The Political Economy of Debt Relief

Andreas Freytag

Friedrich-Schiller-Unversity Jena
and
ECIPE

Paper presented at the
Berlin Roundtable Meeting
June 2, 2007

Outline

1. Introduction
2. The Literature
3. Is Good Governance a Driver for Debt Relief? Theoretical Considerations
4. Empirical Analysis
5. Conclusions

1. Introduction

- A number of debt relief programs have been started in the last two decades, partly by the G8.
- In sum, approximately 100 bn US-$ have been granted.
- They have generated high expectations but poor results, except for the Brady-Plan.
- This leads to three questions:

    1. Can debt relief bring about growth and better governance?
    2. Does governance play a role when granting debt relief?
    3. Have the criteria been changing over time?

1. **Introduction**
2. Literature
3. Theoretical Foundations
4. Empirical Analysis
5. Conclusions

- The topic is relevant as development problems are still huge, in particular in sub-Saharan Africa.
- There are more debt relief programs to come, e.g. Gleneagles 2005.
- Poor taxpayer in rich countries have to bail out (rich people in) poor countries.
- Empirical analysis between 1990 and 2004 with three sub-periods to answer the three questions with a focus on the second and third one.

2. The Literature

1) Rationale for Debt Relief

In the case of debt overhang (Sachs 1983, Krugman 1988),

- debt relief in theory is helpful for debtors (inflation)
- and helpful for creditors (Corden 1991).

- Empirical evidence shows that the debt overhang is relevant (Deshpande 1997).

- Debt between 100 and 200 per cent of exports and 35 and 50 per cent of GDP is detrimental for growth (Pattillo et al. 2002, Bhattacharya/Clements 2004, Imbs/Rancierre 2005).

Debt relief can stimulate investment.

- However, this only holds when aid is not reduced at the same time (Birdsall et al. 2002);
  - no convincing evidence for this hypothesis (Ndikuma 2003),
  - slight crowding out (Hernández/Katada 1996),
  - no evidence for additionality (Bird/Milne 2000).
- In addition, some Sub-Saharan African countries are net capital exporters.

Debt relief can have disincentive effects.

- Higher level of outstanding debt is correlated with higher official net transfers (Bird/Milne 2003);
- debt levels do not affect investment (Birdsall et al. 2002).

2) Effectiveness of Debt Relief:

- Debt overhang is not reduced (Hernández/Katada 1996).
- Debt relief did not increase import capacity (ibid.)
- Institutional quality was not improved (Chauvin/Kraay 2005)
- Public consumption rather than investment increased (Clements et al. 2005).
- Moral hazard (Easterly 1999, Bauer 1991)
- An exception is formed by the Brady Plan: middle income countries with debt overhang could benefit from debt relief.

3) Determinants of Debt Relief:

Economic criteria were not decisive (Hernández/Katada 1996).

The same hold with governance variables (Neumyer 2002).

Instead a political economy model shoed robust:

- path dependeny because governments do not admit past policy failures (Michelowa 2003);
- empirically backed by Neumayer (2002), Birdsall et al. (2002) as well as Alesina/Weder (2002).

This evidence is repeated in the case of ODA aid:

- Voting behavior at the UN and trade relations, historical relations.

3. Is Good Governance a Driver for Debt Relief? Theoretical Considerations

- Our analysis assesses the determinants of debt relief.

H1: Debt relief is granted to highly indebted countries.

H2: Debt relief today is positively correlated with debt relief granted in the past.

H3: Poverty is a driver of debt relief.

H4: Donor countries behave strategically; oil-exporting countries are more likely granted a debt relief.

Creditors may, however, change their behavior due to

- better information in debtor countries and
- to new theoretical knowledge.

H5a: In the third sub-period, debt relief is positively correlated to good governance.

H5b: In the third sub-period, debt relief is positively correlated with improvements in the governance structure.

4. Empirical Analysis

We do cross country estimates for three periods (1990-1994, 1995-1999, 2000-2004). We have chosen these sub-periods because the second and third sub-period almost match the HIPC I and HIPC II initiative respectively.

Debt relief calculated in terms of face value and not in terms on net present value. Reasons are

- no comprehensive database of NPV available (loan by loan);
- face value easier to sell politically;
- NPV not relevant for many creditors and
- ODA is reported in terms of face value (compatibility).

Data sources

Variables:

Macroeconomic data, control variables, institutional variables:

- Civil Liberties (Freedom House)
- Political Rights (Freedom House)
- Corruption Perceptions Index (Transparency International)
- Voice & Accountability (World Bank/KKM)
- Political Stability & Absence of Violence (World Bank/KKM)
- Government Effectiveness (World Bank/KKM)
- Regulatory Quality (World Bank/KKM)
- Rule of Law (World Bank/KKM)
- Control of Corruption (World Bank/KKM)
- Index of Economic Freedom (Heritage Foundation)
- Economic Freedom of the World (Fraser Institute)

With respect to our **hypotheses**, we can state that

H1 can be partly confirmed, debt per GDP is positively correlated with debt relief, debt per exports not.

H2 is confirmed, there was path dependency in the 1990s. Debt relief in sub-period 2 was strongly positively correlated with debt relief in sub-period 1.

H3 is confirmed, poverty drives debt relief, at least in sub-period 3 (21st century).

H4 has to be rejected, oil exporting countries are not treated generously.

H5a can be confirmed, in the 21st century, institutions matter.

H5b can also be confirmed, improvements in governance are positively correlated with debt relief.

In addition, we do not find evidence for debt overhang nor for crowding out of ODA aid.

The evidence can cautiously be interpreted such that governments in donor countries have learned about the role and importance of governance structures.

5. Conclusions

Whereas in the 1990s political economy models explain the pattern of debt relief very well and exclusively, this is different at the beginning of the 21st century:

\ institutions matter for the decision to grant a debt relief!

The G8 has obviously taken this into account \ see the Leitmotif by the German government who acknowledges that Africa needs better governance structures for further and sustainable development.

This generally positive result is backed by a study about aid and institutions (Heckelman and Knack 2006).

Before we take this interpretation as granted, we need more evidence;

- Gleneagles 2005
- Heiligendamm 2007?

We need more theoretical and empirical research about learning processes within governments and international organizations.