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Poor Country Debt Forgiveness: Flaws in the Clinton Proposal

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During a meeting of the International Monetary Fund (IMF) and the World Bank in late September, President Bill Clinton announced that he would ask Congress to pass legislation forgiving the debt that 36 extremely poor countries owe to the United States. This $5.7 billion debt is primarily the product of decades of failed foreign assistance. The Administration also requested $1 billion in fiscal year 2000 to fund his proposal.

Flaws in the Current Proposal. The overall debt that these poor countries owe is overwhelming. Many Heavily Indebted Poor Countries (HIPC) face external debt that is more than twice their gross domestic product, and servicing that debt consumes ever-larger shares of government revenue and scarce foreign exchange. As this burden increases, they must allocate greater portions of their budget to debt service, resulting in higher taxes, more borrowing, and even debt default.

The President's plan follows an agreement by the Group of Seven (G-7) industrial nations to forgive most of the bilateral debt that the poor countries owe them. The G-7 plan is designed to supplement an IMF and World Bank program known as the HIPC Initiative. Essentially, the Clinton proposal would forgive the debt owed to the United States that remains after the G-7 plan is implemented.

Forgiving debt is appropriate, because U.S. assistance, while well-meaning, has fostered dependence on aid and discouraged reform. In fact, foreign assistance has done little more than add to the burden many developing countries face by increasing their overall debt. According to the U.S. General Accounting Office (GAO), bilateral assistance to the 40 original HIPC countries accounted for an average of 45 percent of their total debt in 1995.

Unfortunately, although the President's proposal represents a positive step in addressing a serious problem, it will not solve poor countries' debt problems for three reasons:

First, the IMF and the World Bank refuse to forgive debt. Instead, they have offered to restructure the debt that the poor countries owe them, which at nearly 30 percent of the total debt owed in 1995, is substantial. According to the GAO, the IMF and the World Bank believe "forgiving or reducing debt would diminish assurances of repayment on new lending and, in some cases, hurt their credit ratings." In other words, these agencies are unwilling to accept responsibility for their past decisions by forgiving outstanding loans and reforming their lending practices—which are at least partly to blame for poor countries' debt burdens—because doing so might harm their ability to

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continue lending in the future. Meanwhile, the poor continue to suffer.

The refusal of the IMF and the World Bank to forgive debt is disturbing because poor countries are becoming more indebted to these agencies: their debt grew 10.6 percent between 1996, when HIPC was first proposed, and February 1999, when it reached $48.6 billion. This percentage will continue to rise as debt from other sources is forgiven and new IMF and World Bank loans are extended to poor countries that become more credit-worthy through debt forgiveness. If the Clinton plan becomes a reality, these countries will soon owe the bulk of their debt to international financial institutions—the very creditors who refuse to forgive their debt.

Second, nothing in the G-7, HIPC, or the President's initiatives will prevent the recurrence of unsustainable poor country debt. Elimination of external public debt is only part of the solution: A successful relief program must also prevent the accumulation of future debt. There is every reason to expect that countries whose debt is forgiven will continue to receive bilateral and multilateral assistance, which many consider necessary for development.

But future assistance will not yield results any more positive than what it engendered in the past: Debt that had to be forgiven because the aid did not stimulate sufficient economic growth to allow recipients to finance it. Poor countries will again increase their debt burden by accepting foreign assistance with little possibility of positive economic results. This cycle makes a return to unsustainable debt likely and the President's proposal limited and temporary in utility. Thus, any debt forgiveness proposal should require recipient countries to forego future official assistance.

Third, Clinton's notion of fostering poor country development by conditioning debt forgiveness on increased social spending is flawed. Proponents argue that, in exchange for forgiveness, poor countries must spend the funds they would otherwise use for repaying their debt on such programs as education, health, and other social initiatives. This requirement stems from the premise that government programs, if sufficiently funded, foster development.

This notion is false. Many studies, including The Heritage Foundation's *Index of Economic Freedom,* show that the single greatest determinant of future economic growth is a freer market—not the amount that governments spend on programs. Developing countries must adopt free-market reforms in order to grow.

A Better Plan. If countries wish to receive private foreign investments—a necessity once official lending ends—then they will have to adopt economic reforms. The United States should encourage such reform.

It is impossible to require countries to funnel the savings from debt relief into domestic programs. Money is fungible. Debtor governments can cut spending on social programs even as they comply with creditors' conditionality by allocating debt relief funds to those very same initiatives. Once the creditors forgive debt, they relinquish their influence over a debtor's budgetary decisions.

One-time debt forgiveness alone is not a permanent solution to poor country debt. Only by conditioning debt forgiveness on a cessation of future official borrowing and by encouraging poor countries to adopt economic reforms will creditors be able to effect a long-term solution. President Clinton and others rightly champion one of these steps. However, forgiveness is only one-third of the solution. Those dedicated to advancing the best interests of poor countries must insist that debt forgiveness be accompanied by the other two elements of true debt relief. Only then will poor countries achieve lasting freedom from oppressive debt.

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