPC) Trust fund of the IMF, to the IDA (International Development Association, the soft window of the World Bank) replenishment fund and to funds for concessional loans in the Inter-American Development Bank and other regional development banks. Second, they had to concede more debt restructuring and forgiveness on their own bilateral claims, and thirdly they financed the bulk of multilateral debt relief.

1.3. Moral hazard and continuous lending

Although most bilateral donors including Sweden only give aid grants to these poor and highly indebted countries, they do help to maintain the flow of lending to these countries by the multilateral banks. One can wonder whether this is an efficient use of bilateral aid money. But more importantly, the system has provoked moral hazard among the multilateral institutions and this, in turn, is probably one of the reasons for the continued debt problems of these poor countries to this day. It led to the necessity of the enhanced HIPC initiative in 1999 and again for the Multilateral Debt Relief Initiative (MDRI) in 2005. Bilateral donors finance a large share of the multilateral debt relief in the context of the HIPC initiative and also of the MDRI. If the total world bilateral aid budget is fixed, current demands for maintaining the IDA flow of resources to developing countries simply imply that a larger proportion of bilateral aid budgets flows to multilateral institutions. Grant money is still converted into loans, and the redistribution among creditors and donors continues. More seriously, the multilateral institutions are still subject to moral hazard, which means that debt problems are most likely to continue. This can be stopped by having IDA only provide grants to the poorest countries, and by reducing the creditor role of the IMF in these countries, as has been proposed before (IFIAC, 2000; White and Dijkstra, 2003).

A similar story of moral hazard holds for export credit agencies in the rich countries: they could also continue lending to these heavily indebted countries because their loans were guaranteed by the governments of the creditor countries. As long as it is the same Ministry of Finance that decides on the export credit insurance and pays for the costs if the risk of non-payment materializes, there is of course no moral hazard. However, after paying the exporting firm in the donor

country, the Ministry of Finance maintains a claim on the debtor country and interest on the debt stock and on the flows of debt service due is capitalized. Once these debts are forgiven in total or to 90 per cent, for example in the context of the HIPC initiative, the full amount of these capitalized claims can be registered as ODA (Official Development Assistance) according to the current Development Assistance Committee (DAC) of the OECD definition of ODA. Given that a large part of these debts is fictitious and would never have been paid, debt relief does not provide any real resources to debtor countries. In fact, these debts should have been written off at the time of compensating the exporting firm. ODA budgets are artificially inflated if the full capitalized amount of this “debt forgiveness” is included. For this reason, it has been recommended to change the DAC definition of ODA (Birdsall et al., 2002; Dijkstra, 2004) so as to exclude the writing off of export credits. There is the more reason for this, since the OECD rules prescribe that export credit agencies should be self supporting, that is, they should be able to finance the risk of non-payment from the insurance premiums received.

In those donor countries where the amount of ODA is fixed in terms of gross national income (The Netherlands, Sweden), this is not just an accounting issue. Once there is an agreement on “debt relief” in the Paris Club and once the bilateral negotiations are concluded, part of the available ODA budget of these donor countries is just transferred to the Treasury. This “debt relief” is in fact a negative flow of ODA, since it makes the actual flow of ODA to developing countries smaller. If and to the extent that Ministries of Finance—which make the ultimate decision on export credit insurance—are able to shift lending risks to the development cooperation budget, there is of course moral hazard involved. It will lead to more risky export financing and thus, it will also lead to the perpetuation of debt problems. Changing the DAC definition of ODA will help eliminate this moral hazard and make creditors more responsible.

2. The impact of debt relief

While debt relief should not be equalized with ODA on the donor/creditor side, the same holds for the debtor/recipient side. And the latter is relevant for the impact of debt relief on growth and poverty reduction. As Addison rightly states, there are two possible effects of debt relief: to the extent that debts were actually serviced,

debt relief releases resources and there will be a fiscal effect of debt relief that is similar to the effect of programme aid. But debt relief may also have an impact that aid flows never have, if it reduces a country's "debt overhang". If there is a large debt that is currently not fully serviced, this debt overhang may hamper new foreign loans and other capital inflows and may also hamper domestic investment. Conversely, debt relief that reduces the debt to sustainable (payable) levels may lead to new foreign inflows and increased private investment. In the terminology of the IOB evaluation (IOB 2003), this effect of debt relief is called a "stock effect", as opposed to the "flow effect" that comes about if resources are released from debt relief.

2.1. Stock effects

As Addison rightly observes, the debt overhang or stock effect is difficult to establish in practice in highly indebted poor countries. In many of these countries, inflows of foreign capital and private investment will be hampered by many other factors as well: political instability, insufficient ruling of the law, inadequate government regulatory and other policies, insufficient infrastructure, etc. In those cases, a reduction of the debt stock will hardly influence capital inflows and new private investment. However, when some of these other factors improve at the same time, debt relief may have an impact on private investment and on the country's access to private flows. This was, for example, the case in Peru in the early 1990's (IOB, 2003).

A reduction of debt stocks in heavily indebted poor countries may also have another kind of "stock effect", namely on the policy environment. If countries with high multilateral debts always get debt relief and also get more aid than other countries, irrespective of their policies, this reduces the incentives for improving the policy environment. In other words, the moral hazard and adverse selection embedded in the international aid architecture not only lead to the perpetuation of debt problems, but also to the continuation of bad policies. Once the debts have been forgiven or written off, there is room for a better selection of aid deserving countries. This is a strong argument for debt relief or, with a better term, debt write-offs.

2.2. Flow effects

Some debt relief may indeed free resources and is then comparable to aid flow. To the extent that it is, one can attempt to examine the impact on poverty reduction. Addison argues that this poverty reduction effect of debt relief will be stronger in countries like Tanzania, Uganda and Mozambique with more effective states than in countries like Somalia, which can hardly be called a state, or Myanmar which has a predatory state. In the latter countries, an aid dollar invested in a microfinance scheme for small enterprises may be more effective for poverty reduction than a dollar spent on debt relief. Although I agree on the limited effectiveness of freely spendable resources in Somalia and Myanmar, I would hesitate to draw the same conclusion for all pre-completion point countries listed in the paper and for post-conflict states such as Sierra Leone or Liberia—which implicitly also seems to be the argument in the paper.

Most countries that have achieved the decision point but not yet the completion point suffer from fiscal deficit problems that prevent them from staying on-track with the IMF. In those cases, the flow effect of debt relief (to the extent that there is one) can help achieve fiscal equilibrium. An evaluation of programme aid given over the 1990's has shown that programme aid was very effective in promoting economic and especially fiscal stability in countries like Uganda, Tanzania and Mozambique in earlier periods, when there was not yet any firm commitment to fiscal discipline (White and Dijkstra, 2003). The cushioning effect of programme aid helped these countries introduce foreign exchange and other reforms. It can be expected that the flow effect of debt relief may also be effective in post-conflict states or countries that still have a weaker culture of fiscal discipline, such as Burundi or Guinea Bissau.

3. Conditionality

According to the current international aid architecture, virtually all debt relief is conditional. Countries must be on track with an IMF agreement and, since the enhanced HIPC initiative in 1999, they must also elaborate and implement Poverty Reduction Strategy Papers (PRSPs). These strategies must be developed with participation of the population, in particular civil society organizations. To reach the completion point, they must be on track with the IMF, but also meet a series of structural conditions in line with the earlier structural ad-

justment programmes. All HIPC countries that have achieved the completion point are eligible for the MDRI, provided there is no deterioration in performance with respect to macroeconomic stability and the implementation of their PRSP.¹

While there was an emerging consensus in academic and policy circles in the second half of the 1990's that policy conditionality was not effective, the enhanced HIPC initiative in 1999 has led to an expansion of conditionality in the international aid architecture. The "old" arguments against setting policy conditions to aid still hold, namely their limited effectiveness: countries will only carry out what they already intended to implement and domestic political economy factors are far more influential on policies than donor conditions. Furthermore conditions have often proved to be inadequate in the past.

There are some additional reasons why imposing conditions for debt relief can be considered as even less appropriate than setting conditions for aid. First, as has been shown above, not all debt relief releases fresh resources for a country. To the extent that it does not, setting conditions for the use of these "resources" may lead to distortions in budget allocations and may actually reduce growth. For example, Nigeria is now expected to "spend" its debt relief for its poverty reduction strategy, while actually received resources during the first year after the debt relief agreement are negative: the balance of an amount of USD 6.3 billion of arrears that the country has to pay upfront, and USD 1 billion in freed resources as a result of debt service cancelled.²

Secondly, and given the moral hazard on the creditor side that has often led to large volumes of imprudent lending, we should not even speak of "debt relief" but instead of debt write-offs. Official creditors should take their responsibility for this imprudent lending for—apparently—the wrong projects and purposes, and should take their losses, just like commercial creditors generally do. It is unthinkable that commercial creditors, writing off a portfolio of bad loans, would set conditions on failing debtors. Thirdly, the debts that are now "forgiven" by official creditors are the result of earlier bilateral exports, or of aid projects and programmes. This was usually tied aid in

¹ See Multilateral Debt Relief Initiative Fact Sheet, siteresources.worldbank.org/INTDEBTDEPT/Resources/mdri_eng.pdf.

² "Case Study Nigeria" prepared by Wiert Wiertsema for the Expert Meeting on the Responsibility of the Creditors, The Hague: Jubilee Netherlands, 23 January 2006.

the sense that donors and creditors to a large extent determined the use of the resources they were lending. If the same donors and creditors now set conditions for the “relief” on those debts, they are in fact applying “double tying”. This practice of double tying has long been condemned by official DAC donor statements.

4. Challenges ahead

From the above analysis, it follows that there are some additional challenges for the international aid architecture. The incentive system around aid and debt relief should not only solve the debt problems of the current HIPC, but should also ensure that debt problems are avoided in the future, and that new aid supports countries with good policies and good governance. In order to avoid future debt problems, the moral hazard of multilateral institutions and export credit agencies should come to an end. The DAC definition of ODA should be changed so that debt relief on bilateral export credits no longer qualifies as ODA. In addition, bilateral donors should no longer “throw good money after bad money”, spending their grant aid money to support IDA loans. The flow of new official multilateral loans to the poorest countries should be stopped. This can be achieved by substituting all IDA loans by IDA grants—and similarly for the concessional loans of the regional banks—and by reducing the role of the IMF in low-income countries.

In practice, the share of IDA grants has increased with IDA 14 and IDA 15, but loans still constitute the majority of IDA flows. Furthermore, countries qualify for IDA grants if they are likely to have unsustainable debts in the future, which implies perverse incentives: countries whose debts are likely to become unsustainable are rewarded with grants instead of loans. It is therefore far more desirable to give grants to all low-income countries.

To the extent that the international aid community prefers that the IMF continues its gatekeeper role, giving a seal of approval to countries that have achieved or are bound to achieve macroeconomic stability, this gatekeeper role should be de-linked from the creditor role. In a sense, this is now happening with the new Policy Support Instrument of the IMF, implying a seal of approval of policies without a new loan. However, it can be doubted whether such an approval role is at all necessary in those countries that no longer have a problem with macroeconomic stability. Many post-HIPC countries fall into

this group. They do not suffer from short-term disequilibria, but instead from long-term growth and development problems. This is not the area of expertise of the IMF. In fact, there is more and more sound econometric evidence that IMF agreements have a negative effect on economic growth. (Przeworski and Vreeland, 2000; Barro and Lee, 2005; Dreher, 2006).

Finally, official debt relief should be “given” without any policy conditions. Official donors and creditors should simply write-off their debts to the poorest countries that are not able to pay.

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