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Stiftung
Wissenschaft und
Politik

German Institute
for International and
Security Affairs

Generous Gestures

What is the Point of G8 Debt Cancellation?

Andrea Schmitz

During their meeting at Gleneagles in Scotland, the heads of government of the G8 countries confirmed the decision made by their finance ministers in June to cancel the debts to multilateral financial institutions of eighteen developing countries, most of them in sub-Saharan Africa, and to substantially increase development aid. The cause was championed above all by Britain, which currently holds the G8 presidency and has put the fight against poverty in Africa at the center of a public campaign. The debt cancellation triggered off a debate about the effectiveness of development aid and revealed considerable differences between US and European policy. This debate exposes a structural dilemma at the root of the development business which significantly limits the possibilities of external intervention.

After the G7 decision in 1999 to cancel 90 percent of the bilateral debts of the most heavily indebted poor countries, eighteen of these countries are now to be relieved of their liabilities to the World Bank, IMF, and African Development Bank. They qualified for partial debt cancellation under the Heavily Indebted Poor Countries initiative (HIPC), a scheme established in 1996 by the World Bank and the IMF and extended at the World Economic Summit in Cologne in 1999 to reduce poor countries' burden of debts.

The debt cancellation now coming into force does not demand any great sacrifice of the lenders because no one seriously expected the funds—all interest-free and minimum-interest loans with repayment periods of up to forty years—to ever be repaid. There was merely disagreement ahead of the G8 summit about how the debt cancellation should be financed. While the US first argued in favor of simply writing off the debts and in future only granting subsidies according to particular criteria, calls for a more gradual approach came in particular from Germany, Japan, and initially also France. Experience had shown, they argued, that total and immediate debt cancellation would only encourage the beneficiaries to raise new credits and thus fall ever deeper into the debt trap. Complete debt cancellation would thus create the wrong incentives—also for those developing countries that paid off their debts and fulfilled the requirements of good governance but did not qualify for the HIPC initiative.

In order to be classified as “poor” and “heavily indebted” under the HIPC initiative, a country’s annual per capita earnings must be below a particular cut-off (2004: 965 US$). This is determined every year by the International Development Association (IDA), a unit of the World Bank, and entitles a country to raise the concessionary credits given by the IDA; a country’s foreign debt must exceed 150 percent of its annual export earnings or 250 percent of government revenue. But the country is only eligible for debt cancellation if it can also demonstrate a minimum of good governance, e.g. by implementing a macroeconomic structural adjustment program sponsored by the IMF and successfully executing an IMF and World Bank-approved poverty reduction strategy for at least a year. Then there are countries such as Kenya, which fulfils almost all donor preconditions for subsidies and low-interest loans and has per capita earnings far below the HIPC upper limit, but does not qualify for debt cancellation because it falls short of the debt-to-export ratio.

Creditors’ Divergent Interests

The G8 countries and the EU will now foot the bill for the cancelled debts which currently amount to over forty billion US dollars. In this way it is at least guaranteed that the debt relief “will bring additional resources to the development business and not come at the expense of World Bank resources,” as the institution’s new president Paul Wolfowitz put it (see *Financial Times*, June 11, 2005, p.4).

Indeed, the American proposal to cancel the debts completely was unacceptable to the Europeans, in particular because it would have meant a weakening of European influence on World Bank policies. The US share of Official Development Assistance (ODA) for sub-Saharan Africa is currently 25 percent, and at first glance the proposal was as rational as it was radical: It only made sense for a bank to lend money if the recipients were also able to pay it back. This presupposed proper budgetary management; countries with orderly budgets generally also had access to the commercial capital market and were thus not dependent on the IDA’s soft loans. With the HIPCs and other “bad performers,” loans of this kind were counterproductive because they gave the governments no incentive to put their budgets in order and become creditworthy. The World Bank should switch to subsidies, the US argued, which the recipients would have to apply for and which would be granted according to the prospects of the projects presented.

Such a shift in allocation practices and criteria would have drastic consequences for the World Bank—it would be transformed from a multilateral development bank into an aid organization for managing acute crises and allocating subsidies as decided by the donor countries. This would make it virtually impossible to maintain the IDA’s current level of funding, around 30 percent of which is currently recycled from loan repayments. A reduction in funding would mean a drastic reduction in the number of recipients of development aid—and precisely that was the ultimate aim of the American proposal. The Europeans rightly fear that this would be to the detriment of the “bad performers” who would then no longer have any incentive to implement reforms. But the US’s option was unacceptable to the Europeans in particular because they feared it would subordinate development policy to American foreign policy and security interests. The Bush administration was already suspected of harboring such intentions when it nominated former Deputy Defense Minister, Paul Wolfowitz, as the new head of the World Bank. Critics feared that Wolfowitz would turn the multilateral institution into a tool of American unilateralism, but this fear was partly allayed when Wolfowitz pleaded for the creditors of the World Bank to pay compensation for the cancelled debts of the eighteen HIPCs.

The Europeans prefer to pay compensation rather than write off these debts

mainly because they wish to preserve the World Bank as a multilateral development agency and not leave control to the USA. But there is another reason why the G8 countries can well afford to finance the debts—compensation payments to the multilateral financial institutions can be counted towards ODA contributions, and these are to be raised considerably in the next few years. This is of particular advantage to Italy and Germany, whose low ODA contributions (only 0.15 percent and 0.28 percent of Gross National Income respectively) place them at the bottom of the league.

Debt Cancellation and Millennium Development Goals

The main problem with this debt remission is that it will be similarly ineffective to partial debt cancellation in the past. World Bank representatives themselves concede that the HIPC initiative has not given the countries concerned any lasting relief so far and must essentially be considered a failure. This is because the structural causes of poor countries' debt crises cannot be removed by one-off across-the-board cancellation. Years of mismanagement have left most of the affected countries with little infrastructure, and the unattractive business climate deters long-term investments, although both infrastructure and investment are indispensable for effectively fighting poverty. In order to achieve the Millennium Development Goals (MDGs), the G8 want more developing countries to be relieved of their liabilities; development aid is to be raised by fifty billion dollars per annum until 2010. Half of this money is to go to Africa. The UN Millennium Project's development specialists have calculated that at least 25 billion dollars more are needed per annum for sub-Saharan Africa alone in order to achieve the central goal of the MDG—the halving of extreme poverty by 2015. As yet there is no consensus on how this big push is to be financed, and no agreement was reached at the G8 summit.

Even more contentious, however, is whether debt relief and the major injections of additional funds that are meant to follow can really contribute to effectively fighting poverty—and just how that would work. Skeptical observers fear that insufficient institutional capacities in the recipient countries could prevent the demanded increase in ODA funds from being absorbed and that existing obstacles to development would be perpetuated. Since independence in the 1960s Africa has received hundreds of billions of dollars in foreign aid, but large parts of the continent are in a worse position today than they were then. The reason is that the central obstacles to development are largely political in nature—monopolization of power and resources, corruption, and legal uncertainty. These cannot be removed by extending debt relief and increasing ODA payments.

Conditionalities and Double Standards

The accountability of the donor countries to their taxpayers demands that further debt relief and the granting of financial resources be tied to the fulfillment of particular conditions, and the G8 heads of state have by all means adhered to this principle. But this demand is not new. After the failure of the structural adjustment programs in the 1980s, bi- and multilateral donors have begun making their loans and subsidies conditional on the willingness of recipient countries to institute better governance. It is now standard practice for donors to only grant funds on the condition that the countries undertake independent efforts to fight poverty and corruption—a policy change manifested in the Poverty Reduction Strategy Papers (PRSPs). Debt relief under the HIPC initiative too always involved a qualification process in which one criterion was taking visible measures against poverty. In some instances this did in fact lead to governments spending more money on basic social services and improving access to primary education and basic

health care for the poor. At the same time, however, poverty and social inequality have increased in many places—despite increases in economic growth. Conditionality in resource allocation evidently leads only to isolated improvements whose sustainability is uncertain.

One reason for this is that the allocation of funds is tied to formal guidelines which the recipient countries often do not have the administrative and staff capacity to implement. The internal revenue services in particular are often overwhelmed by the sheer multitude of different donor requirements they are confronted with. This strain is one factor that hampers the absorption of funds.

A harmonization initiative was therefore established in 2003 within the Development Assistance Committee (DAC) of the Organization for Economic Cooperation and Development (OECD) for the donors to work on ways of implementing development aid more efficiently. The coordination of financing procedures, the adjustment of donor programs to the priorities laid down in the PRSPs, and results-oriented monitoring with the involvement of the partner countries were to put these in a position to direct their own development.

But this does not alter the fact that the funds still come from donor countries who are neither willing nor able to completely relinquish supervision of their use. Conditionality in development aid is thus unavoidable. This gives rise to the paradoxical situation that the recipient countries are expected to adopt and identify with programs that have ultimately been made for them by others. They respond to this imposed "ownership" with double standards—fulfilling requirements pro forma, but not adopting them. Therefore the practical implementation is largely inadequate.

This dilemma of development politics is one of the causes of the debt cycle. In these circumstances it is unlikely that the recent debt cancellation will contribute to a lasting reduction in the volume of debt and make the debtors creditworthy. It is not enough to simply provide funds—even further generous debt relief and resource transfers will hardly help uproot the poverty bred by years of mismanagement, poor governance, and structural imbalances in global trade.

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SWP
Stiftung Wissenschaft und Politik
German Institute for International and Security Affairs

Ludwigkirchplatz 3−4
10719 Berlin
Telephone +49 30 880 07-0
Fax +49 30 880 07-100
www.swp-berlin.org
swp@swp-berlin.org

ISSN 1861-1761