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To give or forgive

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The G8 wants to wipe clean the debts of impoverished nations. Erasing poverty will be harder

MISERS may be disliked, but usurers are despised. This may explain the remarkable success of the long-running campaign by churches, charities and celebrities to have the debts of poverty-stricken countries written off. Even when aid budgets were especially tight—roughly speaking, from 1993 to 2001—the campaign shamed the governments of the G7 rich nations into cancelling much of their bilateral debt. Reluctant to give money to poor countries, rich countries' governments became equally chary of collecting debts from them.

On June 11th, the debt-relief campaign won another triumph. At a meeting in London hosted by Gordon Brown, Britain's chancellor of the exchequer and a strong advocate of debt relief, the finance ministers of the G8 (the G7 plus Russia) agreed to cancel all the debts that 18 heavily indebted poor countries owe to three multilateral lenders, the World Bank, the International Monetary Fund (IMF) and the African Development Bank (AfDB).

The beneficiaries are Guyana, Honduras, Nicaragua, Bolivia and 14 African countries. The debts in question have a face value of about $40 billion, on which an annual average of $1 billion-1.5 billion is paid in debt service. Nine other countries may benefit within a few years, and a further 11 would be eligible if their governments were not so inept and corrupt.

To understand how the London agreement works, you have to follow the money. Next year, for example, Rwanda was due to pay at least $4.5m in debt service to the Bank and the AfDB and a further $2.9m to the IMF. Assuming the G8 proposal is passed and implemented promptly, Rwanda will no longer need to do that. However, the loans or grants it receives from the Bank and the AfDB in 2006 will be “adjusted” (ie, cut) by $4.5m, the same amount it saves on servicing its debts to them. So in the first instance it will have just $2.9m extra—the money it would have paid to the IMF—to spend on health care, education and so forth.

Some—notably, America—would have been happy to leave it at that. But at Britain's insistence, the new agreement goes further. The G8 acknowledges that, by freeing Rwanda and its sort of their debts, it is depriving the Bank, Fund and AfDB of loan revenue. The IMF will have to take the loss on the chin. But the Bank and the AfDB will be reimbursed. The two can then pass this new money on to poor countries, as they see fit. Rwanda might well see some of this extra money, but it need not.

There is one last twist in the money trail: from where will the G8 countries get the money to refund the Bank and the AfDB? They could raise it from their taxpayers. They could divert it from funds already allocated to their own aid budgets. Or they could deduct it from money they might otherwise have given the Bank and the AfDB. Their donations to the Bank have already been settled for the next three years, so any such diversion will be easy to spot in the short term. But in the future, there will be no way to know how much the G8 would have given the Bank in the absence of 100% debt relief. So one cannot know whether the money promised in London will come in addition to, or instead of, the money they would have given anyway.

Give and take

There is thus less to the London agreement than first meets the eye. Rich countries are often accused of giving with one hand and taking with the other. That said, in general, what donors take in debt repayments, they give back several times over in aid. Mozambique, for example, paid $71.8m on its debts in 2003. But the aid it received from all donors, multilateral and bilateral, amounted to about 14 times that figure. Admittedly, that includes the value of debt relief itself, and Mozambique's experience is extreme. But on average, reports the Bank, in the 1990s the heavily indebted poor countries received about twice as much in aid as they paid in debt service.

In a recent article*, Raghuram Rajan, chief economist at the IMF, teases out the implications of these two-way flows. Suppose a country pays $100m a year in debt service, but receives $200m in aid. How does its situation differ from a debt-free country that receives $100m in aid a year? The annual net inflow of money is the same; only the stock of liabilities differs.

Under certain circumstances, Mr Rajan notes, this stock of debts can cast a shadow over a country's prospects. It may deter private investment, because investors fear the government will overtax their profits to repay its creditors. A lack of investment will stunt growth, further diminishing the country's ability to service its debt. Debt relief is then in the interest of creditors and debtors alike. It will increase the real value of the creditors' claims, because it restores the confidence of investors and thus the economy's ability to meet its obligations.

However, Mr Rajan doubts the relevance of this idea to the beneficiaries of the G8's proposal. There are many reasons why private investors might be deterred from an impoverished African country: corruption, insecure property rights, fragmented markets, lousy infrastructure. Debt is the least of them.

Mr Brown sees debt relief as but one step in increasing the resources that are made available to fight poverty. Aid budgets have already been rising; and Mr Brown and Britain's prime minister, Tony Blair, are pushing for another big increase in aid at the Gleneagles G8 summit in July. But Mr Brown's American counterpart, John Snow, sees debt relief as the last turn in a long-running “cycle of lend and forgive”. Efforts to ease Africa's official debts date back at least as far as 1987. Since then, Mr Snow points out, donors have repeatedly lent poor countries fresh money to help repay old loans gone sour. This month's deal should go some way to achieving Mr Snow's objective. But it will do little by itself to secure Mr Brown's.

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* “Debt Relief and Growth”. *Finance and Development*, June 2005.