

Debt Relief : Did the G8 really think things through?

On June 11th, 2005, the finance minister of the G8 meeting in London before the summit meetings announced an agreement to cancel all the debts that 18 heavily indebted poor countries owe to three multilateral lenders, the World Bank, the International Monetary Fund, and the African Development Bank. The beneficiaries are (in alphabetical order) Benin, Bolivia, Burkina Faso, Ethiopia, Ghana, Guyana, Honduras, Madagascar, Mali, Mauritania, Mozambique, Nicaragua, Niger, Rwanda, Senegal, Tanzania, Uganda, and Zambia. The face value of relief would amount to \$40 billion. A further \$15 billion was to be awarded later to 9 other HIPC countries.

Good news? Maybe. Rajan (2005) argues in his article the merits of various debt relief schemes. At the heart of the matter is how a country accumulated debt in the first place and the situation in which the country is in financing the debt now. The perfect case scenario where debt relief would be most helpful is where a corrupt administration used debt for personal gains, yet the country was able to get rid of the government (hopefully, along with its corruption) and, at the same time, where the private sector is ready to channel investment through its system. With a lot of debt, these countries are likely to face debt-overhang problems that impede growth opportunities, especially if the private sector is ready. Krugman (1989), I believe, drew the first debt Laffer curve that showed how the market value of debt actually decreased with a larger face value – in other words, this eases the losses of debt relief to creditors as there will be a higher probability of repayment afterwards.

It is important that it is of little use giving debt relief to corrupt regimes – all you would be doing is just propping them up with no end in sight. Of course, the issue of how the general people fair with or without debt relief is another problem. The question to ask would be, “Do corrupt regimes deprive their people more or less with debt relief?” The answer is not as easy as it seems. The answer lies in whether a corrupt government substitutes from taking away from its citizens, or uses its larger resources to increase its own political power to take away more. This is a difficult problem indeed, and aid through NGS’s might be a better substitute to debt relief, or even official aid for that matter.

The agreement made in London is an accounting trick in a way. For the debt to the WB and the AfDB, the G8 countries are planning to relieve debt burdens, but simultaneously, they are planning to decrease loans and grants coming from these institutions by the same amount. Only the IMF debt relief is clean-cut, no questions asked with no ifs or buts. Rajan (2005) argues that it may be in a debtors interest when social infrastructure needs revamping (which cannot be adequately provided by a malfunctioning private sector), where the additional funds in the next period may be more imperative and more useful than good old fashioned debt relief. This “additionality” factor that Rajan (2005) mentions, I think, is important. For countries that are relatively free of corruption, this sort of debt relief will be greatly helpful. My guess is that they did pick the countries that measured up to certain governance criteria. However, I wonder if they made sufficient notice of whether the private sector was ready to take off or not.

Note: according to the Penn World Tables 6.1, Nicaragua had the lowest average growth rate in terms of PPP per capita income for thirty years from 1970-2000 among 101 countries, which was less than -2.6% a year (for 30 years!) Niger had the second lowest growth rate at -1.8%.

References

BBC News - <http://news.bbc.co.uk/> (in the business section, June 11, 2005)

The UK Treasury website - <http://www.hm-treasury.gov.uk/> (they made a site that has all the important proclamations from the G7 finance ministers' meeting)

Economist June 18th-24th 2005 in Economics Focus entitled "To give or forgive."

Krugman, Paul. "Market-based debt-reduction schemes." In Jacob Frenkel, Michael Dooley, and Peter Wickham, eds., *Analytical issues in debt*. Washington D.C.: IMF.

Rajan, Raguram. "Straight Talk: Debt Relief and Growth" *Finance and Development*, June 2005, 42:2