SWEDISH ECONOMIC POLICY REVIEW 13 (2006) 205-230

Debt relief: The development and poverty impact

Tony Addison*

Summary

■ This paper discusses how the poor-country debt crisis arose as a result of low growth, uncoordinated donor-lending and the absence of a market that could mark down the debt's value. It assesses the state of play with the Heavily Indebted Poor Countries (HIPC) Initiative and Multilateral Debt Relief Initiative (MDRI). The paper then turns to the development and poverty impact of debt relief, discussing the debt over-hang and fiscal effects as well the role of economics versus politics in determining the amount of debt relief—and some of the dangers and opportunities that lie ahead. The paper concludes by emphasizing the importance of getting poor countries effectively connected to the international capital market where they can share in the growth of global portfolio flows and foreign direct investment. ■

JEL classification: F41, O16, N25.
Key words: Debt Relief, HIPC, Fiscal Policy.

* *Tony Addison is Professor of Development Studies and Executive Director of the Brooks World Poverty Institute, University of Manchester. He is also an Associate Director of the Chronic Poverty Research Centre.*

SWEDISH ECONOMIC POLICY REVIEW 13 (2006) 205-230

Debt relief: The development and poverty impact

Tony Addison*

No development issue has quite captured the public imagination in the same way as debt relief. The juxtaposition of the billions of dollars owed and the grinding poverty of the countries concerned deliver an easy campaigning slogan and a seemingly straightforward policy recommendation: cancel the debt. But simultaneously debt is also a complex issue, evident in measuring the stream of principal and interest payments over time (the net present value (NPV) of debt with, in turn, its assumptions about discount rates), the arcane language of 'decision points' and 'completion points', the vexed question of what we mean by 'debt sustainability (and the assorted ratios of debt-to-exports, debt-to-GDP, and debt-to-revenue), not to mention the inter-connections with Poverty Reduction Strategy Papers (PRSPs) and the Millennium Development Goals (MDGs). Successive debt relief initiatives from the 1980's onwards with, over the last decade, the Heavily Indebted Poor Countries (HIPC) Initiative (later 'enhanced') and now the Multilateral Debt Relief Initiative (MDRI) have steadily become more generous—but just how generous remains a matter of dispute. And not all indebted poor countries are HIPCs, and not all poor countries have large debts. The issue of horizontal equity across countries as well as the problem of moral hazard therefore arise.

We are now in the middle of another large shift in the debt landscape as the debt-cancellation announced at the 2005 G-8 summit in Gleneagles Scotland comes to fruition in the form of the MDRI. This paper discusses how the poor-country debt crisis arose as a result of low growth, uncoordinated donor-lending and the absence of a market that could mark down the debt's value (Section 1) and the implications of the HIPC Initiative and MDRI for aid flows (Section 2). We then turn to the development and poverty impact of debt relief, dis-

* *Comments from conference participants, especially Geske Dijkstra were very helpful, as were comments by an anonymous referee of this paper. Discussions with Mark McGillivray were also useful. The usual disclaimers apply.*

cussing the debt over-hang and fiscal effects together with the respective roles of economics and politics in determining the amount of debt relief—and some of the dangers and opportunities that lie ahead (Section 3). The paper concludes by emphasizing the importance of getting poor countries effectively connected to the international capital market where they can share in the growth of global portfolio flows and foreign direct investment (FDI) (Section 4).

1. The present situation

Much ink has been spilled on the causes of high-indebtedness in poor countries and ways to resolve it (Box 1 presents a small selection of views). But the issue ultimately comes down to this; successful sovereign debt management depends on a country's ability to achieve high growth and foreign-exchange generation—thereby containing debt-to-GDP, debt-to-exports, and debt-to-revenues at reasonable ('sustainable') levels. Otherwise the fiscal position becomes unsustainable.[1] This is the lesson of the 1980's: heavy debtors such as South Korea managed to outgrow their debts in ways that the more inward-orientated Latin American economies did not, and Africa is fundamentally the same.

Of the 40 HIPCs, 33 are in sub-Saharan Africa (SSA). Africa's growth is improving but Africa is far from achieving any big breakthrough; total factor productivity (TFP) has been negative for all three decades 1970-1980, 1980-90, and 1990-2000 (the only region for which this is the case) with the two big sources of productivity growth—capital deepening and labour productivity growth—being negative since 1980 (see TFP calculations by Crafts, 2006, p. 26). Whatever the desirability of BWI reforms in terms of economic efficiency and poverty reduction, they do not appear (as yet) to have pushed Africa onto any kind of growth fast-track. Environmental fragility, tropical diseases, limited human capital and inadequate physical infrastructure all constrain growth. And the production of tradables (both exportables and import-substitutes) does not recover quickly when high political uncertainty discourages private investment—particularly in the "post-conflict" debtors.

When private creditors hold the debt of an individual, company or country in default the loan is eventually written down on the credi-

[1] "Fiscal policy is sustainable if the time path of the debt/GDP ratio is bounded i.e. does not continue to grow without limit" (see Cuddington, 1997, p. 13).

tor's books. The Brady plan ultimately reduced Latin America's debts in this way, with the price of a country's debt reflecting the secondary market's assessment of repayment prospects (including the government's chances of reducing absorption below national income to make the requisite net transfer abroad, and the limit on how far consumption has to fall before the political pain becomes unbearable). In contrast, Africa's debt is mostly the legacy of concessional loans given during the 1980's to support "structural adjustment" together with earlier aid-project lending (Nigeria has the largest commercial debt). This includes bilateral debt, but most importantly money owed to the International Development Association (IDA), the IMF, and the African Development Bank. Official creditors have maintained the debt at its full value on their books until written off (debt relief is valued at its net present value (NPV) using a discount rate to take account of its grant element). Therefore official debt is always larger—and any debt relief always looks more generous—than would be the case in a secondary market. Some imputations of the market value of HIPC debt put it as low as 28 cents on the dollar (Cohen, 2000, p. 22).

Box 1. Viewpoints on debt and debt relief

"There is a compelling economic argument for borrowing when the rate of return on these investments exceeds the cost of capital. And there is a corresponding compelling political argument: the gains from borrowing will be felt now, while the problems of repayment will occur under someone else's watch…." (Stiglitz, 2005, p. 21).

"…the current system's dysfunctionality arises in part from the fact that donors are involved too intrusively in a country, in the name of aid effectiveness … deep debt relief will be an important step on the road to achieving greater toughness and more of an arm's length relationship on aid flows." (Kanbur, 2000, p. 422).

"… debt problems can in large part be attributed to uncoordinated lending associated with a poorly functioning international institutional framework…. It is hard to explain the debt and financing problems of low-income countries in the context of a single (altruistic) lender or donor… Such a lender would presumably have lent prudently and avoided excessive debt build-ups." (Claessens, 2005, pp. 140-141).

"The entire edifice of loans is built upon presumptions of high rates of growth that will not occur unless more fundamental reform takes place within financial institutions and LDC economies as a whole….USAID abandoned sovereign loan programmes 25 years ago. A number of other donors

donors continue to lend money to countries that cannot repay them." (Natsios, 2006, p. 137).

"Debt forgiveness grants aid to those recipients that have best proven their ability to misuse that aid. Debt relief is futile for countries with unchanged government behavior. The same mismanagement of funds that caused the high debt will prevent the aid sent through debt relief from reaching the truly poor." (Easterly, 2001, .p 136).

"For all the [Africa] Commission's many sensible recommendations, it is a reminder of how previous plans died when exposed to rich country self-interest….. Yet great scepticism is justified for any proposals driven by London, which continues to leach African wealth such as the billions of dollars processed through British financial institutions by the late Nigerian dictator General Sani Abacha and his associates." (Peel, 2005, p. 2).

"Debt sustainability has, until now, been narrowly assessed according to a country's ability to pay in terms of its export earnings—regardless of other demands on public funds. This prevents governments in many developing countries meeting the basic needs of their citizens. A new approach to debt sustainability is urgently needed in order to reduce poverty and promote sustainable development." (New Economics Foundation, 2006, p. 5).

"Given the extent of looting and repression by many dictators, it seems plausible that the efficiency gains from preventing odious debt are much larger than the efficiency gains from solving debt overhang. Loan sanctions against such dictators could potentially prevent some of this borrowing." (Jayachandran and Kremer, 2006, p. 91).

1.1. Successive debt initiatives

This is not the place for a detailed history of debt relief (instead see Birdsall and Deese, 2005). Suffice it to say that by the mid-1990's the debt build-up was alarming and the HIPC Initiative was launched in 1996 and significantly enhanced in 1999 (Addison et al., 2004; Kanbur, 2000). The main criterion for eligibility is a high debt-to-export ratio (originally set at 250 per cent and then reduced to 150 per cent in 1999) and high ratios for debt-to-GDP and debt-to-revenue are also included in the IMF and World Bank's overall assessment of debt sustainability. Many observers have argued that these debt-sustainability criteria are essentially arbitrary (see for instance Sachs, 2002, p. 276). Given the uncertainties associated with predicting the trajectory of the main foreign-exchange earner, commodities, it is difficult to disagree with this assessment, and the concept of debt-sustainability will always be a "grey area" (this is not, however, to deny the importance of further technical work in refining debt-sustainability since benchmarks are needed around which to construct a debate about each country's prospects: see for example Kraay and Nehru, 2006). The criteria have become more generous over time, notably with the Enhanced HIPC Initiative and most recently with the introduction of the MDGs which must now be taken into account in debt assessment (Vallée and Vallée, 2005). And debt relief has come to be seen as not just an economic instrument but also as a tool for encouraging political transition, including conflict resolution (Addison and Murshed, 2003). With a PRSP in place (criticism of the first PRSPs has led to a more participatory process of late) and the IFIs satisfied with the pace of economic reform, a country reaches decision point: debt relief is provided first by reducing interest payments (at decision point) followed by cutting the debt stock itself (at completion point).

Who is in, and who is out, of the HIPC Initiative raises questions of horizontal equity among debtors as well as "moral hazard". There is a group of non-HIPC debtors who may be eligible for HIPC inclusion; these are the so-called "sunset clause" countries and four of them (Eritrea, Haiti, the Kyrgyz Republic, and Nepal) were recently reclassified as HIPCs. There are also "grey zone" countries (Bangladesh, Bhutan, Sri Lanka and Tonga) whose debt ratios fall within a 10 per cent range around the HIPC thresholds (IMF and World Bank, 2004; IMF and World Bank, 2005, p. 2).

Nigeria's status has been an anomaly until the recently concluded debt relief agreement. Despite Africa's largest external debt, Nigeria's classification as an "IDA-blend" country put it outside the HIPC Initiative (it has now been reclassified as IDA-only as part of the debt relief package).[2] Only 8 per cent of its USD 34 billion debt is multilateral, and 80 per cent is owed to Paris Club creditors—and most of that to just three countries: France, Germany, and the UK (Moss et al., 2005). Payments to Paris Club creditors alone exceeded public spending on health and many Nigerians asked why Iraq and not Nigeria was receiving debt relief. By 2005, the need for economic reform—improving the fiscal management of oil revenues, for example—was being submerged by increasingly strident calls for debt re-

[2] Blend countries have access to both IDA and IBRD, but they are not eligible for grants (except for HIV/AIDS projects). Blend countries do not qualify for soft terms from the Paris Club and are automatically excluded from HIPC. Now that Nigeria has been reclassified, Zimbabwe is the only African blend country.

pudiation along the lines of Argentina. For donors it became urgent to help President Olusegun Obasanjo's team of modernising technocrats gain acceptance for reform and the 2005 Africa Commission report backed extension of debt relief to Nigeria under a wider "debt compact" arguing, essentially, that the deep poverty of Nigeria's 130 million people could not be ignored. In summary, Nigeria illustrates the fact that the political dimension of debt relief is as important as its economic dimension. A strong global oil price enabled Nigeria to build its foreign exchange reserves (to about 60 per cent of its external debt) thereby facilitating the buy back in 2006 of a substantial portion of the commercial debt at a discount (see further discussion below).

1.2. The multilateral debt relief initiative

The 2005 summit of G-8 leaders proposed full cancellation of the debt owed to the three multilateral lenders by countries that have reached, or will eventually reach, their completion points under the Enhanced HIPC Initiative. The IFIs subsequently fleshed out the G-8 proposal, resulting in MDRI, which commenced on 1 July 2006. In essence countries at completion point get their debts reduced to the level defined as sustainable under the Enhanced HIPC Initiative and then the remainder owed to the IMF, the World Bank and the AfDF cancelled under MDRI.[3] Low-income *non-HIPCs* are also eligible for MDRI, at least in the case of IMF debts (eligibility for full cancellation of IMF debts has been extended to all countries with a per capita income less than USD 380 on the basis of the Fund's principle of "uniformity in resource use"). [4]

Among the 40 HIPCs, 20 are initially eligible for 100 per cent debt cancellation (Table 1) i.e., they are at their completion point (Benin, Bolivia, Burkina Faso, Cameroon, Ethiopia, Ghana, Guyana, Honduras, Madagascar, Malawi, Mali, Mauritania, Mozambique, Nicaragua,

[3] The MDRI is confined to debts owed to the three multilateral lenders and therefore countries may still be left with some debt after the MDRI and enhanced HIPC Initiative processes are complete, since "…. the MDRI does not propose any parallel debt relief on the part of official or private creditors, or of multilateral institutions beyond the IMF, IDA and the AfDF." (IMF, 2006, p. 1).

[4] While the MDRI is an initiative common to the three multilateral lenders they can vary its coverage and implementation (IMF, 2006).

Niger, Rwanda, Senegal, Tanzania, Uganda and Zambia).[5] Cameroon, and Malawi were granted completion point status in 2006 after further economic reform, particularly in the area of public expenditure management (Mauritania was included earlier, with fiscal reform also being a condition of full debt relief). Two low-income non-HIPCs (Cambodia and Tajikistan) also receive MDRI relief of their IMF debts.

Of the remaining 20 HIPCs, 9 have reached their decision point and will be eligible for debt cancellation once they complete their reforms (see Table 1). Of the countries at decision point, the Bank and Fund reckon that 2 (São Tomé and Príncipe and Sierra Leone) could reach completion point this year (IMF and World Bank, 2006, p. 1). The remaining decision point countries have stalled on economic reform in one-way or another (usually in fiscal management) and Chad is in a very serious political crisis. The 11 Pre-Decision Point countries are in a range of complex political situations: Eritrea (tense relations with Ethiopia following the 1998-2000 border war); Haiti (hesitant post-conflict reconstruction and democratization); Nepal (civil war); Somalia (no internationally recognized government); Sudan (peace agreement with the southern secessionists but genocide in Darfur); and Côte d'Ivoire (tentative peace).

For the completion-point countries, MDRI amounts to USD 37 billion in debt relief over 40 years (World Bank, 2006), somewhat lower than the estimate in late 2005 of USD 42.5 billion (IMF and World Bank, 2005). The average NPV debt-to-export ratio of these 18 countries will fall from 180 per cent (after HIPC relief) to about 52 per cent after implementation of MDRI (IMF and World Bank, 2005, p. 2). Following completion, annual gross assistance flows from IDA and AdDF to a country will be reduced by the amount of debt relief during the year that debt relief takes place and subsequent aid flows then depend on a country's performance. Since debt-savings are netted out of future IDA flows, there is no net impact on cash flow. We now turn to debt relief's relationship to the bigger picture for Official Development Assistance (ODA).

[5] The completion point is reached when: a PRSP has been implemented for one year; a reform programme supported by an IMF Poverty Reduction and Growth Facility (PRGF) has shown at least 6 months of satisfactory performance; and all completion triggers have been met.

Table 1. Enhanced HIPC initiative: List of participating and potentially eligible countries

Completion point countries (20) currently eligible for MDRI	Decision point countries (9)	Pre-decision point countries (11)
Benin	Burundi	Central African Republic
Bolivia	Chad	Comoros
Burkina Faso	Democratic Republic of Congo (DRC)	Côte d'Ivoire
Cameroon	Republic of Congo (Congo-Brazzaville)	Eritrea
Ethiopia	The Gambia	Haiti
Ghana	Guinea	Kyrgyz Republic
Guyana	Guinea-Bissau	Liberia
Honduras	São Tomé and Príncipe	Nepal
Madagascar	Sierra Leone	Somalia
Malawi		Sudan
Mali		Togo
Mauritania		
Mozambique		
Nicaragua		
Niger		
Rwanda		
Senegal		
Tanzania		
Uganda		
Zambia		

Notes: To reach decision point: Countries must have: a track record of macroeconomic stability; have prepared an Interim Poverty Reduction Strategy (through a participatory process); cleared any outstanding arrears. The amount of debt relief required to bring debt indicators to HIPC thresholds is calculated. Then countries start to receive debt relief on a provisional basis. To reach completion point: Countries must: maintain macroeconomic stability (under a PRGF-supported programme); undertake structural and social reforms; implement a Poverty Reduction Strategy satisfactorily (for one year). The country's creditors then provide debt relief irrevocably.
Source: www.worldbank.org.

2. The implications for aid flows

Debt relief (both HIPC and non-HIPC) is having a significant impact on the volume of ODA. Debt relief accounted for most of the increase in aid over 2004-05: ODA from OECD-DAC members rose by 31.4 per cent to USD 106.5 billion in 2005 with aid in the form of debt relief grants increasing by more than 400 per cent (see Table 2 using data from OECD-DAC). A large portion of the increased debt relief is accounted for by debt forgiveness grants for Iraq and Nigeria (USD 14 billion and USD 5 billion, respectively), debt relief that is outside the HIPC Initiative.[6] OECD-DAC predicts that total ODA will fall over 2006-07 as debt relief declines.

OECD-DAC includes debt relief for Nigeria and Iraq in the 2005 ODA total. Most of the debt relief for these two countries counts as debt relief because the original loans went out as "Other Official Flows" (OOF) and not as ODA. Consequently, the write down can count as ODA, whereas if a concessional loan goes out as ODA, its write down does not count as ODA again. However, a coalition of NGOs (including Oxfam, ActionAid and Save the Children) argues that this inflates the EU aid effort in particular since much of this relief is for export credit debts—the purpose of which was to subsidize the commercial operations of European companies during Iraq and Nigeria's dictatorships (Eurodad, 2006). Thus although this debt relief for Iraq and Nigeria meets some of the ODA classification criteria (both are on the list of DAC recipients, the relief contains a grant element, and it is given to governments) its purpose was not developmental (a key ODA criteria) in the view of the NGO coalition.[7] Accordingly, ActionAid (2005) labels such debt relief "phantom aid".

Whether debt relief should be counted as aid is a thorny issue, and OECD-DAC plans to reopen the debate about what constitutes aid in 2007. One line of argument focuses on the budgetary space that increases by the relief of export credit debts (or indeed loans given for military and political purposes) which is then available for development spending: it is not the *purpose* of the original loan that matters so much in deciding whether debt relief constitutes aid, but whether the release of *resources* is for development (a key DAC criteria for ODA). The counter-argument is that by defaulting the country unilaterally releases those resources for development, irrespective of whether the

[6] Iraq's official debt burden is USD 120 billion, of which USD 40 billion was held by Paris Club members prior to this year's debt relief.

[7] OECD-DAC defines as ODA grants or Loans to countries and territories on Part I of the DAC List of Aid Recipients (developing countries). These must be: (i) undertaken by the official sector; (ii) have economic development and welfare as their main objective and (ii) be on concessional financial terms (for a loan having a grant element of at least 25 per cent). Technical co-operation is included in addition to financial flows but grants, loans and credits for military purposes as well as transfer payments to private individuals are generally excluded.

creditor keeps the debt on its own books. Essentially creditors are maintaining the full value of the loan on their books irrespective of whether the debtor can realistically pay (and for much longer than any private creditor would do), and then counting the write-downs in the value of those assets as aid. Accounting regulations force commercial lenders to eventually write down the value of non-performing loans and if official lenders had followed this practice—perhaps imputing a value to the debt using the commercial debt market as a guide—then donors would not today be able to make such large claims of generosity. The fundamental point is: did the debt stand any chance of being paid? It is this larger, systemic, issue that underlies the principle adopted in the 2002 Monterrey Consensus that debt relief should not detract from, but should be additional to, ODA.

The scale of debt relief has given rise to much discussion (and some alarm) over the impact on the capital base of IDA. The cost to IDA of MDRI is USD 42.5 billion over 40 years (rising to USD 56.5 billion if the "sunset countries" qualify as HIPCs).[8] Debt relief yet to be provided under the HIPC Initiative is USD 11.7 billion. IDA's assets stand at USD 144.5 billion. MDRI and the remaining HIPC Initiative debt relief will together reduce IDA's capital base by about 37 per cent over 40 years if not replenished (46 per cent if the sunset countries are included). The financial impact in the first decade (2007-2016) of MDRI is also sizeable: USD 8.9 billion which, together with HIPC Initiative relief, amounts to some 14 per cent of IDA's capital base. Note that MDRI's first decade ends just after the MDG target-date (2015), so any reduction in IDA would reduce the chances of MDG success.[9] However, while MDRI's impact on IDA's capital base appears dramatic it must be set in the context of IDA's replenishment.

[8] The data reported in this section of the paper are from IMF and World Bank (2005, p. 3).

[9] The effect on the capital base of the regional development banks is also a concern. Bolivia has asked the Inter-American Development Bank (IDB) for relief, but Brazil and Mexico are concerned about the impact on their ownership stakes and have suggested that the US and the EU take responsibility for relieving most of the debt.

Table 2. Share of debt relief grants in net official development assistance. Preliminary data for 2005.

	ODA USD million, current	of which: Debt relief grants	Per cent change 2004 to 2005[a] without debt relief grants
Australia	1666	9	6.1
Austria	1552	901	9.0
Belgium	1975	471	17.2
Canada	3731	455	17.8
Denmark	2107	20	0.8
Finland	897	150	11.6
France	10059	3199	0.0
Germany	9915	3573	-9.8
Greece	535	-	11.4
Ireland	692	0	11.4
Italy	5053	1680	40.0
Japan	13101	3553	12.1
Luxembourg	264	-	8.4
Netherlands	5131	410	16.6
New Zealand	274	-	18.7
Norway	2775	25	12.6
Portugal	367	3	-65.1
Spain	3123	498	13.7
Sweden	3280	53	20.3
Switzerland	1771	224	0.1
UK	10754	3699	-1.7
US	27457	4073	16.2
Total DAC	106477	22995	8.7
Memo: items included in the above:			
EC	9629	-	8.7
DAC EU countries combined	55704	14657	3.8
G7 countries	80068	20232	8.9
Non-G7 countries	26409	2763	8.3
Non-DAC countries:			
Czech Republic	131	10	15.8
Korea	744	-	57.1
Poland	283	0	101.0
Slovak Republic	56	-	87.7

Note: [a] Taking account of both inflation and exchange rate movements.
Source: OECD, 30 March 2006

With regard to replenishment, the G-8's commitment to preserve multilateral financing while canceling debt is somewhat ambiguous and three levels of "commitment" can be observed. First, there are "unconditional" commitments to replenish IDA in its next round. This is money that is budgeted and available. Then there are conditional "commitments"; money that is in principle available but has to be allocated by finance ministries. Finally, and the weakest of all, are "political commitments" to maintain IDA funding at its present level over the next 40 years (these must be ratified by parliaments so that the finance minister can write to the multilateral lenders making the commitment). Smaller donors are worried that the political commitments of the G-8 donors (who account for about 75 per cent of IDA) are too vague, and that ex post there will be a sizeable IDA shortfall. In summary, whether debt relief has a negative long-term impact on IDA's financial standing depends on the future course of replenishments, and there could well be some tension within the donor community over this. We must therefore hope that the ethical imperative of ensuring sufficient finance to meet the MDGs prevails in future decisions on IDA's replenishment.

3. The impact of debt relief

The development impact of debt relief works through two major channels. One is the impact on incentives for private investment since a large debt-overhang is almost always associated with macroeconomic disequilibrium (which in its turn distorts and undermines private investment incentives) and therefore debt relief should stimulate investment when associated with economic reform. But the scale of this effect is difficult to pin down, not least because *expectations* play a critical role in private investment decisions—and the high uncertainty that continues when reform is hesitant can dampen any positive investment response from debt relief per se. Sudden shifts in property rights are also problematic. The Government of Bolivia recently nationalized the natural gas industry (the largest sector for FDI), arguing that their earlier privatization was unconstitutional. This could discourage foreign capital inflow, thereby offsetting the positive investment impact of reaching completion point status under the HIPC Initiative.[10]

[10] Bolivia's largest foreign investor, Petrobas (the state-owned Brazilian oil company) halted plans to invest USD 5 billion in Bolivia's gas sector (it has invested

The relief of commercial sovereign debt—the focus of the 1980's debt over-hang literature—will usually generate fresh inflows of private capital (both portfolio and FDI) to finance physical investment since country-risk premiums fall upon relief. Relief of official debt can do this if the country has a sovereign credit rating (or makes it easier to obtain one). This has been a big consideration in the Nigerian debt deal; Nigeria was able to obtain a sovereign rating of BB- from Fitch and Standard and Poor's (the same as Ukraine and Venezuela). However, for the smaller and poorer debtors there can be no certainty that they will become any more attractive for private capital (which may in any case have earlier discounted the value of debt relief when the prospects of eventual repayment were judged to be low). Their prospects for new inflows to finance new investment then depend upon new ODA flows, which will mainly fund public infrastructure investment (this having an indirect stimulative effect on private investment). The empirical literature generally finds that ODA "additionality" is important in determining whether debt relief has a significant and positive effect on investment and growth (Hansen, 2004).

3.1. Fiscal management and governance

The fiscal effect of debt relief is the second major channel connecting debt to development. By releasing resources otherwise spent on debt-servicing, poverty and development spending are expected to rise (although the standard comparison of such spending with debt-service almost always over-estimates the benefit since the debt is unlikely to be ever fully-serviced: this follows from the "market-value" point made earlier). But the weak part in this channel is the fiscal system itself. Poor countries need good systems of public expenditure management and domestic revenue mobilization if they are to invest effectively in the services and infrastructure of most benefit to the poor (and national development, more broadly), meet the recurrent costs of those investments, and build effective and democratically-accountable states. On the fiscal deficit side, they need to be able run expansionary fiscal policies without financing these through inflationary monetary expansion. Over time, the domestic debt market can grow (and the attractiveness of their debt to foreign investors can in-

USD 1.5 billion to date) when the nationalization was announced, but the government's relations with foreign investors are now improving after it clarified its policy stance.

crease) thereby providing more scope for bond-financed public spending growth—and reducing their very high dependence on ODA to meet the expenditure-revenue gap. None of this is easy to achieve, requiring as it does major institutional overhaul in the context of often chronically weak states (Kayizzi-Mugerwa, 2003). Nevertheless, it remains imperative. Difficulties in fiscal reform are preventing Burundi, Chad, DRC, the Gambia, Guinea and Guinea Bissau (all decision-point countries) from reaching HIPC completion (IMF and World Bank, 2006, p. 2).

For the HIPCs that have reached the decision point, the data suggest a rise in poverty-reducing expenditures as classified by IMF and World Bank (2006, p. 29) and reproduced here in Table 3. This is welcome news, but all such numbers must be treated with caution; budgeted resources frequently do not reach intended beneficiaries (Reinikka and Svensson, 2002) and, in contrast to the conclusions of the Bank-Fund study just cited, Chauvin and Kraay (2005) find little evidence that debt relief has positively affected the level and composition of public spending in HIPCs. And even well-spent money may not achieve desired outcomes. Take health for example. More funding for training health personnel will show up as a desirable rise in health expenditure, but whether health indicators improve proportionately to spending depends on the effectiveness of those personnel (i.e. on the health-care system in which they operate) and, indeed, on whether they remain in their own country once trained. There are more Malawian doctors in my home city—Manchester—than in all of Malawi.[11] Much of the discussion of MDG-financing assumes that the key factor in MDG-service supply—skilled labour—is a fixed, rather than mobile, factor. This is not an argument for giving up: instead, we must redouble efforts to ensure that pro-poor services really do improve.

A great deal comes down to "governance". Donors continue to struggle with recipient corruption, strategies wavering between using aid to induce reform (e.g. establishing anti-corruption commissions) to withholding aid to punish corrupt politicians. Overall, however, the effect of corruption on aid allocations appears to be weak; Svensson (2000) finds no evidence that donors allocate aid towards the less corrupt, for example. This is one reason why the HIPCs, with their leg-

[11] Malawi has one physician to 36,000 people; Manchester has one physician to 550 people, according to WHO.

acy of past aid loans, are found disproportionately among the worst performers in the Transparency International Index of Corruption with one (Chad) at the very bottom. Allowing the Republic of Congo (Congo-Brazzaville) to reach decision point status in 2006 was especially controversial: the IMF argued that extra resources from debt relief would enable Congo-Brazzaville to strengthen anti-corruption institutions, but the Fund is unduly optimistic since the country's corruption appears to start at the very top (Moss, 2006). To make progress on debt relief, "post-conflict" Sierra Leone has to get to grips with its still resilient corruption problem—otherwise the country will remain stuck at the HIPC pre-decision point indefinitely (another "post-conflict" country, Liberia, may move up to decision-point status later in 2006).

Large amounts of oil revenue are "missing" from the fiscal accounts of Nigeria and São Tomé and Príncipe while Chad and the World Bank were recently in dispute over the revenue-allocating mechanism created as a condition of the Bank financing Chad's oil pipeline project. More of the revenue is going to the military to fend off an intensifying rebellion—interconnecting with the Darfur crisis in neighbouring Sudan—and Chad illustrates the point that the absence of a robust "social contract" underlies weak policy and the debt problem (Addison and Rahman, 2004).[12] For the oil producers, initiatives such as the Extractive Industries Transparency Initiative (EITI), which was championed by the Africa Commission, need more action on the "supply-side" of corruption, including vigorous prosecution of those from the North who bribe in the South.

[12] In April 2006, Sudan allegedly sponsored an invasion of Chad to overthrow President Déby, partly for granting some 200,000 of Darfur's refugees a safe haven in UN-run camps. Sudan is said to want to replace him with a warlord closely involved in the Darfur massacres and the invasion force consisted of elements of Sudan's notorious janjaweed militias.

Table 3. Summary of poverty-reducing expenditure by the 29 countries that have reached the decision point

	1999	2000-01	2002	2003	2004	2005	2006	2007	2008
		Average	Actual			Preliminary		Projected	
			(In millions of US Dollars)						
Poverty-reducing expenditure [a]									
African countries	4140	4466	5491	7077	8333	10776	12114	13273	13978
Latin American countries	1800	1963	2055	2074	2378	2717	3000	3174	3369
Total	5940	6428	7546	9151	10712	13493	15114	16446	17347
			(In percent)						
Ratio of poverty-reducing expenditure to government revenue [b]									
African countries	38.6	40.4	41.9	43.1	43.0	45.7	46.7	47.5	46.0
Latin American countries	47.6	49.6	52.3	50.7	49.8	47.9	49.4	49.7	50.0
Total	40.0	42.7	44.3	44.6	44.3	46.1	47.2	48.0	46.7
Ratio of poverty-reducing expenditure to GDP [b]									
African countries	5.5	5.6	6.1	6.8	7.0	8.0	8.3	8.4	8.3
Latin American countries	10.8	10.2	10.7	10.4	11.0	11.5	11.7	11.8	11.8
Total	6.4	6.5	6.9	7.4	7.6	8.5	8.8	8.9	8.8

Notes: [a] Data are not available for all countries, for all years. The following data are missing: Burundi for 1999, Democratic Republic of Congo for 1999-2001, Republic of Congo for 1999-2002, and 2005-10; Guinea-Bissau for 1999-2001, Sierra Leone for 1999, and São Tomé and Príncipe for 2000. No data replacement methodology was applied. The coverage of poverty-reducing expenditures varies across countries, but is generally consistent with the definition in the PRSP and the budget. In some countries, the definition of poverty-reducing expenditures has evolved over time to include more sectors; therefore, some of the increase in such spending over the 1999-2003 period may reflect changes in the definition. [b] Weighted averages
Sources: World Bank and IMF (2006) using HIPC country documents; and World Bank and IMF staff estimates.

.

3.2. Debt relief and other instruments for poverty reduction

Debt relief like other forms of development finance is subject to diminishing returns. As we move down the HIPC list from the completion countries to the pre-decision countries (Table 1), so the value of an additional dollar of debt relief to poverty reduction almost certainly falls, since essentially we slide down the scale of states that are "development effective" (in particular the quality of the fiscal system declines markedly). The marginal return to poverty reduction will be positive in Mozambique, Tanzania and Uganda which are building their institutions (with budget support eventually taking over from project aid) but zero for Somalia which has no internationally recognized state (it would merely be an accounting transfer within donor governments and international financial institutions) and close to zero (or even negative) in Myanmar which has a predatory state.

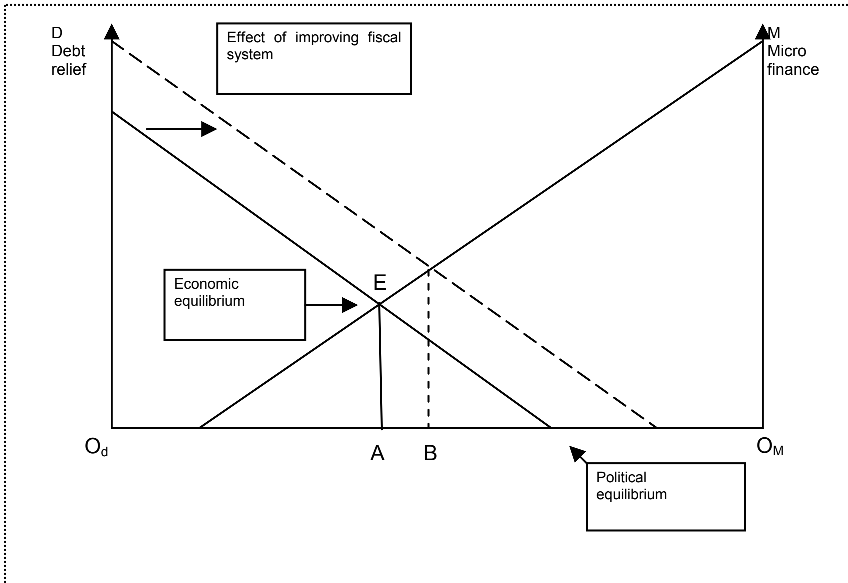
Debt relief is a state-to-state transfer which is then *intermediated* into poverty reduction by a chain of institutions of varying effectiveness. In contrast, donor-funded micro-finance programmes use NGOs (or quasi-state bodies) as the intermediary often with good results, including reaching some of the chronically poor (those stuck in deep and persistent poverty) (Arun and Hulme, 2003). Micro-finance is also subject to diminishing returns (not all of the chronic poor can make good use of it, for example) but diminishing returns are likely to set in faster for debt relief especially in very fragile states—which cannot cope with the allocation and disbursement of very large amounts of debt relief and ODA until institution-building progresses. In summary, neither micro-finance nor debt relief constitute miracle cures, each has its strengths (micro-finance improves livelihoods while debt relief funds services and infrastructure) and diminishing returns eventually set in for both.

Figure 1 illustrates the issue. Assume two uses of a fixed amount of donor money (measured by the horizontal axis along the distance $Od \longleftrightarrow Om$). The respective vertical axes measure the rates of return (to poverty reduction) from debt relief (left axis) and an alternative use of the money, for example micro-finance (right axis). An efficient allocation of donor money will be that which equalizes returns to debt relief and micro-finance at the margin; this is point E (which we label the "economic equilibrium"). Of the total available funding, $Od \rightarrow A$ is then allocated to debt relief and $A \leftarrow Om$ to micro-finance. An improvement in intermediation can shift the schedules, raising the marginal return: in debt relief's case constructing a better (pro-poor) fiscal system shifts the schedule right (shown by the dashed line) and a larger share (*Od*→*B*) can now be allocated to debt relief.

However, the debt agenda has become increasingly politically driven especially with the 2005 G-8 summit taking relief beyond the level earlier identified as necessary to reach debt sustainability under the Enhanced HIPC Initiative—the political objective largely being to drive the debt stock of HIPCs down to zero, irrespective of whether there is a better use for the money. The "political equilibrium" therefore probably lies to the right of the economic equilibrium in Figure 1 in the range where the marginal return to the alternative (microfinance) exceeds that of debt relief, perhaps including the point at which further debt relief yields zero (economic) return.

The intention here is not to undermine the case for substantial and generous debt relief, nor to deny the importance of political considerations in determining debt relief. Rather, it is to emphasize the importance of keeping constantly in mind the alternative uses of donor money in the cause of poverty reduction—as more money is allocated to one intermediating instrument rather than to others. Mobilizing more development finance in total will ease the dilemmas of choice, but can never completely remove them. This point also relates to horizontal equity across poor countries. As stated earlier, debt relief for many of the pre-decision point HIPCs will have limited impact: what Somalia needs now is not debt relief but humanitarian assistance and effective international peace-keeping to support the eventual resurrection of the Somali state. But the allocation of resources (and attention) to this crucial set of tasks is minimal when set alongside the amount devoted to debt relief. This is true of other conflict and post-conflict countries as well.

Figure 1. Allocating resources across debt relief versus an alternative (micro-finance)



3.3. Dangers and opportunities ahead

The HIPCs are overwhelmingly dependent upon primary commodities for their export earnings, as are most of the non-HIPC debtors including the sunset clause countries (with the exception of Bangladesh which has significant manufacturing). Producers of oil and gas (e.g. Bolivia, Congo-Brazzaville, and São Tomé and Príncipe) as well as metals (e.g. Tanzania and Zambia) are now experiencing a strong upturn in export prices after more than a decade of decline, with many agricultural commodity prices up as well. Optimists talk of a commodities "super-cycle" lasting a decade at least and driven by strong world demand. Pessimists note the propensity of such booms to collapse as rising prices eventually choke-off demand as they did in the 1980's (and the terms of trade for net oil importers who export agricultural commodities or metals depends on the relative size of the different (import and export) price effects, and the overall balance of payments effect depends on the size of the supply and demand responses).

Countries have found it difficult to manage commodity-price booms (Botswana is the exception). At the time of the last boom in the 1970's many countries treated rising commodity prices as a permanent rather than temporary windfall, spending it unwisely (often consuming rather than investing) thereby causing macro-economic disequilibrium—leaving economies in a precarious position when commodity prices inevitably turned down (Collier and Gunning, 1999). If this is the start of a commodity super-cycle (which largely depends on China's future growth rate) then it represents an extraordinary opportunity, but also a dangerous moment since past mistakes could be repeated—potentially on an even larger scale.

The last few years have been very favourable to sovereign borrowers; in early 2006 emerging market sovereign spreads over US Treasuries (as measured by JP Morgan's EMBI+ index of Emerging Market bonds) were less than 2 per cent, compared to 10 per cent in late 2002. But Africa, excepting South Africa, is largely absent from the portfolio of the typical bond fund. With better prospects for their export prices, poorer countries may become attractive to the international-bond market that is "reaching for yield" (although the political risks for lenders remain high). If such borrowing is wisely invested in human capital formation and well-chosen infrastructure it can accelerate growth and economic diversification thereby facilitating debt service: but if it is wasted (as in the past) then countries will put themselves into an unsustainable position when, inevitably, commodity prices turn down again. And for the oil producers better macroeconomic management is imperative; the "Dutch disease" effects of an oil boom can, by moving the real-exchange rate against tradables, undermine external debt-service as Nigeria demonstrated in the 1980's.[1] Managing Angola's oil boom is proving especially difficult and the country has a history of ill-conceived borrowing using oil as collateral, dating from the civil war years.

4. Conclusions

The HIPCs that have reached their completion points account for 64 per cent of the HIPC Initiative assistance to be delivered by creditors

[1] Some oil producers must also face adjustment to a decline in their oil endowment. Gabon has borrowed heavily and now faces a difficult adjustment as its oil supplies decline, implying a large (and unprecedented) shift into non-traditional exportables requiring, in turn, a sizeable real exchange rate adjustment (Söderling, 2006).

(IMF and World Bank, 2006, p. 1). We are therefore much further down the road than just a few years ago, and the MDRI has recently added further impetus. Ultimately, debt is the product of a larger picture of global finance for poor countries, including the governance of the international aid architecture and the role of the Bretton Woods Institutions, which we have only touched upon (the reader is referred instead to Atkinson, 2004; and Sagasti et al., 2005). And the main challenges going forward are scaling up aid, reducing aid volatility, achieving increased aid effectiveness and—the overarching goal—improved governance especially in the use of public money, whether provided by taxation, debt relief or new ODA.

Given the very high social returns from investing in primary education, basic health care, and safe water and sanitation—rates of return that exceed concessional, and indeed commercial, rates of interest—it makes sense to borrow both domestically and externally for poverty reduction and national development. Historically no nation has developed without creating deep and liquid domestic markets for government debt, thereby facilitating non-inflationary financing of the fiscal deficit as well as better management of output and employment across the business cycle. As a government's credit profile improves, its debt denominated in domestic currency eventually finds a market with international investors, allowing it to expand beyond the initially narrow base of demand in its own financial system. And there are other benefits as well, not least the deepening of the financial sector that accompanies the creation of a larger and more liquid market for government debt, thereby allowing domestic banks, insurance companies, and pension funds to better match their assets and liabilities. This in turn improves their ability to lend and invest in the private sector, the main motor for output and employment growth.

Therefore the objective of action in the area of debt and development cannot be to "end debt forever". To do so would have a very high opportunity cost in terms of poverty reduction and economic growth foregone. Rather, it must be to move countries out of their present impasse with creditors, make their debt positions sustainable (that is, enable debt to be serviced without endangering economic and social objectives) and to develop marketable debt instruments for sovereign, corporate, and municipal borrowers that are attractive to both domestic and international investors. The history of the emerging economies shows that this can be done but only by careful macroeconomic management, better governance, and judicious use of well-targeted and generous international assistance.

References

Addison, T., Hansen, H. and Tarp F. (eds.) (2004). Debt Relief for Poor Countries, Palgrave Macmillan for UNU-WIDER, Basingstoke.

Addison, T. and Murshed, S.M. (2003),. Debt relief and civil war, Journal of Peace Research 40, 159-176.

Addison, T. and Rahman, A. (2004), Resolving the HIPC problem: Is good policy enough?, in T. Addison et al. (eds.), Debt Relief for Poor Countries, Palgrave Macmillan for UNU-WIDER, Basingstoke.

ActionAid (2005), Real Aid: An Agenda for Making Aid Work, ActionAid, London.

Arun, T. and Hulme, D. (2003), Balancing supply and demand: The emerging agenda for microfinance institutions, Journal of Microfinance 5, 1-6.

Atkinson, A.B. (ed.) (2004), New Sources for Development Finance, Oxford University Press for UNU-WIDER, Oxford.

Birdsall, N. and Deese, B. (2005), Beyond HIPC: Secure, sustainable debt relief for poor countries, in F. Cheru and C. Bradford (eds.), The Millennium Development Goals: Raising the Resources to Tackle World Poverty, Zed Books, London.

Chauvin, N. and Kraay, A. (2005), What has 100 billion dollars worth of debt relief done for low income countries?, Mimeo, The World Bank, Washington, D.C.

Claessens, S. (2005), Institutional changes to prevent the recurrence of debt problems, in J.J. Teunissen and A. Akkerman (eds.), Helping the Poor? The IMF and Low-Income Countries, FONDAD, The Hague.

Cohen, D. (2000), The HIPC initiative: True and false promises, Technical Paper 166, OECD Development Centre, Paris.

Collier, P. and Gunning, J. (eds.) (1999), Trade Shocks in Developing Countries: Volume 1—Africa, Oxford University Press, Oxford.

Crafts, N. (2006), The world economy in the 1990's: A long-run perspective, in P.W. Rhode and G. Toniolo (eds.), The Global Economy in the 1990's: A Long-Run Perspective, Cambridge University Press, Cambridge.

Cuddington, J.T. (1997), Analyzing the sustainability of fiscal deficits in developing countries, Policy Research Working Paper 1784, World Bank, Washington, D.C.

Easterly, W. (2001), The Elusive Quest for Growth, MIT Press, Cambridge, MA.

Eurodad (2006), EU Aid: Genuine Leadership or Misleading Figures?, Eurodad, Brussels.

Hansen, H. (2004), The impact of external aid and external debt on growth and investment, in T. Addison, H. Hansen and F. Tarp (eds.), Debt Relief for Poor Countries, Palgrave Macmillan, Basingstoke.

IMF (2006), The multilateral debt relief (MDRI), March 2006, International Monetary Fund, Washington, D.C.

IMF and World Bank (2004), Heavily indebted poor countries (HIPC) initiative: Status of implementation, August 22, International Development Association and IMF, Washington, D.C.

IMF and World Bank (2005), Note on the G-8 debt relief proposal: Assessment of costs, implementation issues, and financing options, September 21, Development Assistance Committee, DC 2005-0023, Washington, D.C.

IMF and World Bank (2006), Heavily indebted poor countries (HIPC) initiative—statistical update, March 22, International Development Association and International Monetary Fund, Washington, D.C.

Jayachandran, S. and Kremer, M. (2006), Odious debt, American Economic Review 96, 82-92.

Kanbur, R. (2000), Aid, conditionality, and debt in Africa, in F. Tarp (ed.), Foreign Aid and Development: Lessons Learnt and Directions for the Future, Routledge, London.

Kayizzi-Mugerwa, S. (ed.) (2003), Reforming Africa's institutions: Ownership, incentives and capabilities, UNU-Press for UNU-WIDER, Tokyo.

Kraay, A. and Nehru, V. (2006), When is external debt sustainable?, World Bank Economic Review 20, 341-365.

Moss, T. (2006), Congo-Brazzaville: Too corrupt for debt relief or too indebted to fight corruption?, Center for Global Development, Washington, D.C.

Moss, T., Standley, S. and Birdsall, N. (2005), Double standards on IDA and Debt: The case for reclassifying Nigeria, CGD Brief, Center for Global Development Washington, D.C.

Natsios, A.S. (2006), Five debates on international development: The US perspective, Development Policy Review 24, 131-139.

New Economics Foundation (2006), Debt Relief as if People Mattered: A Rights Based Approach to Debt Sustainability, New Economics Foundation, London.

Peel, M. (2005), Amnesia and self-interest cloud debate on Africa, Financial Times, March 11 (http://news.ft.com).

Reinikka, R. and Svensson, J. (2002), Beyond Debt Relief: Assessing Frontline Service Delivery, World Bank, Washington, D.C.

Sachs, J. (2002), Resolving the debt crisis of low-income countries, Brookings Papers on Economic Activity 1, 257-286.

Sagasti, F., Bezanson, K. and Prada, F. (2005), The Future of Development Financing: Challenges and Strategic Choices, Basingstoke, Palgrave Macmillan for Ministry for Foreign Affairs, Sweden.

Stiglitz, J. (2005), Development policies in a world of globalization, in K.P. Gallagher (ed.), Putting Development First: The Importance of Policy Space in the WTO and IFIs, Zed Books, London.

Svensson, J. (2000), Foreign aid and rent-seeking, Journal of International Economics 51, 437-461.

Söderling, L. (2006), After the oil: Challenges ahead in Gabon, Journal of African Economies 15, 117-148.

Vallée, O. and Vallée, S. (2005), The poverty of economic policy: Is debt sustainability really sustainable?, Journal of International Affairs 58, 177-192.

World Bank (2006), World Bank approves US$ 37 billion for multilateral debt relief initiative, World Bank Press Release 2006/327/PREM, Washington, D.C.