



Forgive Debt, but Keep Lending

by Daniel Cohen, Pierre Jacquet and Helmut Reisen

- ◆ Cancelling of poor-country debt does not mean that the best way to give aid is through grants only.
- ◆ Aid through loans may often prove superior, provided that it maintains debt sustainability.
- ◆ A new scheme for soft loans is suggested, with higher interest rates and cancellation provisions if bad shocks occur, to minimise moral hazard and strengthen debt sustainability.

A crusade of good intentions has militated for total cancellation of poor-country debt since the 1980s. One result is to give loans a bad name. Grants seem sweeter and problem-free. That would be a muddled and wrong conclusion with negative consequences for the poor.

The World Bank has embarked on a year-long, \$20bn-plus fundraising drive to replenish the International Development Association (IDA) - its main financing arm for poor countries. IDA needs replenishing every three years to subsidise its soft loans, but the need for subsidy is now much greater because of the debt relief promised at the G8 in 2005, and its corollary, the move towards grant finance. For IDA and other development finance institutions a shift from concessional loans to grants will mean that repayments by successful developing countries would cease to refinance soft-loan schemes.

The Heavily Indebted Poor Countries (HIPC) Initiative, established in 1996 and enhanced in 1999, has dealt with the claims of bilateral creditors grouped in the so-called Paris Club (and other creditors on a voluntary basis). It resulted in a minimum 90 per cent reduction in net present value terms of the debt of beneficiary countries. The 2005 Multilateral Debt Relief Initiative (MDRI) was intended to deal with debt owed to international agencies such as the World Bank and the African Development Bank. Both are supposed to contribute to attaining the UN's Millennium Development Goals.

Meanwhile, Western bilateral donors have increasingly favoured grants over loans. This preference has been emulated by the multilateral aid agencies. The remaining role for subsidised (soft) loans is being eclipsed by full debt cancellation and the move to grants. Soft loans, in contrast to most commercial loans, carry a *grant element*. This reflects their generous financial terms: interest rate, maturity (interval to repayment) and grace period (interval to the first repayment of capital).

A tale of two aid instruments

Should donors provide grants only, and leave loans to the market? It could be argued that loans carry perverse incentives. Unscrupulous leaders can borrow now, waste the money and leave their successors with the problem of repayment, a "debt overhang". Grants by definition do not need to be repaid and, thus, do not pose a problem for future generations. Lending is also given a poor reputation by tendency of multilateral development banks to operate "defensive lending", rolling over debts by according more loans to cover old debt.

If only it were that simple.

Grants are not the panacea they appear to many to be. To rely on them alone would deprive both aid donors and recipients of higher leverage over time, better incentives and more protection against external shocks:

- A given amount of aid as loans can be leveraged over time. The first borrower partially finances the second with repayments, and so on. "Defensive lending" would tend to distort this benefit. Evidence shows that defensive lending to many African countries was indeed prominent for multilaterals in the 90s, but not in the 80s, and neither for bilateral donors. Defensive lending is not an intrinsic feature of soft loans.
- Aid, in whatever form, will only work with the right set of incentives to use and invest it efficiently. Since grants do need to be repaid, they do not imply a need to raise public revenues and efficient financial management. Grants could, in fact, lead to the perverse outcome of increased aid dependency.
- The argument that grants can be used as counter-cyclical devices to bail countries out in bad times is disingenuous; the delay between the start of a crisis

and disbursement may overshoot the crisis itself. Lines of credit are a better way to protect a country against adverse shocks. They are drawn upon rapidly by a country in trouble, and repaid after the crisis. Where a sequence of crises makes a country's debts unsustainable, subsidised public lending – soft loans – can more easily accept rescheduling or total cancellation in extreme cases.

Development-friendly loan design

A new scheme of subsidised development loans would change the way in which the “grant element” is provided. Soft loans would carry higher interest rates and shorter grace periods than they do now, but would contain a provision that the service of the debt would be cancelled should the country experience a negative shock. These provisions will have to take into account raw material shocks and natural disasters.

Protection against misuse of loans – the moral hazard problem – would be afforded by provisions related to creditworthiness. These take into account institutional risks and *a priori* external and internal causes likely to prevent a country from repaying its debts. In addition, a country that moves to constitute lower risk (a better credit rating) would be rewarded. For the group of best-governed countries, grant aid worth 100 units would translate into a loan worth 400, thanks to a low rate of provision. The worst-governed countries, by contrast, would receive grants only.

Smart development finance should be built on an aid architecture that manages to make development debt sustainable. Debt cancellation can still be applied where needed, but turning our back entirely on soft loans in favour of grants would be a costly error. Rich countries can choose to be generous with debt relief *in order* to be able to keep making soft loans in the future. At a moment when infrastructure deals and new loans are being provided by emerging economies to poor countries, the latter deserve more than mere charity treatment by the West.

* The authors' OECD Development Centre Policy Brief No.31 *After Gleneagles: What Role for Loans?* is available at: www.oecd.org/dev/.



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