Debt relief, Debt Sustainability, and Growth in Low-Income Countries

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Why Is Debt Sustainability a Global Issue?

Debt sustainability may be defined as a country’s ability to meet its debt service obligations without resort to exceptional financing or a major correction in its balance of income and expenditure. It is therefore an important precondition for economic stability, which in turn is crucial for economic growth and development. This means that a country’s debt sustainability matters not only to the debtor country itself but also to its creditors, since their repayment depends on the debtor’s stability and growth. But, important as it may be to both sides, if debt sustainability essentially involves the financial relationship between an individual borrowing country and its creditors, in what sense is it a global issue?

The answer to this question has become increasingly apparent in recent years. The financial crises of the last decade spread through a large number of middle-income emerging market economies at rapid speed, affecting even countries with a fairly good track record of economic management. The lesson this taught was that the impact of a country’s financial troubles is not necessarily limited to that country: with financial contagion, mismanagement by one country can be an important threat to debt sustainability elsewhere. Meanwhile many low-income countries, which unlike the middle-income countries mostly rely on official aid financing, have proved unable to use the loans offered them on concessional terms to generate even the minimal rate of return required to repay those loans. Something had to be done, and on a global scale, to relieve the debt burdens of these desperately impoverished countries, or else a large proportion of humanity would face a grim economic future, with consequences for the rest of the world economy as well.

The Millennium Declaration and the associated Millennium Development Goals (MDGs), by focusing the world’s attention on the plight of the poorest, have also played an important role in elevating debt to a global issue. Meeting the MDGs by the target date of 2015 will require substantial financial flows to developing countries. If these resources are provided in the form of loans on burdensome terms, these countries will face a renewed risk of debt distress. Moreover, as countries, donors, and other stakeholders struggle to find these resources, some have legitimately questioned why countries that are unable to meet the basic needs of their people should have to repay their debts to countries that are far more prosperous.

1 This note was prepared by Dr. Sona Varma, Senior Economist, Economic Policy and Debt Department, PREM Network, the World Bank. Valuable inputs were received from Soniya Mitra, Mark Roland.
Consequences of Excessive Debt

Heavy debt burdens on low-income countries have various adverse consequences not only for the borrowers but also for their creditors and the global aid architecture.\(^1\) The need to repay debt reduces what the debtor country can spend internally on investment in education, health, and infrastructure; this in turn reduces its growth potential and thus its future ability to service the debt. And because external debt must nearly always be repaid in foreign currency, debt service may siphon off a large share of a country’s foreign exchange holdings, limiting its ability to import capital goods and thus further hindering growth. A large debt overhang may also dampen incentives to invest in the debtor country, because potential investors realize that higher taxes will likely be imposed on the returns to their investment, in order to service the debt. Investors also have reason to fear that the country will resort to currency devaluation or inflation to maintain debt service. Finally, when a rising share of revenue must be devoted to debt service, the government’s ability to implement its own policies is weakened. The result can be a severe loss of credibility that undermines public support for policy reform and brings governments under pressure to renege on their debt service obligations.

For their part, when creditors and donors must provide debt relief to their borrowers with heavy debt burdens, they are usually left with fewer resources to finance new investment, as their aid budgets are limited. Moreover, creditors are often hesitant to lend to countries that have required large-scale debt relief in the recent past, for fear the cycle will merely repeat itself. This results in a shift from lending to grant financing, which is seldom available on the same scale that the lending would have been. Indeed, as debt relief for low-income countries has increased in recent years, a number of bilateral creditors have already shifted toward greater grant financing.

How Did Countries Become Overindebted?

The current debt crisis in low-income countries is partly the result of disappointing performance in economic growth and the struggle against poverty. Among the countries meeting the official criteria for “heavily indebted poor countries” (HIPC; see further below), nominal debt stocks rose from moderate levels in the early 1980s to, on average, some 800 percent of exports and 160 percent of gross national income in the mid-1990s. In some countries such indebtedness amounted to a severe debt overhang, which may have contributed to their poor growth performance. In a global environment in which many economies prospered from growing trade and financial integration, some of the world’s poorest countries were thus left further behind, seemingly unable to put large amounts of net external financing to good use. Although the debt problem was only one of several factors contributing to slower growth, this experience is a reminder of the challenges that lie ahead in translating new borrowing into growth-enhancing projects and policies.

The reasons behind the unsustainable rise in these low-income countries’ debt offer important lessons for preventing debt crises in the future. Although the specifics differ from country to country, a common theme is that borrowing decisions were predicated on growth projections that never materialized: the borrowed resources failed
to generate the expected returns. This is not to say that the expectations were unreasonable. Figure 2 shows that if low-income countries had grown in real terms at an annual rate of 5 percent since 1980, their average debt-to-GDP ratio today would be more than a third smaller than it is. A 5 percent real growth rate is a relatively modest target for a developing country, yet only a little more than one in three low-income countries achieved that rate of growth during the period.

Other factors were also partly responsible for the disconnect between debt and growth in most of the crisis countries. One of these was a severe shock to the terms of trade: prices of primary commodities—the predominant export category for many low-income countries—fell sharply at the start of the 1980s and remained low for many years. Others included bad weather; waste of resources due to policy deficiencies, poor governance, or weak institutions; inadequate debt management, reflected in unrestrained borrowing at unfavorable terms; nonconcessional lending and refinancing policies on the part of creditors, primarily in the early years, motivated in part by the desire to promote their own exports; and political factors, such as civil war and social strife, which often had devastating economic consequences. In addition, the debt crisis developed in slow motion as bilateral creditors at first used stopgap solutions to deal with payment difficulties. This is discussed in greater detail below.
Figure 1: HIPC Debt Burden Ratios and Per Capita Income, 1979-2001
(In percent)
HIPC Debt Service and Total Stock of Debt

Sources: World Bank, Global Development Finance, 2003; World Bank Debtor Reporting System; and staff estimates.

1/ Average of individual ratios for 42 HIPCs for which data is available.

This figure is reproduced from IMF, 2003.
The International Community’s Response

Bilateral Creditors

The initial responses to the debt crisis in low-income countries were predicated on the belief that the problem was temporary. Bilateral creditors addressed the emerging debt servicing problems through new net lending and flow rescheduling, first on commercial and subsequently on increasingly concessional terms. Net flows to these countries (grants and loans minus debt service paid) remained positive, averaging 13 percent of the borrowing countries’ GDP over 1984–96, but because a large share of the new flows came in the form of new debt rather than grants, they did little to relieve the debt burden. This strategy also distracted the attention of both debtors and donors from more fundamental economic issues and, by pushing debt service payments into the future, added to the debtors’ solvency problems. The acknowledgment that the debt stocks of these countries were effectively unsustainable, and that indebtedness itself could be among the factors impeding investment and growth, started to take hold only in the early 1990s, when the Paris Club began to consider stock-of-debt operations. This realization culminated in 1996 in the HIPC Initiative, with its comprehensive treatment of all the outstanding obligations of eligible low-income countries, as discussed below.

Multilateral Creditors
It soon became apparent that bilateral debt relief was insufficient to alleviate the payment difficulties faced by the poorest countries. Indeed, as bilateral debt relief through the Paris Club took hold, an increasing share of low-income countries’ debts came to be owed to multilateral lenders such as the World Bank, the International Monetary Fund (IMF), and the regional development banks such as the African Development Bank (AfDB). In 1996 the World Bank and the IMF launched the HIPC Initiative, which created a framework within which all creditors, including multilateral creditors, could provide debt relief to the world's poorest and most heavily indebted countries.

Today 38 countries are potentially eligible to receive HIPC assistance. Of these, 28 are already receiving debt service relief totaling more than $59 billion—the World Bank’s contribution to date is $14 billion. The resulting lower debt service payments have allowed debtor governments to spend more on social needs, including basic health, education, and infrastructure. With HIPC relief, poverty-reducing expenditure in these countries is expected to rise from less than twice that on debt service payments to more than four times. Annex 1 provides some information on how debt relief has helped several low-income countries deal with their debt burden.

Other Stakeholders

Politicians, civil society organizations, and religious groups have also sought to place debt relief at the forefront of the global agenda. Together they played a key role in lobbying for multilateral debt relief and ultimately in the creation of the HIPC Initiative in 1996 and its enhancement in 1999. Activist civil society groups such as Jubilee International also held numerous debt relief campaigns worldwide, exerting strong political pressure on the leaders of the industrialized nations to take action. The Jubilee 2000 campaign was a highly effective global lobbying campaign that managed to put this relatively arcane issue on the negotiating table throughout the world. Continued pressure also played an important role in the June 2005 proposal by the finance ministers of the Group of Eight major industrial countries, which called for the International Development Association (IDA, the World Bank’s concessional lending affiliate), the IMF, and the AfDB to cancel 100 percent of the debt owed to them by all HIPCs worldwide.

Recent Initiatives

As of September 2005 the G-8 proposal for complete HIPC debt cancellation had been endorsed by the shareholders of the World Bank, the IMF, and the AfDB. The main objective in canceling this debt is to help the HIPCs reach the MDGs. The cost to the World Bank of financing the initiative is estimated to be $42.5 billion. For IDA and the AfDB, debt cancellation is being financed 100 percent by additional donor resources, effectively nearly doubling the financial impact of the HIPC Initiative.

In addition, the World Bank and the IMF are implementing a forward-looking debt sustainability framework for low-income countries that aims to contain the risk of
future debt crises by preventing a renewed buildup in external debt. The Bank and the Fund approved this framework in early 2005 to ensure that low-income countries are provided resources on terms commensurate with their risk of debt distress. Staff of the two institutions are using this framework to jointly analyze debt sustainability in those countries eligible for assistance from IDA, and IDA has adopted this framework as the basis for grant allocation under the upcoming fourteenth replenishment of its funds (IDA-14). By current estimates about 40 countries could receive part or all of their IDA allocation in the form of grants, because of concerns related to medium-term debt sustainability. Overall about 30 percent of IDA-14 could be provided as grants. Although further debt cancellation will significantly reduce debt ratios in the HIPC’s, a strong forward-looking framework that mitigates the risk of recurring debt problems remains important to preserving sustainability in these countries as well as in those not qualifying under the initiative.

**Is Debt Relief the Answer?**

Debt relief can be an important alternative source of financial flows to countries that desperately need financing to meet their basic needs, in a world where such flows to the poorest countries are limited. For example, some of the resources that African countries currently spend on debt service (around $2 billion annually) could surely be better used in pursuit of the MDGs: this is the main argument behind the G-8’s initiative described above. Some of these needs can indeed be met with relatively modest amounts of financing (in the view of Jeffrey Sachs, director of the Earth Institute at Columbia University, among others), and in such cases debt relief may be sufficient on its own to provide the necessary resources.

To the extent that the poorest countries continue to face difficulties in maintaining debt sustainability, debt relief can be beneficial. Debt relief can contribute to debt sustainability but cannot guarantee it. Although the HIPC Initiative has sharply reduced debt service and laid the basis for debt sustainability in the qualifying countries, further debt relief could serve some other important objectives:

- It could reduce any remaining debt overhang problems and reinforce debt sustainability objectives.
- It could ease balance of payments pressures arising from any future economic shocks.
- It could offer a vehicle for the international community to provide the additional resources needed to meet the MDGs in a predictable and easily accessible form.

For accomplishing the broader objectives of growth and sustainable development, however, debt relief is a limited tool, in several ways. First, the resources that can be generated from debt relief are obviously limited by the existing stock of debt; the potential of debt relief is therefore modest when compared with the potential gains from trade liberalization and increased access to markets (a major part of the agenda under the Doha round of international trade negotiations). Second, the benefits of debt relief can
quickly be erased if relief is not accompanied by sustained improvement in policies and a prudent new strategy for future borrowing. The history of debt relief is filled with countries that began once again to accumulate new debt fairly rapidly after receiving a debt relief package. Third, lasting poverty reduction and growth require a lot more than debt relief: both additional financing and sound policy measures are needed to strengthen institutions and reduce vulnerabilities to shocks. Debt relief is therefore not an end in itself, but only a means to the end of sustainable development, and that will require a number of interdependent actions on the part of low-income countries, their creditors, and the world community.

Another important caveat is that, to the extent that donors provide debt relief by reallocating resources already earmarked for aid, the recipient countries will see no net increase in resources. Although the HIPC Initiative was supposed to provide resources that were additional to existing aid programs, donors have to some extent simply reallocated their new aid flows toward the initiative. In the future a necessary condition should be that the donor community increase its overall aid envelope, and not reduce other aid flows to finance debt relief.

Finally, one must not overlook some serious issues related to equitable treatment and moral hazard that continue to plague the effectiveness of debt relief. Given limited donor resources, debt relief to selected countries tends to divert funds away from other poor countries that have managed their debts responsibly. For example, between 1999 and 2003, HIPCs received nearly five times more aid per capita than other low-income countries. Equally important is the issue of moral hazard: the expectation of future debt relief may cause governments to engage in irresponsible lending in the hope that it will someday be forgiven. Empirical analyses have in fact indicated a strong positive relationship between debt distress (and hence the need for debt forgiveness) and poor policy and institutions. The presence of moral hazard strengthens the argument that strong policy performance must be a precondition for debt relief.
Annex 1. The Role of Debt Relief in Development: Selected Country Profiles

**Bolivia.** The debt crises of the 1980s brought external financing by Bolivia’s commercial creditors to a complete halt by the 1990s. Official creditors, however, continued to finance structural reforms aimed at enhancing the productivity of the export sector. Terms-of-trade shocks in 1992 and 1995 and the effects of the financial crisis in Brazil in 1999 required additional debt restructuring agreements, which culminated in two stock-of-debt reductions under the framework of the original HIPC Initiative and the Enhanced HIPC Initiative in 1998 and 2000, respectively. Public debt has been increasing since 2000, as a result of pension reforms and an economic slowdown.

**Ethiopia.** From 1991 to 1994, as Ethiopia completed the transition from a communist regime to a market-oriented economy, public debt increased sharply as a result of currency devaluation, economic contraction, and new borrowing needs. Subsequently, the government maintained macroeconomic stability, which supported sustained growth, but it also accumulated arrears on its debt despite rescheduling and cancellation of some of the debt. During 1999-2003 a sharp reduction in the price of coffee and a severe drought undermined economic growth. The external debt shrank, principally because of debt relief granted under the HIPC Initiative, but domestic debt, to finance the war with Eritrea in 2000 and for other public expenditure, increased.

**Ghana.** Ghana’s external debt increased sharply from 1991 to 1993. In addition, failure to achieve fiscal discipline, accompanied by subsidies to public enterprises and the recognition of some large contingent liabilities, resulted in an increase in domestic debt. During 1999-2000 sound fiscal performance was undermined by a terms-of-trade shock, which sharply increased the external debt burden. Since 2001, however, public debt has steadily declined thanks to debt relief granted under the HIPC Initiative, a return to macroeconomic stability, and a partial repayment of domestic debt.

**Laos.** In 1991 Laos’s public external debt amounted to $1.8 billion, or 200 percent of GDP. About 80 percent of the debt was owed to Russia and other former members of the Soviet bloc, and less than 20 percent to multilateral creditors. From 1991 to 1995 the ratio of debt to GDP declined, as economic growth was sustained by structural reform, macroeconomic stability, and the availability of concessional financing. However, in 1997-98, during the Asian financial crises, the debt-GDP ratio increased sharply as a consequence of economic slowdown and lack of adequate financing of an ambitious public investment program. During 1999-2003 the debt burden again decreased substantially as a result of a successful stabilization program and debt cancellation received from Russia in 2003.

**Uganda.** In 1991 Uganda’s stock of public debt reached the equivalent of 163 percent of GDP. The steady decline of coffee prices, the country’s main export commodity, and continued external borrowing to finance an ambitious adjustment program substantially increased the debt burden. In 1992-97, thanks to macroeconomic stability and debt reduction received from bilateral creditors, the debt decreased. The debt burden continued to decline in 1998-2003, thanks to continued stability of the exchange rate and additional debt relief granted under the original and enhanced HIPC Initiatives.
BIBLIOGRAPHY


Valuable inputs in the preparation of this chapter were received from Soniya Mitra, Mark Roland Thomas and Luca Bandiera of the World Bank and Christina Daseking of the International Monetary Fund.

1 This section draws heavily on Moss and Chiang (2003).

2 For a discussion of the historical role and objectives of export credit agencies see Stephens (1999).
3 For a discussion of these factors and the specific experience of 10 low-income countries see Brooks and others (1998).
4 For the group as a whole, the ratio of aggregate net transfers to aggregate GDP (that is, the GDP-weighted average flow) was 7 percent, reflecting proportionately smaller flows to the larger economies in the group.
5 The Paris Club provided its first concessional stock-of-debt operation in 1995 to Uganda. For a brief history of debt relief to low-income countries, see Daseking and Powell (1999).
7 See Kraay and Nehru (2004)