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Article — Published Version

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Intereconomics

Suggested Citation: Krüger, Malte; Morath, Florian (2007) : 'Burden of debt' in HIPC countries in the light of current account statistics, Intereconomics, ISSN 0020-5346, Springer, Heidelberg, Vol. 42, Iss. 2, pp. 105-108,
<https://doi.org/10.1007/s10272-007-0210-2>

This Version is available at:

<https://hdl.handle.net/10419/41998>

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Malte Krüger* and Florian Morath**

“Burden of Debt” in HIPC Countries in the Light of Current Account Statistics

For many years, debt relief has been a prominent theme in public debate. Supporters of debt relief argue that debt service drains the resources of needy countries – resources which could be employed in such important areas as infrastructure, education and medical treatment. The question, however, whether foreign debt does, indeed, lead to a draining of resources is hardly ever addressed.

In June 2005, debt relief was, once again, high on the agenda of international politics. The G8 summit, chaired by the UK government, passed a plan to cut the debt of a group of heavily indebted poor countries (HIPC). Politicians and part of the press hailed this decision as a historical step.¹ Indeed, the heads of government of the leading industrialised countries agreed to reduce the foreign debt of 18 developing countries by around US\$ 40 billion.

Arguments in Favour of Debt Relief

With this step, the heads of government gave in to ever louder calls for debt relief, which came from a large group of NGOs, individuals and government organisations. The arguments in favour of debt relief, cited over and over again by this group, are straightforward. The text of a flyer of the German ministry of economic cooperation and development serves as a typical example: “Why debt relief? Debt is one of the most severe obstacles in the fight against poverty. For decades, high levels of debt have constrained development in the poorest countries ... The consequences are the extreme poverty of large parts of the population and an increasing indebtedness of the state. The countries in question enter a debt trap: overdue payments are increasing and interest plus interest on interest are piling up ... In many of the poorest countries, debt has reached such high levels that governments have to spend more on servicing debt than on education and health combined.”²

It is important to note that the “burden of debt” is understood not just as a financial burden but as a real burden. As the argument goes, developing countries have to commit real resources to service foreign debt – real resources that cannot be used within the country. Debt relief would free these resources for internal

use.³ In this way, the situation of the population in these countries could be substantially improved.

Sceptics, however, point out that debt relief may provide perverse incentives. Countries that have used funds inefficiently are rewarded. In the present study, we do not want to review the pros and cons of debt relief.⁴ Rather, we focus on the question whether foreign debt does, in fact, entail a real burden. In order to tackle this question, we analyse the balances of payments of a group of highly indebted countries – focussing on those sub-balances that mirror real exchanges with the rest of the world, i.e. the balance of trade and services and the “non-interest current account”.

“Burden of Debt”: Different Concepts

If the burden of foreign debt is interpreted as a transfer of real resources to the rest of the world, it can be determined from balance of payments figures. The balance of payments covers all transactions between

¹ The echo in the German speaking press was generally favourable. Cf. G8-Finanzminister feiern historischen Schuldenerlaß, in: SPIEGEL ONLINE, 11. Juni 2005; Historischer Schuldenerlass für Dritte Welt, in: NZZ am Sonntag, 12. Juni 2005; or Schuldenerlaß für die ärmsten Länder der Welt, in: Die WELT, 13. Juni 2005.

² Cf. Bundesministerium für wirtschaftliche Zusammenarbeit und Entwicklung (BMZ): Warum wir Schulden erlassen. Die deutsche Entwicklungspolitik ist Motor der Entschuldungsinitiative, Berlin 2005, www.bmz.de/de/themen/dokumente/entschuldungsflyer.pdf. (Our translation.)

³ The debt relief initiatives of the World Bank and the IMF are also based on this logic. In these initiatives, debt relief is combined with the requirement to use freed funds in the fight against poverty. Cf. International Monetary Fund: The Logic of Debt Relief for the Poorest Countries, IMF Issues Briefs September 2000, <http://www.imf.org/external/np/exr/ib/2000/092300.htm>.

⁴ The pros and cons of debt relief are analysed in W. M. Corden: Debt Relief and Adjustment Incentives, in: J. A. Frenkel, M. P. Dooley, P. Wickham (eds.): Analytical issues in debt, Washington D.C. 1989, International Monetary Fund, pp. 242; and P. Krugman: Financing vs. Forgiving a Debt Overhang, in: Journal of Development Economics, Vol. 29, No. 3, 1988, pp. 253-268. Cf. also W. Easterly: How did highly indebted poor countries become highly indebted? Reviewing two decades of debt relief, Policy Research Working Paper 2225, Version of June 2001, World Bank, Washington DC 2001; and R. J. Langhammer: Mit Schuldenerlass allein ist es nicht getan, in: Frankfurter Allgemeine Zeitung, 17 May 1999.

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locals and foreigners (defined on the basis of residency): sales and purchases of goods and services, borrowing and lending, sales and purchases of assets, gifts etc.

Intuitively, a first port of call could be data on international payments of interest and re-payments. These payment flows are booked in the income account. The figures are difficult to interpret, however. They may reflect actual payment flows. But it is also possible that no payment has been made. According to the accounting principles of the IMF, overdue interest payments are booked as interest received. Simultaneously, the amount of debt is increased. Thus, balance of payments statistics may contain high figures under "interest payments made" although, effectively, no payments have been made.⁵

Given this accounting practice, it is sensible to focus on real flows of goods and services. Such a focus is also preferable because the supporters of debt reduction focus on the real burden of debt.

The flow of goods and services is recorded in the balance on trade and services. An outflow of real resources implies that more goods are sold to the rest of the world than purchased from the rest of the world. Thus, a net outflow corresponds to a surplus in the balance on trade and services. If, on the other hand, a country experiences deficits in the balance on trade and services, it is a net receiver of real resources from the rest of the world. Thus, when interpreting the burden of debt as a real burden, the balance on trade and services can be used as a measure.

It could be argued that the balance on trade and services is too narrow an indicator of the burden of debt. For instance, if foreign aid cannot be employed to foster development but has to be used to pay interest, there also exists a kind of real burden. Suppose a country receives US\$ 50 million in aid payments. However, it can only finance a resource inflow of US\$ 20 million with this aid money because it has to spend US\$ 30 million on debt service. In this case, it could be argued that there is a real burden in spite of the resource inflow. This burden consists of the difference between the aid flow and the inflow of resources. When this definition is used, the correct indicator of the burden of debt would be the "non-interest current account" (cf. Figure 1).

The non-interest current account is derived from the balance on trade and services by adding current transfers (mainly aid and cross-border income payments).

⁵ Cf. International Monetary Fund: Balance of Payments Manual, 5th Edition, Washington DC 1993.

Figure 1
Illustrating Measures of the Burden of Debt

| credits | debits | |
|---------|----------------|--------------------------------|
| Ex: 80 | Im: 100 | |
| Aid: 50 | | } Balance on trade & services |
| | Interest: 10 | |
| | Repayments: 20 | } Current account |
| | | } Non-interest Current account |

Assuming that capital exports (other than repayments) and reserve account changes are zero.

A surplus on the non-interest current account implies that export income and net foreign aid have not been completely used to finance a real resource inflow (imports). In the absence of private capital flows, it shows to what extent a highly indebted country has used its own export income or aid received to service its foreign debt.⁶

A deficit in the balance on trade and services or the non-interest current account implies that a country has experienced a net inflow of real resources from the rest of the world. Thus, the claim of the board of advisers to the German ministry of economic cooperation and development, that current account deficits are a prime reason for the continuing problems of highly indebted countries, seems debatable.⁷ These deficits are a reflection of foreign aid in the form of current transfers and concessional loans. Without this aid (and the corresponding deficits) these countries would be worse off.

Data Problems

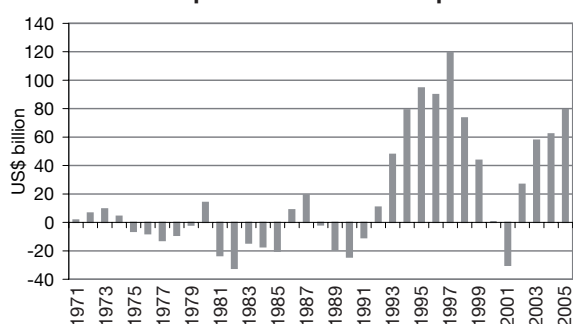
The present study is based on balance of payments statistics published by the IMF. One cannot expect these figures to be 100% correct. A glance at aggregated figures for the world as a whole illustrates this point. For the world as a whole, exports should equal imports. However, in the early 1990s a large gap emerged reaching US\$120 billion in the peak year (cf. Figure 2). This may not be as bad as it looks. After all, it was equal to less than 2% of the total of world exports.

Unfortunately, the aggregate figures may paint too rosy a picture. An IMF analysis from 1995 shows that statistical errors sometimes become larger if

⁶ Of course, the funds may also have been used to finance capital exports. Thus, both the balance on trade and services and the non-interest current account measure the upper limit of the real burden of debt.

⁷ See Wissenschaftlicher Beirat beim BMZ: Verschuldungsprobleme armer Entwicklungsländer, Stellungnahme des Wissenschaftlichen Beirats beim BMZ, July 2000, <http://www.bmz.de/de/service/infothek/fach/spezial/spezial25/spezial90.pdf>.

Figure 2
World Exports minus World Imports



Source: International Monetary Fund: World Economic Outlook Database, April 2004.

one moves to sub-balances of the current account. Moreover, it is not unlikely that figures in the group of highly indebted countries are less accurate than, say, in OECD countries. Thus, balance of payment figures for this group have to be interpreted with caution.

However, given that our results unambiguously point in one direction and would even hold after drastic data revisions, the data problem does not seem to affect the basic results. Moreover, there seems to be some evidence that errors in balance of payments statistics are partly off-setting (cf. Table 1). Thus, there are sound reasons to underestimate import values (in the case of import duties) as well as overstate them (in the case of restrictions on capital exports). A similar argument can be made for the export side.

Empirical Results

The two burden concepts introduced above form the basis of the following empirical analysis which focuses on the group of HIPC as defined by the IMF and covers the period from 1974 to 2004.⁸ However, of the entire group of 38 HIPCs there are only 25 countries for which data are available for most of the period.⁹ For a group of 10 countries, there are only data for about 50% of the past 15 years.¹⁰ For three countries (the Democratic Republic of Congo, Liberia, and Somalia), no balance of payments data have been published.

⁸ A critical discussion of the HIPC-Initiative can be found in P. Hjertholm: Analytical History of Heavily Indebted Poor Country (HIPC) Debt Sustainability Targets, Development Economics Research Group (DERG) Working Paper, 1999, <http://www.econ.ku.dk/derg/papers/DSTHisto-marts99.pdf>.

⁹ Benin, Bolivia, Burundi, the Republic of Congo, Cote d'Ivoire, Ethiopia, Ghana, Guinea, Guinea-Bissau, Guyana, Honduras, Lao People's Democratic Republic, Madagascar, Malawi, Mali, Mozambique, Myanmar, Nicaragua, Rwanda, Senegal, Sierra Leone, Sudan, Tanzania, Togo and Uganda.

¹⁰ This group consists of Burkina Faso, Cameroon, the Central African Republic, Chad, Comoros, Gambia, Mauritania, Niger, Sao Tome and Principe, and Zambia.

Table 1
Statistical Discrepancies in World Balance of Payments Figures 1995
(US\$ billion)

| | |
|-----------------------------|--------|
| Current account | -82.4 |
| Trade balance | 114.6 |
| Services balance | -30.2 |
| of which transport | -72.6 |
| Income balance | -123.2 |
| of which investment balance | -166.2 |
| Current transfers balance | -43.5 |

Source: J. Motala: World Economy in Transition: Statistical Discrepancies in the World Current Account, in: Finance & Development, Volume 34, No. 1, March 1997.

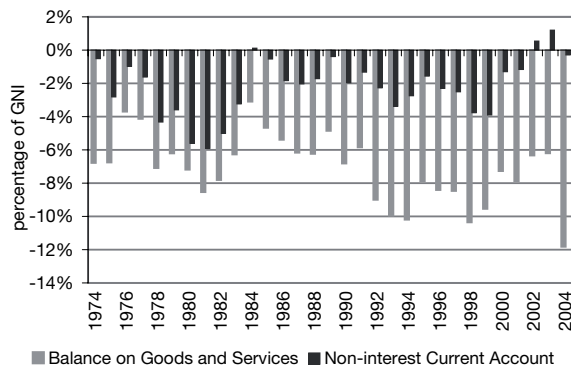
Figure 3 provides an overview of aggregate balance of payments data for the group as a whole. The pattern that emerges is typical for most of the individual countries. The HIPCs as a group have experienced annual net inflows of goods and services of about 7.5% of GDP, on average. As Figure 3 shows, this inflow has been somewhat lower in the 1970s and 1980s – rising to 8-10% in the 1990s. Even when focussing on the non-interest current account, there is a small surplus in only 3 years – implying that, at most, a small fraction of foreign aid had to be used to service foreign debt (or finance capital exports). So, even if a wide definition of the burden of debt is used, there is no indication of a real burden of debt. In almost the entire period, debt service has been completely financed by capital imports. Some of these capital imports may consist of “true” capital flows (market borrowing) but it seems likely that a large part simply reflects re-scheduling of debt repayments and interest payments.

The analysis of aggregate data may mask large differences at the level of individual countries. However, as far as it is possible to judge from the incomplete data, the results also hold for most of the countries individually. 21 of the analysed 35 countries are characterised by persistently high deficits of the balance on trade and services.¹¹ This finding refutes the argument that highly indebted countries suffer an outflow of resources due to high debt service. Even when looking at the non-interest current account, only a few countries exhibit small surpluses for one or two years.

A second group of countries (Bolivia, Ethiopia, Ghana, Guinea-Bissau, Honduras, Mauritania, Sierra Leone and Sudan), experienced a surplus on the balance on goods and services and/or the non-interest

¹¹ This result holds for Benin, Burkina Faso, Burundi, the Central African Republic, Chad, Comoros, Guinea, Guyana, Laos, Madagascar, Malawi, Mali, Mozambique, Nicaragua, Niger, Rwanda, Sao Tome and Principe, Senegal, Tanzania, Togo, and Uganda.

Figure 3
Aggregated Balance of Payments Data of the
“Heavily Indebted Poor Countries”



Source: IMF Balance of Payments Statistics Yearbook (various issues), own calculations.

current account in three or more years.¹² But even for these countries, the net outflow of real resources was small in comparison with the net inflow during the deficit years. Ghana is a typical example of this group (cf. Figure 4).

29 countries of the group of HIPC's have seen an almost continuous resource inflow over the past 30 years. Six countries, however, have experienced outflows for a number of years. Gambia and Zambia, for instance, experienced sustained surpluses on the non-interest current account. A group of four countries – Cameroon, the Republic of Congo, Cote d'Ivoire, and Myanmar – experienced periods of sustained trade surpluses. Thus, for these countries, debt service may have meant a real burden. Consequently, for these countries, debt forgiveness might free resources for investment and the fight against poverty.

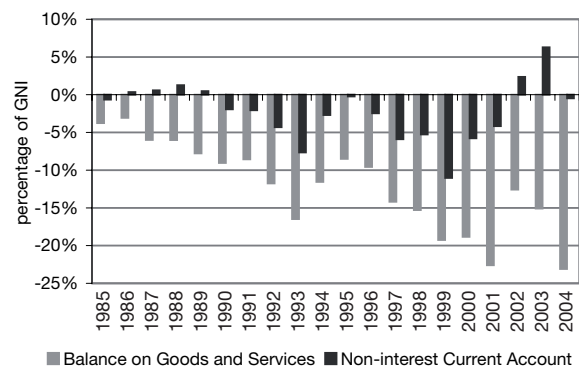
Conclusions

Sub-balances of the current account can be used to measure whether and to what extent foreign debt really poses a real burden for a country. Depending on how “burden” is defined, the balance on trade and services or the non-interest current account can be used. Looking at both balances for the past 30 years, a clear result emerges: HIPC's have been net receivers of goods and services for almost the entire period under study. Debt service almost never implied an outflow of real resources.

While somewhat reassuring, this result has a sobering implication: debt forgiveness will hardly have any real impact at all. This results looks surprising at first. However, it can be easily explained. Most of the HIPC's

¹² Bolivia, for instance, saw high export surpluses in the first part of the 1980s that were used to finance debt service on market loans.

Figure 4
Resource Transfers and the Burden of Debt: the
Example of Ghana



Source: IMF Balance of Payments Statistics Yearbook (various issues), own calculations.

have not made any real effort to service their debts. Therefore, debt forgiveness also does not imply any real reduction of the debt burden.

Given the results of this study it is surprising that the German ministry of economic cooperation and development is proclaiming that debt forgiveness has had tangible results: “In the group of 26 countries that profit from debt relief, expenditure on schools, social and health institutions has been rising significantly. Before debt relief, these countries jointly spent about US\$ 5.8 billion on social improvements. Today, this figure has risen to US\$ 9.1 billion annually.”¹³

Whatever factor has been the cause of this rise in social spending, it cannot possibly have been the reduction in the real burden of debt. Possibly, the conditions that came with debt relief (increased investment in health and education) played a role. It remains to be seen whether these changes will have a lasting impact.

On the whole, the debt forgiveness announced by G8 governments is far less “historical” than donor countries wish us to believe. Basically, donor countries are writing off debt that had no more value anyway. However, this move may enhance the credibility of development policy by ending the endless chain of crisis meetings and debt re-scheduling. In the future, donor countries should be more concerned with the ability and willingness to repay loans. In the case of the very poor countries, they should consider moving from loans to grants. In this way, at least transparency would be improved.

¹³ See Bundesministerium für wirtschaftliche Zusammenarbeit und Entwicklung (BMZ), op. cit. (Our translation.)