After the Crisis is before the Crisis: 
The Political Economy of Debt Relief

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The global financial market crisis has fed fears that individual countries face so serious problems that they might even go bankrupt causing a crisis cascade. In particular, developing and emerging economies, which so far have been regarded as being decoupled from the crisis in the industrialised world, are expected to be endangered (Reinhart and Reinhart 2008). Countries that may be regarded as problematic in this context are Hungary, Pakistan and Iceland. Hungary, for instance, has run substantial current account deficits in the recent past, which are expected to drop significantly, raising fears of a sudden stop with negative macroeconomic consequences. In addition, the country has built up huge external debt, which amount to more than 106 per cent of GDP in 2008 and are expected to increase to more than 115 per cent of GDP in 2009 (IMF 2008). This mixture is problematic from several perspectives. A great problem is the macroeconomic downturn because of withdrawn international capital and a subsequent recession. However, the danger of bankruptcy seems also relevant. If a country is in severe need of foreign assistance and credits, a withdrawal of capital might cause insolvency. It is by far too early to make an informed statement about the state of e.g. Hungary’s or individual African countries’ public finances and to draw conclusions, but some countries may rather quickly become another target of speculation and face the threat of a bankruptcy subsequently.

The International Monetary Fund (IMF) had awarded a loan of 15.7 billion $US to Hungary to help the country combat negative fallout from the global financial crisis. Most recently, Pakistan got into deep trouble when the country’s foreign exchange reserves shrunk dramatically and the rupee plunged in October as the balance of payments deficit in the three months from July 1 widened to $3.95 billion from $2.27 billion a year earlier. The decision of the IMF to approve a US$7.6 billion credit to Pakistan to stave off a balance of payments crisis reduces for the time being the prospect of Islamabad defaulting on its foreign debts. Iceland received a bailout of almost $5 billion from the International Monetary Fund and the neighbouring Nordic countries. The IMF also promised to help Latvia deal with its economic crisis after it assisted Iceland, Hungary, Ukraine, Serbia and Pakistan. Table 1 shows the cost of some of the bailout programmes since the mid 1990s.
In this paper we analyze the rationale as well as the political and economic determinants of debt relief for highly indebted poor countries, thereby drawing lessons for the emerging economies in trouble. In particular, the question of the creditors’ motivation to grant debt relief is relevant. For this purpose we first give an overview on the latest debt relief programs. Second, we search for the rationale of debt relief. Third, we ask whether or not debt relief can be expected to be effective in stimulating economic growth as well as – since good governance and decent institutions have been proved to be of special importance for economic growth and development – in improving governance qualities in these countries. After answering this question, we concentrate on the determinants of debt relief. The final section concludes our findings.

**Debt Relief Programs in recent history**

Although the world had seen earlier concerns about the debt situation in developing and transition countries resulting in some debt relief initiatives like the Pearson Report in 1969 and the Retroactive Terms Adjustment (RTA) program in 1978, the debt problem became apparent in 1982 with Mexico defaulting on its debt payments. This event marks the beginning of the debt crisis of developing countries. In the subsequent years, various debt relief and restructuring programs had been intro-

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**Table 1: Crises and bailout-cost**

<table>
<thead>
<tr>
<th>Crisis</th>
<th>GDP (in billions)</th>
<th>Cost (in billions)</th>
<th>%GDP</th>
</tr>
</thead>
<tbody>
<tr>
<td>U.S. 2008</td>
<td>$14,312</td>
<td>$1.500*</td>
<td>&gt;10%</td>
</tr>
<tr>
<td>Pakistan 2008</td>
<td>$130</td>
<td>$7.6</td>
<td>6%</td>
</tr>
<tr>
<td>Hungary 2008</td>
<td>$170</td>
<td>$15.7</td>
<td>9%</td>
</tr>
<tr>
<td>Argentina 2000</td>
<td>$299</td>
<td>$22</td>
<td>7%</td>
</tr>
<tr>
<td>Brazil 1998</td>
<td>$844</td>
<td>$42</td>
<td>5%</td>
</tr>
<tr>
<td>Russia 1998</td>
<td>$271</td>
<td>$24</td>
<td>9%</td>
</tr>
<tr>
<td>Korea 1997</td>
<td>$527</td>
<td>$57</td>
<td>11%</td>
</tr>
<tr>
<td>Thailand 1997</td>
<td>$151</td>
<td>$17</td>
<td>12%</td>
</tr>
<tr>
<td>Indonesia 1997</td>
<td>$238</td>
<td>$21</td>
<td>9%</td>
</tr>
<tr>
<td>Mexico 1995</td>
<td>$421</td>
<td>$48</td>
<td>11%</td>
</tr>
</tbody>
</table>

* Final Treasury, FSLIC and RTC spending on S&L bailout; total value of IMF rescue packages assembled for others. Developing-country GDPs are currency-basis in the year preceding the relevant crisis. PPI (2008) and own estimations.
duced, mainly to prevent further defaults of debtors through the provision of new loans and debt rescheduling. Most of the debt restructuring programs of the 1980s, such as the Baker Plan and the Brady Plan, bailed out private sector creditors and allowed commercial banks to write off some of the active debts by rescheduling them, converting them into bonds (e.g. Brady-Bonds), or “selling” them to the IFIs. These included not only developing countries but also today’s transition countries such as Poland. Some authors claim that the main goal of these plans was to avert a financial crisis in the West (Pettifor and Greenhill 2002, p 13). Nevertheless, the Brady Plan was successful with respect to the problem of debt overhang in some middle-income countries (Arslanalp and Henry 2005). Since the early 1990s, however, official debt is in the center of the political activity and become a major playground for NGOs and activists, just to mention the Jubilee movement and the Bono-Geldof-Live8-movement.

The Paris Club, a group of creditor countries with 19 permanent members, agreed on various debt cancellations and rescheduling programs, focusing on the rescheduling of ODA debt and a partial cancellation of Non-ODA debt.¹ The so-called London Terms were formulated in 1991 and provided a reduction of up to 50 percent of Non-ODA debt. The Paris Club agreements contained some rather vague clauses that took a country’s need for debt forgiveness or rescheduling into account and should have stipulated adjustment programs in the debtor countries.² With the introduction of the Cologne Terms by the G8 in 1999, the Paris Club creditor countries accepted to raise the level of debt cancellation for the poorest countries up to 90 percent or even more if necessary. This debt forgiveness is taking place within the framework of the initiative for Heavily Indebted Poor Countries (HIPC). Cologne terms are implemented on a case-by-case basis. To qualify for these terms, debtor countries have to show “continuing strong economic adjustments” (Paris Club 2006b). Given these terms, one would expect that the debt relief plans implemented by the Paris Club in recent history stipulated sound policies in debtor countries and therefore contributed to economic growth there.

However, the debt relief initiatives until the mid-1990s did not solve the debt problem. Many developing countries, particularly in Sub-Saharan Africa, rather experienced a dramatic rise of their external debt

¹ All in all, the agreements reached by the members of the Paris Club since the mid-1980s covered an amount of more than $500 billion so far. Of course, the amount of the debt that has actually been forgiven falls way behind the amount negotiated.

² “Debt treatments are applied only for countries that need a rescheduling and that implement reforms to resolve their payment difficulties. In practice conditionality is provided by the existence of an appropriate programme supported by the IMF, which demonstrates the need for debt relief.” (Paris Club 2006a).
over two decades. The constant difficulties to meet their debt obligations can be traced back to several factors, including exogenous shocks, such as the deterioration in the terms of trade, civil strife, a lack of sustained adjustment or the denial of structural reforms, improper lending behavior of creditors, and the lack of prudent debt management policies by debtor countries (Boote and Thugge 1997, p 4). In view of the fact that the traditional mechanisms for dealing with the debt situation of the HIPC could not solve this problem sufficiently, the IMF and the World Bank launched the Heavily Indebted Poor Countries initiative in 1996, which focused on the debt burden of the poorest countries in the world by reducing the multilateral debt relief of these countries. The main goal was to reduce debt burdens to a sustainable level, which was defined as a debt-to-export ratio within the range between 200 to 250 percent, and a ratio of debt service to exports within a range of 20 to 25 percent, all in net present value terms (NPV). For the first time, this initiative included the main multilateral creditors such as the International Monetary Fund (IMF), the International Development Association (IDA), and the African Development Fund (AfDB). The HIPC initiative introduced some guiding principles regarding a country’s eligibility for debt relief. To be considered for HIPC Initiative assistance, a country must face an unsustainable debt burden, beyond traditionally available debt-relief mechanisms, and establish a track record of reform and sound policies through IMF- and IDA-supported programs. The eligibility of a country is assessed in a staged process. If a country is deemed eligible, it has to commit itself to certain reforms and structural adjustments to reach the decision point. The debt relief is finally delivered at the so-called completion point. During the period of the initial decision point and the completion point, the progress of the country with respect to institutional reforms and structural adjustments is under observation and supported by the IMF and the World Bank.³

In late 1999, the HIPC initiative was expanded in order to provide deeper and more rapid debt relief to a larger number of countries. The enhanced HIPC initiative (HIPC II) integrated debt relief plans into a comprehensive poverty reduction strategy requiring Poverty Reduction Strategy Papers (PRSPs) on a broad-based participatory process as a necessary condition to qualify for debt relief. With this approach, the global donor community for the first time took governance structures in the debtor countries (at least implicitly) into account. Furthermore, the thresholds for sustainable debt levels were redefined and lowered to a debt-per-export ratio of 150 percent and a debt-to-revenue ratio of 250 percent. In practice the time span between

³ For further details on the HIPC II initiatives see Andrews et al (1999).
HIPC II and the completion point is rather large (IMF/IDA 2006, Annex III). Some countries are still waiting to reach the completion point.

Contrary to some traditional debt relief programs the HIPC initiative and especially the HIPC II initiative emphasize explicitly on poverty reduction and the institutional dimensions of economic development in low-income countries. As soon as the awarding procedures of multilateral creditors and the Paris Club members really started to follow these conditions, one would expect that debt relief since the late 1990s would have been provided almost exclusively to countries that fulfill these conditions, which would be a good sign with respect to the expected success of recent debt relief programs.

The Rationale of Debt Relief

One popular efficiency argument for the provision of debt relief is the so called ‘debt overhang’. It has been stated that highly indebted countries benefit very little, if ever, from the returns on any additional investment because of the debt service obligation. Large debt obligations — so the underlying argumentation — can be seen as a high tax on investment, policy reforms and development, because a significant part of the gains from economic adjustment would go to foreign creditors and not to the country itself. Put differently, the higher the stock of external debt, the higher are the opportunity costs of current sacrifices for the sake of future economic growth. This is the basis for the hypothesis of the debt Laffer curve, which refers to the relationship between the size of a country’s debt and the value of repayments. The net present value of debt repayments increases with the face value of total debt up to a certain threshold. Beyond this level of indebtedness a higher face value of debt is associated with lower efforts and investments, lower economic growth and therefore with a lower (expected) net present value of debt service. Creditors should therefore offer debt relief to countries with large stocks of external debt in order to reduce future debt obligations. This would increase the share of any marginal gains from economic adjustments that goes to the debtor country and create incentives to make these adjustments (Corden 1991). This strategy could end up in a win-win-situation by not only easing the debt burden of debtors but also increasing future repayments to the creditors. Debt overhang is also supposed to depress growth by increasing private investors’ uncertainty.

The concept of debt overhang was initially introduced by Sachs (1983). See also Sachs (1989). Krugman (1988) defined debt overhang as a situation in which the expected repayment on foreign debt falls short of the contractual value of the debt.

Tengstam (2006) provides a multi-period model to show that debt relief stimulates adjustment even in the absence of an initial debt overhang and questions the hypothesis that a too generous debt relief might reduce the adjustment efforts of developing countries.
about actions the government might take to meet its debt-servicing obligations, such as a sudden and stark increase of money supply causing inflation (Clements et al. 2005), or distorting future tax policies.

Several studies have examined the existence of a debt overhang in developing countries. Despite a few ambivalent and mixed results, the empirical literature mainly provides support of the debt overhang hypothesis. Deshpande (1997) finds the debt overhang effect to be valid for a small sample of 13 countries in the period from 1971 to 1991. Pattillo et al. (2002), using panel regressions for 93 developing countries over the period 1969-1998, suggest that debt levels beyond 160-170 percent of the exports or 35-40 percent of GDP are detrimental to growth. Bhattacharya and Clements (2004) estimate the debt overhang threshold at about 50 percent of GDP for the face value of external debt and about 100-105 percent of exports for the net present value of external debt based on data over the period 1970-1999 for a group of 55 low-income countries. Imbs and Ranciere (2005) provide non-parametric evidence supporting the existence of a debt Laffer curve among developing countries. Their results indicate that debt overhang occurs when the face value of debt reaches 60 percent of GDP or 200 percent of exports.

Since both theoretical literature and empirical evidence suggest that huge debt burdens tend to be associated with low investment and low economic growth in low-income countries, debt relief might have a stimulating effect on investment and economic development. This justification of debt relief seems to be quite convincing at first glance. But the clincher with respect to the resource position of low-income countries and therefore to the capacity to pay their obligations — at least in the short run — and to invest, is still the net resource transfer from donors, including bilateral and multilateral aid which is of special importance for HIPCs. Since the reduction of multilateral debt is partly financed by bilateral donors (e.g. through their contributions to multilateral funds), and these contributions usually come from the same political reservoir, namely the donors’ aid budget, there might be a trade-off between debt relief and official development assistance (Birdsall et al. 2002, p 10). As Martin (2004) suggests, there is evidence of aid diversion to fund debt relief. However, the empirical literature on additionality of debt relief does not provide strong support for these qualms about it.

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Claessens (1990) generally confirms the existence of the debt Laffer curve in a sample of 29 highly indebted Sub-Saharan African countries but found only a handful on the “wrong” side of the inverted U-curve. Hansen (2001), recognizing a negative impact of the initial stock of external debt and debt service on growth for 54 developing countries, stressed that these relationships become insignificant once some policy indicators are added to the regression model.
In the case of Hungary or other emerging countries the relationship between foreign debt and investment is not that strong. Here the rationale for debt relief could follow different lines; it rather is a threatening cascade effect, which might encourage other countries and the international community to bail out the former. If an individual country’s bankruptcy causes investors to withdraw their capital from other countries with similar but not identical problems, the crisis cascades and even countries without the structural problems of the country in question are endangered. To give an example: consider a country that displays both a huge public debt and a substantial current account deficit. Investors withdraw their capital, causing a default and bankruptcy. This might spread to a country with a similarly high current account deficit but without huge public debt. Despite the fiscal soundness, the latter country will also experience a sudden stop and a macroeconomic crisis, ending in insolvency.

Ndikumana (2003) investigating the relationship between debt alleviation programs and official development assistance (ODA) does not find a direct causal link between the volume of debt relief or debt forgiveness respectively and the volume of ODA disbursed, although the total supply of ODA and grants declined in the 1990s. Hernández and Katada (1996) find a slight crowding-out effect between ODA debt relief and new lending from bilateral resources in a sample of 32 Sub-Saharan African countries during the period 1989-1993. While there is at least no clear-cut empirical evidence of a crowding out of ODA or other sources of finance by debt relief, there is no evidence for addi-
tionality either. In the face of very little, if not zero additionality, the question turns out to be whether it is better to have debt relief or more conventional forms of aid (Bird and Milne 2000, p 201).

Furthermore, taking into account the net resource transfer given to highly indebted low-income countries, the incentive argument becomes more complex than in the traditional debt overhang theory. If the net resource transfer from donors is positively related to a country’s level of indebtedness, the (dis)incentive effects of initial external debts and debt services to invest and to repay the credits may switch in the opposite direction. Bird and Milne (2003) show that higher levels of outstanding debt are usually associated with higher levels of net resource transfers from official sources. This contradicts the hypothesis of debt overhang: countries that increase their capacity (and willingness) to pay are expected to receive less future resource transfers. The disincentives to introduce promising but costly adjustments do not occur because of the so called debt overhang but because of the tax on development, which stems from the declining share in aid budgets given to relatively successful developing
countries. The findings of Cordella et al. (2005) support this hypothesis. The authors found that HIPCs indebtedness did not affect either investments or growth. In their findings the so called debt irrelevance threshold is situated between 50 and 60 percent of GDP. One explanation is that severely indebted low-income countries benefit most from the resource transfer provided by donors.

Birdsall et al. (2002) suggest that net transfers are larger in high debt and especially in the high multilateral debt regimes. Countries with high debt ratios and high debts due to multinational institutions have received larger net transfers. This can be interpreted as a debt subsidy rather than a debt tax.

Considering these theoretical and empirical findings high debt burdens seem on the one hand to be detrimental to economic growth in low-income countries. On the other hand, because of the crucial role of net transfers especially through bilateral and multilateral aid and because of ambivalent incentive effects, it is far from sure that debt relief alone can enhance further economic growth in highly indebted poor countries. In the next subsection we will present a brief overview of the existing literature on the effectiveness of debt relief.

The Effectiveness of Debt Relief

Any debt relief would be economically irrational if the success was low. Therefore, future policy measures should be based on careful analysis with respect to effectiveness (and efficiency). Is debt relief a proper instrument to reduce debt overhang, to diminish poverty, to increase growth, and to improve governance structures? As mentioned above, the Brady Plan was rather successful, in particular because the situation in the countries in question was not as hopeless as it is in Sub-Saharan Africa today. However, most other examples of debt relief have produced rather depressing results.

Hernández and Katada (1996), analysing grants and ODA debt forgiveness to 32 Sub-Saharan African countries, reveal that debt relief did not reduce the debt overhang of Sub-Saharan African countries at all, but that the nominal debt stock of many countries even doubled between 1984 and 1993 and their arrears increased dramatically. The authors suggest that it may be the case that the debt which had been forgiven

7 The authors suggest that, at intermediate levels of debt, there is a negative relation between the degree of indebtedness and economic growth. According to their study, the debt to GDP overhang lies between 25 and 40 percent. Once the debt irrelevance threshold is reached, this relation becomes nil.

8 The literature concentrates on effectiveness, one exception being Arslanalp and Henry (2005) who claim to deal with efficiency, but rather model effectiveness. Efficiency would imply that an objective is met with a minimum of resources. This question is barely discussed in the literature.
was not being serviced, which indicates that debt relief activities have not freed additional resources for the recipient countries. They also find that receiving more debt relief did not increase a country’s import capacity. Some countries that have received less debt relief have been able to expand their imports more than countries that have received debt relief to a substantially larger extent. Since the written-off debt has not been serviced, this shows that debt relief does not free resources.

Because the consensus of opinion in economic literature is that decent institutions and governance structures play a crucial role for economic development and growth, the question remains if debt forgiveness can be expected to contribute to improvement in governance quality in low-income countries, thus creating institutional conditions that are conducive to economic growth. Chauvin and Kraay (2005) show that debt relief in 62 developing countries between 1989 and 2003 did not improve the institutional quality, nor lead to rising FDI or higher rates of economic growth. Easterly (1999) finds that highly indebted poor countries became highly indebted mainly because of poor policies, not because of external shocks or wars. He estimates a statistically significant association between debt relief and new net borrowing in 40 HIPC’s during the period 1989-1997. He concludes that official lenders did not adhere to prudential rules, and the IMF and the World Bank provided far more financing to HIPC’s over 1979-1997 than to other developing countries of similar income levels, although the policies in many HIPC’s have been worse. Given these rather unsatisfying results, the effectiveness of debt relief with respect to governance quality and economic development in low-income countries becomes highly questionable, because it might cause moral hazard and incentives to delay institutional reforms necessary for growth. Bauer (1991) raises moral hazard and disincentive issues, too, claiming that the beneficiaries of debt relief are governments that have not fulfilled their obligations and have been allowed to do so very largely unscathed. Thomas (2001) points out, that some HIPC’s had no policy responses to poverty, HIV/Aids, or corruption until they were required to do so under the HIPC Initiative. Therefore, he suggests, unless debt relief is effectively conditioned on the proper use of funds and the pursuit of structural reforms, it is unlikely to help the poor.

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9 See Rodrik et al. (2004). Sachs (2003) questions the dominance of institutions and claims that geographical conditions are of special relevance to economic development.

10 “Even worse, debt-relief funds may be used to support activities that actually worsen poverty, such as war…” (Thomas 2001, p 42). However, the pleading for strong conditionality in order to force developing countries to introduce reforms is not undisputed. Dollar and Svensson (2000), analysing the failure of structural adjustment programs, claim that the role of donors is to identify reformers, not to create them.
Clements et al. (2005), using data for 55 low-income countries over the period 1970-1999, find that large debt burdens have not seriously hampered public investment in low-income countries and that in most cases debt relief has led to greater public consumption rather than investment that could have contributed to further economic growth. Taking into account that only a relatively small share of debt is supposed to be channeled into public investment, the impact of debt relief on growth will at best be modest.

To the contrary, Arslanalp and Henry (2005), on the other hand, show that the debt restructuring and reduction under the Brady Plan led to rising asset prices, increased investment, and faster growth in the 16 countries that received Brady deals between 1989 and 1995. According to the authors, the Brady Plan worked quite well, because debt relief was granted to a group of middle-income developing countries where debt over-hang genuinely stood in the way of profitable new lending and investment. It is far from certain that the positive results of the Brady Plan can be used to forecast the potential impact of further debt relief on HIPCs (Arslanalp and Henry 2005, p 1048). Consequently, Arslanalp and Henry (2006) do not expect that further debt relief will address the fundamental problem of inadequate economic institutions that impedes investment and growth in the world’s poorest countries. In their opinion, the (indirect) approach of debt relief does little, if any, good. Given the overwhelming evidence that debt relief cannot be expected to have notable positive effects on governance quality and economic growth, why do creditor countries actually grant debt forgiveness and what are the main determinants of the allocation of debt relief for the poorest?

The Determinants of Debt Relief

Since past debt relief programs have been rather ineffective, one wonders why activists still plead for more debt relief and — more important — what actually motivates international donors to provide further debt relief. The determinants of debt relief obviously deviate from economic reasoning as discussed in section 3. This is exemplified by Hernández and Kata da (1996). They argue that neither absolute poverty nor lack of access to foreign exchange (through exports) have been criteria in allocating ODA debt relief and pure grants during the period 1989-1993. Michaelowa (2003) provides a highly plausible theoretical explanation for this evidence. In a political economic model, based on the utility maximizing behavior of the political actors participating in the decision making process of debt relief programs she argues that, if politicians and international bureaucrats realize that default risks become very high, they prefer to
grant debt relief in order to conceal their imprudent past lending and to “sell” the renunciation of funds as an innovative poverty reduction measure, especially if lobbying by non-governmental organizations (NGOs) in favor of debt relief increases their chances of obtaining positive public credit for the delivered debt relief. According to this reasoning, politicians in donor countries do not like to admit policy errors. Suppose that despite (or even because of) past debt relief, the debtor country did not improve its economic and political situation. Politically rational governments in creditor countries would not take this result as a signal to stop their activities, as this would be a confession of bad economic policy in the recent past. Rather, they would find arguments for further debt relief measures. Thus, debt relief is driven by path dependence. Famines, natural catastrophes and the like can be instrumental when the government is not willing or able to run different, and probably more effective, development policies such as opening foreign trade for agricultural products and Heckscher-Ohlin goods.\footnote{This does not say that debt relief is useless in any poor country. The evidence however suggests that debt relief is more helpful in middle-income countries to reduce the debt overhang (Arslanalp and Henry 2006) and that poor countries are poor mainly because of poor governance (Easterly 1999).}

Debt relief then is a politically cheap, but economically expensive form of publicly visible development policy. The government can improve its position against the country’s opposition that cannot argue against it without appearing heartless and stingy, having moral as well as medial difficulties to argue against the policy deal. In addition, the moral and intellectual support of NGOs demanding debt relief can be obtained. The political gains can even be increased if the debt relief initiative is a joint undertaking of many countries. In particular, the G8 provides a good platform for its members’ governments to gain a competitive edge against the opposition at home. By forming a front, the governments can agree and assign a greater competence to each other (Vaubel 1991).\footnote{An appropriate example for an application is the G8’s initiative to bridge the global digital divide (Freytag 2003).}

Empirical evidence on debt relief is in line with this reasoning. Birdsall et al. (2002, 2003), analyzing a sample of 37 Sub-Saharan African countries, prove that debt relief between 1977 and 1998 has been rather independent of policy variables in high debt countries, whereas net transfers are more dependent on governance indicators in the low debt regimes. This indicates that the international community as a whole seems to be less selective with respect to the institutional quality of high debt countries. The authors also find that policy selectivity has declined over time, and that in the 1990s multilateral and bilateral donors were actually financing bad policies in high debt coun-
tries. Neumayer (2002) finds very little evidence of a connection between the quality of governance and the allocation of debt forgiveness between 1989 and 1998. Only one out of six governance indicators seemed to be a statistically significant determinant of whether or not a country is deemed eligible for receiving debt relief.

Alesina and Weder (2002) point out that corrupt government pursuing very poor policies have received just as much aid and debt relief as less corrupt ones. According to their empirical study, covering several time periods between 1970 and 1995, there is not even weak evidence of a negative effect of corruption on received foreign aid or debt relief. Alesina and Dollar (2000) find a strategic nature of aid, which implies the same behavior of donors with respect to debt relief.\footnote{They use control variables such as colonial status (number of years in the 20th century in which countries have been colonies), FDI flow relative to GDP, and UN voting patterns.}

In sum, theoretical literature and empirical evidence clearly show that it has not been the governance quality or the effort to create better economic and political circumstances that has driven debt relief in the past. In a recent study however, Freytag and Pehnelt (2006) make the case that this pattern may have changed. In a cross country analysis over more than 100 developing countries, they compare the time span between 1995 and 1999 with the period between 2000 and 2004 with respect to the degree to which creditor countries consider governance structure and quality and changes thereof. They use a Tobit regression model. The endogenous variable is the debt relief to GDP ratio. The authors use governance indicators from different sources as independent variables. In addition, they use former debt relief as a proxy for path dependence, the level of the debt burden, poverty as one major rationale to reduce debt burdens, official development assistance as well as a number of controls such as colonial history as well as other strategic variables such as an oil-exporter dummy.

The findings are interesting and encouraging, as creditor governments indeed seem to learn. The most striking result for the 1990s is the strong path dependence of debt relief. Once a country received debt forgiveness in the early 1990s, the probability of gaining from additional debt forgiveness in the second half of the 1990s is close to one. At the beginning of the 21st century, this relationship seems to have changed. Path dependence, though still visible to some extent, is much weaker in the period 2000-2004. In this period, the institutional quality became more relevant, in particular the change in institutional quality. The provision of debt relief in recent years seems to follow some prudential rules and to be conditioned on relatively decent policies rather than only the level of indebtedness and the amount of pre-
vious debt forgiveness. In addition, poverty matters.

The results also suggest that recent debt relief has been provided in favor of poor countries that have shown improvements in their governance quality, of course not neglecting the level of indebtedness and the amount of debt relief granted in the 1990s (see table 2).

<table>
<thead>
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<tbody>
<tr>
<td>Past Debt Relief</td>
<td>Positive and highly significant</td>
<td>Positive and weakly significant</td>
</tr>
<tr>
<td>Poverty</td>
<td>Positive and significant</td>
<td>Positive and highly significant</td>
</tr>
<tr>
<td>Institutions</td>
<td>No correlation</td>
<td>Positive and significant</td>
</tr>
<tr>
<td>Change in institutions</td>
<td>n.a.</td>
<td>Positive and significant</td>
</tr>
<tr>
<td>Controls</td>
<td>No significant correlation</td>
<td>No significant correlation</td>
</tr>
</tbody>
</table>

Table 2: Determinants of Debt Relief 1995 - 2004

It seems that international donors do pay attention to the criteria of the HIPC and HIPC II initiative that refer explicitly to poverty reduction and — at least implicitly — take some institutional aspects into account. This result is promising and suggests that the discussion of institutions in development, which has its roots in academic circles and has been transferred into the international development organizations, has not only produced political statements but also some policy measures. A recent study by Heckelman and Knack (2006) reaches similar conclusions with respect to official development aid. Whereas in the 1980s institutions did not play a role in the decisions to grant aid, this in the 1990s has changed. At the same time when international donors started to link debt relief to institutional reforms, aid has been given — at least partially — depending on governance quality. Along these lines, a debt relief for emerging economies in the current situation may also be based on economic rather than on political rationality.

Conclusions

The history of debt relief is characterized by political failure and short-term thinking. Consequently, so far debt relief did not deliver promising results. Neither the economic performance nor the governance quality has increased. Analyzing the determinants of debt relief programs in the 1990s, we derive a standard result of international political economy. Governments of creditor countries have granted debt relief rather because of political than of economic reasoning. “Political rationality” outpaced “economical rationality” in the 1990s. In particular, we can confirm a path dependence with respect to debt relief granted.
However, the determinants of debt relief for highly indebted poor countries have changed slightly, which indicates learning processes in creditor countries. The G8 may have contributed to this by focusing on the HIPCs initiative, which is based on governance improvements as a precondition for debt relief. Thus, recent debt relief programs since 2000 seem to be positively influenced by economic and institutional development as well as the results of the latest research on the role of institutions for growth and development. This may indeed be the result of a successful learning process of donor countries’ governments and a slight change in the allocation pattern of debt relief along with the introduction of some sensible criteria during the last decade. Analyzing debt forgiveness within the framework of the Enhanced HIPCs initiative, one can find a relation between debt relief and enhanced institutional quality. This is a very promising sign for those who still aim at development in highly indebted poor countries in the southern hemisphere.

As a consequence of the dramatic financial crisis the world has changed. The global financial system will never be the same. Traditional instruments, certain financial products and regulations will disappear. A new order is requested, though yet to be developed. What we have seen so far was a bustling reaction that helped to gain some time. The determined reaction of the IMF and national governments has undoubtedly helped securing the savings of many people and has been necessary to prevent a collapse of the banking sector and whole economies. However, the question remains if bailing out broke countries and banks will stabilize the financial markets and fiscal policies in the future or rather set further incentives for irresponsible lending, unsound policies and business practices.

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