Debt Relief and Growth

How to craft an optimal debt relief proposal

by Raghuram Rajan

In a number of developed countries, debt relief for low-income countries has become an important political issue. Rock stars and politicians rightly point to the overwhelming burden borne by poor countries who have to set aside a significant fraction of their national income to repay creditors. Worse still, they argue, much of this debt is “odious,” built up by past corrupt dictators who whisked the money to Swiss bank accounts. Furthermore, evidence that countries with high debt tend to have low growth suggests that debt relief can help poor countries grow.

Several debt relief proposals are on the table, but there is little agreement among donors on which one makes the most sense. The proposals typically have a one-size-fits-all flavor, in part because uniform treatment would avoid politicking by potential recipients. But would poor countries benefit from uniform treatment? This article tries to clarify some of the broad principles that could lead to an optimal debt relief proposal.

Net flows, not debt relief, matter

Consider a poor country that has to repay $100 million to official creditors such as developed countries or international financial institutions in the current period. Assume it earns $50 million in foreign exchange in this period and has no other resources. Clearly, it cannot repay the debt fully out of its own resources. Now consider three alternative proposals. First, the creditors do not forgive the debt, but lend $120 million to the country. Second, creditors forgive the debt down to $50 million, but lend nothing. Third, creditors forgive the entire debt and lend nothing. Which alternative is best for the country?

Assuming this country has no access to private capital markets, the answer seems obvious: full debt forgiveness, which would be twice as good as half debt forgiveness and surely better than a loan that is not much bigger than the full debt amount. Yet when
viewed in terms of net resources available to the country during the period, under the first proposal these would amount to $70 million (the loan of $120 million plus inflows of $50 million, less the repayment of $100 million), under the second they would amount to nothing, while under the third they would amount to $50 million. Of immediate importance to a resource-starved poor country is the amount of additional resources it gets in the current period (termed “additionality”). The best proposal in terms of additionality is the first, which offers no debt relief.

The point is that if official creditors take with one hand (collecting debt service) but give more with the other (in the form of a loan), the poor country may have more financing in the short run than with debt forgiveness. And debt forgiveness may actually be problematic if it exhausts donor aid budgets. Of course, without forgiveness, in the long run, the country will have more debt on its books, which may become unsustainable. In the three proposals, the country will end the period owing $120 million, $50 million, and nothing, respectively. However, high or unsustainable debt is a problem only if it hurts the country’s growth. Let us turn to that.

High debt can be detrimental to a country’s growth. It can increase the risk of financial distress or crisis, when foreign creditors rush to cash in their claims, resulting in the failure of banks and firms. However, if official creditors hold the bulk of the poor country’s debt, it is unlikely they will precipitate a crisis, so the country will not experience a meltdown no matter what its level of debt.

A second reason why a high level of debt might hurt is that it can create a debt overhang problem. For instance, when a country has high debt outstanding, private investors may be reluctant to invest for fear that the debt will eventually be repaid by levying extra taxes on corporations. Similarly, the government may hesitate to invest because the returns will largely go to service debt. Hence, high debt can impair investment and thus growth, and reducing debt may be necessary to jump-start growth. Compelling as these arguments may be in the case of emerging markets, I am not convinced they are important for poor developing countries. Investors in poor countries face other, more significant impediments to investment, such as a discouraging business climate and uneven regulation. A reduction in the level of government debt, without any additional resources or policy change, is unlikely to jumpstart investment.

Some analysts have indeed found a negative correlation between debt and growth in poor countries, but there are other possible explanations. For instance, the causality could run from low growth to high debt, with countries that have weak growth (which may be due to poor policies) running larger deficits, and thus borrowing more. If this is the direction of causality, then debt forgiveness will not spur more growth, and I have yet to see compelling evidence against this possibility. This means that for poor countries borrowing primarily from official creditors, the extent of debt forgiveness matters only in that it increases net resources. Sometimes more additionality—at least in the short term—can be obtained with no debt relief, especially if forgiveness impairs donor aid budgets. And the “unsustainable” outstanding debt can eventually be dealt with through some mix of repayment and forgiveness (when donors have more budget room).
A possible role for debt relief

This is not to say debt relief never makes sense. Debt relief could effectively provide predictable additional resources directly to the budget (via the repayments that no longer have to be made) and could offer a way to force coordination on conditionality among donors. Equally important, debt relief could allow a poor country to obtain access to loans from private foreign investors. Private investors may be unwilling to lend to a highly indebted country for fear that the country will be unable to repay, but if official debt is completely forgiven, they will jump in to lend, because even the worst debtor can be trusted to service small amounts of debt. Thus, official creditors may be able to expand a country’s access to private resources through debt forgiveness.

Would such additional resources from the private sector be beneficial? That depends on how much official debt is left on the books, on the nature of the recipient government, and on whether projects have a commercial or social orientation. Clearly, if most of the official debt is forgiven, the private sector has little need to be careful in its lending. Moreover, if the poor country’s government is irresponsible it can build up debt again by spending on worthless projects. As a result, the citizens of the recipient country will not benefit from this renewed debt buildup. In addition, donor countries will likely suffer from “forgiveness fatigue” the next time around. By contrast, moderate debt forgiveness can lead to higher-quality investment as the private sector will have to evaluate the profitability of projects carefully, which in turn can help improve the quality of commercial projects. Of course, if projects produce a social return but no commercial one, the private sector will likely not provide any funds, and official aid will be necessary.

Different situations, different approaches

Let us then summarize where logic leads us. If a poor country has no access to private markets, and the investment climate is bleak, financial distress or debt overhang are unlikely to result from high debt. A focus on debt forgiveness—as opposed to the net incremental resources available in the short run (that is, additionality)—is misplaced. Debt forgiveness makes sense if it generates more resources from the private sector, but the country authorities must have the incentive to use resources well and the private sector to lend responsibly. Interestingly, this means that depending on the country’s situation, the status quo, as well as any one of the three proposals I outlined, could be the best approach for the country.

If the country’s government is thoroughly corrupt, then the status quo—no forgiveness and no additional aid—is best, for it gives the government no official resources to misuse and limits its ability to raise private sector funds. Aid in this case should be distributed directly to nongovernmental organizations. If the country has a reasonably committed government, look at the country’s primary need. When social sector projects top the list, then what matters is the extent of official sector net funding. Here, the first alternative—debt is not forgiven but official creditors lend more—is best. But if most projects are commercially viable, the second alternative—some relief but leaving enough outstanding
official debt that foreign private investors lend responsibly—may be optimal. Finally, substantial debt forgiveness is prudent if the risk of financial distress really is a serious problem—an unlikely eventuality. But there must be an assurance that the country does not borrow up again from private creditors and game the system to get further debt relief. Donor imposed limits on borrowing may be needed.

Political momentum in the developed world is building for offering some form of debt relief, and while no developing country situation will fit neatly into these categories, debt relief proposals can be better crafted. One-size-fits-all proposals, while politically more convenient, are unlikely to benefit recipient countries as much as proposals that tie debt relief and additional aid to a country’s specific situation. Of course, the more transparent the proposals and the more quickly they can be implemented, the better off the recipients will be.